BETWEEN:

THE ROYAL TRUST COMPANY and EMMA LOUISE STEVENSON, Executors of the will of RUSSELL S. SMART .. . . . . APPELLANTS;

1947
Nov. 3 & 4
1948
Jan. 24

AND

THE MINISTER OF NATIONAL REVENUE . RESPONDENT.

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 6 (1) (a) (b) and 30—Partnership—Purchase of partner's interest—Money not "wholly, exclusively and necessarily laid out in earning the income"—Payments on account of capital—No estoppel by reason of prior assessments—Appeal dismissed.

S. an active member of the firm of S. & B., was also a member of the partnership of F. & Company which carried on business in Ottawa and elsewhere in Canada and in the United States. He was in personal charge of the Ottawa office of that company. The agreement between S. & B. provided that in calculating their respective shares in the partnership the net share of S. in F. & Company should be included. By an agreement dated December 3, 1928, J.F., one of the partners in F. & Company, assigned all his interest therein, other than that of the New York office, to S. The third member of the firm, F.B.F., joined in to approve of the assignment. By the terms of the assignment S. was to pay to J.F. certain annual payments during his lifetime as consideration for the assignment of J.F.'s interest. The agreement provided for the return of J.F. to the partnership in the event that the receipts of S. from the business of any one year did not equal the annual amount to be paid to J.F. S. thereby became entitled to the share of profits to which J.F. had been previously entitled, and during his lifetime S. paid to J.F. the annual sum provided for by the assignment. Later, by terms of a court judgment, S. acquired the interest of F.B.F. in the partnership of F. & Company, undertaking to pay to him during his lifetime the same share of profits in F. & Company which he had been receiving.

The profits of the Ottawa branch of F. & Company were divided between S. and F.B.F. in the proportions agreed upon and the share of S. and all his profits from the other branches of F. & Company were paid into the bank account of S. & B. S. then made the annual payments referred to above to J.F. and the balance of the agreed share to F.B.F. out of the bank account of S. & B. S. did not include the sums represented by these payments or any part thereof as part of his income. S. died in 1944 and in 1946 the respondent assessed his estate for income tax for the years 1939 to 1943 inclusive, including the profits from the firm of S. & B. and the money paid to J.F. and F.B.F. Appellants are the executors of the will of S.

Held: That the agreement, dated December 3, 1928, was a sale by J.F. and a purchase by S. of the former's interest in the business of F. & Company and J.F. thereupon ceased to be a partner in F. & Company;

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the payments to J.F. were not paid by F. & Company out of its profits but by S. out of his augmented share of the profits from F. & Company and were not wholly, exclusively and necessarily laid out for the purpose of earning the income of F. & Company as S. expended these amounts not in the process of earning the income but after the income had been fully earned and in fulfillment of the terms on which he purchased the share of J.F. Nor were they wholly, exclusively and necessarily laid out in the process of earning the income of S. & B. since they were laid out to satisfy an antecedent liability of one of the partners of that firm.

2. That the payments to J.F. were payments on account of capital and not deductible from income.

3. That the settlement between S. and F.B F. in substance effected a sale of F.B.F.'s share in the business of F. & Company and the annual payments to F.B.F. were payments on account of capital and not deductible from income.

4. That the respondent is not estopped by reason of any original assessments.

APPEAL under the provisions of the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Cameron at Ottawa.

C. C. Robinson, K.C. and *J. C. Osborne* for appellants;

J. Ross Tolmie and *E. S. MacLatchy* for respondent.

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

CAMERON J. now (January 24, 1948) delivered the following judgment:

This is an appeal by the executors of the will of the late Russell S. Smart, K.C., from assessment to income tax for the years 1939 to 1943, inclusive. Smart died on May 18, 1944, and in his lifetime had paid all income tax to which he had then been assessed. The present appeal is from final or amended assessments for the years in question.

In his lifetime, Smart was a partner in the firm of Fetherstonhaugh and Company, Patent Attorneys, carrying on business in Ottawa and elsewhere in Canada and the United States. He was also a partner in the legal firm of Smart and Biggar, of Ottawa. The amended assessments and the present appeals have to do with certain

payments made out of the profits of Fetherstonhaugh and Company to J. E. M. Fetherstonhaugh and F. B. Fetherstonhaugh, each of whom was at one time a partner with Smart in Fetherstonhaugh and Company.

The only oral evidence at the hearing of the appeal was that of J. E. M. Fetherstonhaugh. A large number of documents was referred to, and for the sake of brevity these documents will, after identification, be referred to by the numbers given them in the record filed.

By agreement dated October 1, 1925, (2) Smart, who had been the Ottawa manager of Fetherstonhaugh and Company for twenty years, and J. E. M. Fetherstonhaugh, a son of F. B. Fetherstonhaugh who was the founder of Fetherstonhaugh and Company, entered into a partnership agreement with F. B. Fetherstonhaugh to carry on the business of Fetherstonhaugh and Company.

By agreement dated November 1, 1926, (3) Smart entered into a partnership agreement with Mr. O. M. Biggar, K.C. That agreement contains the following clauses:

(1) That Smart and Biggar agree to become partners in the practice of law, their relative interests as hereinafter defined extending to the earnings of Smart and Biggar in the practice of law after the date of commencing of the partnership, and to the then and prospective interests of Smart in the business of Fetherstonhaugh and Company.

(3) The respective shares of Smart and Biggar shall be calculated by reference to the sum of the gross fees received by them severally or jointly from the practice of law, and Smart's net share from time to time in the profits of Fetherstonhaugh and Company, subject only to the deduction of such additional office expenses as, by reason of the association of Biggar with Smart in the practice of law, are not payable by Fetherstonhaugh and Company under the terms of the agreement dated 1st of October, 1925, the net amount thus ascertained being hereafter referred to as the income of the partnership.

(12) The benefit of any additional interest in Fetherstonhaugh and Company which may be acquired, or which may fall in to Smart under the agreement dated the 1st of October, 1925, shall accrue to the partnership hereby constituted.

By an agreement dated December 3, 1928, (4) J E. M. Fetherstonhaugh assigned all his interest in Fetherstonhaugh and Company to Smart, F. B. Fetherstonhaugh joining therein to approve of the same. In part, that agreement is as follows:

AND WHEREAS it has been agreed between the parties that the Assignor should assign to the Assignee all his interest in the partnership under the terms hereinafter set out.

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NOW THIS AGREEMENT WITNESSETH that:

1. The Assignor, as of October 1, 1928, hereby assigns to the Assignee all his interest in the business carried on by Fetherstonhaugh & Co., and after that date all his rights in relation to the said firm and the business carried on by it except as hereinafter provided.

The Assignor, as of October 1, 1928, with the consent of the Assignee and the Party of the Third Part, assumes all the assets and liabilities of the New York Office of Fetherstonhaugh & Co., and after such date the profits and assets of New York Office shall belong solely to him.

2. The ASSIGNEE, in consideration of the assignment to him of the interest provided in clause 1, covenants and agrees out of his receipts from the business of said firm to pay to the Assignor during the latter's life the sum of . . . . . Dollars ($ . . . . .) annually, by quarterly installments on the first days of January, April, July and October in each and every year, commencing January 1, 1928, said annual sum to be the first charge on any receipts from the business of the firm which the Assignee may receive during each and every year. If any annual payment balance is outstanding at the end of any year it shall be carried forward to the succeeding year or years.

3. In the event of the Assignee's share of receipts from the business for any one year not equalling . . . . Dollars ($ . . . .), and consequently the Assignor receiving less than the agreed upon annual sum, then, the Assignor shall have the privilege and right, upon his election, *to come back into the partnership* on the same terms as existed prior to this assignment without affecting the assets and profits of the Assignor as to his New York Office as herembefore provided in clause 1, upon such Assignor paying back to the Assignee any difference between the total sum paid to such Assignor and the total amount he would have received as his share of the profits from the partnership had this assignment not been made, such repayment to include simple interest at the rate of five per cent (5%) per annum. The repayment shall only apply when the total amount paid by the Assignee to the Assignor shall be greater than the total amount such Assignor would have received as his share of the profits of the firm had he continued in the partnership.

Pursuant to the terms of this agreement, Smart became entitled to the share of profits to which J. E. M. Fetherstonhaugh had been previously entitled, as well as his own; and during his lifetime the said Smart paid to J. E. M. Fetherstonhaugh the said annual sum of $. , save for two or three years when there was a dispute which resulted in a compromise settlement. All of Smart's profits in Fetherstonhaugh and Company (save as hereinafter mentioned) were paid into the bank account of Smart and Biggar, and all payments to J. E. M. Fetherstonhaugh were paid by cheque on that account.

On June 19, 1940, Smart learned of breaches by F. B. Fetherstonhaugh of the partnership agreement of October 1, 1925. On June 25, 1940, he instituted an action in the Supreme Court of Ontario asking for a declaration in

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accordance with clause 19 of the partnership agreement of 1925 (2), that F. B. Fetherstonhaugh had forfeited all his rights in and to the assets and goodwill and firm name of Fetherstonhaugh and Company, and that the share thereof formerly held by F. B. Fetherstonhaugh had become vested in Smart and was his property. After some weeks of negotiation, the litigation was finally settled in September, 1940, on the terms that F. B. Fetherstonhaugh should not defend but should allow judgment to go as prayed and that *Smart* should pay him during his lifetime the same share of profits of Fetherstonhaugh and Company, after judgment, as before. The judgment of September 16, 1940 (7) was given accordingly in default of defence, as prayed.

Paragraphs 18 and 19 of the Statement of Claim in this appeal are:

18 In accordance with this settlement the profits of Fetherstonhaugh & Co. continued to be divided as between Smart and F. B. Fetherstonhaugh in the same proportions as before; and from the date of the said judgment until Smart's death Smart made the appropriate payments to F. B. Fetherstonhaugh whenever such profits were divided. When profits of the Ottawa office were so divided, Smart, as before, paid F. B. Fetherstonhaugh's share by a cheque of Fetherstonhaugh & Co. on that firm's local Ottawa account, and deposited his own share, paid by a similar cheque, in the account of Smart & Biggar. The other offices of Fetherstonhaugh & Co. all now remitted their profits to Smart instead of to F. B. Fetherstonhaugh, and Smart continued to deposit all that he so received in the bank account of Smart & Biggar, paying F. B. Fetherstonhaugh his share by a cheque on that account, and leaving the remainder in that account as his own net share of these profits.

19. The only exception to the practice described in paragraph 18 arose from an advance made by Smart to Fetherstonhaugh, on the conclusion of the settlement, of $ . . . . . on account of Fetherstonhaugh's share of future profits; Smart paid this by a cheque on the Account of Smart & Biggar; he recouped himself, and repaid Smart & Biggar, at first by depositing in Smart & Biggar's account the whole of any profits from the Ottawa office of Fetherstonhaugh & Co., and paying no part to F. B. Fetherstonhaugh of any profits from the other offices, and later, at Fetherstonhaugh's request, by paying Fetherstonhaugh, out of the appropriate account at each division of profits, only half Fetherstonhaugh's share of such profits. In this way the advance was finally wiped out, and Smart & Biggar were fully repaid, in March, 1942. A list (No. 10) of the cheques to F. B. Fetherstonhaugh, from September 1940 to May 1, 1944, shows by which firm each was drawn.

The Statement of Defence admits the facts set out in these two paragraphs.

It is in respect of these payments to J. E. M. Fetherstonhaugh and F. B. Fetherstonhaugh that the assessments now in question charge Smart and the appellants, as

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executors, in proportion to Smart's share in the partnership profits of Smart and Biggar. Each of the other partners in Smart and Biggar is similarly charged in proportion to his share in those profits.

In his income tax returns for the years in question, Smart had not included these payments, or any part thereof, as part of his income.

The assessments, as to the matters in question, are made under section 30 of The Income War Tax Act as follows:

> Sec. 30. *Partnerships*—Where two or more persons are carrying on business in partnership the partnership as such shall not be liable to taxation but the shares of the partners in the income of the partnership, whether withdrawn or not during the taxation year shall, in addition to all other income, be income of the partners and taxed accordingly.

I shall first consider the liability of the appellants in regard to the payments made to J. E. M. Fetherstonhaugh. It is to be kept in mind that the payments were made pursuant to the agreement (4) between J. E. M. Fetherstonhaugh and Smart, and were to be paid out of Smart's receipts or profits from the business of Fetherstonhaugh and Company. Neither the firm of Smart and Biggar or the individual members thereof, as such, were parties to the agreement. The obligation to pay was the obligation of Smart as a partner of Fetherstonhaugh and Company. Smart's assessment to tax was a personal assessment and he was liable to tax in respect of income from all sources, including the income to which he was entitled from Fetherstonhaugh and Company, qualified as to amount, possibly, by his agreement with his partners in Smart and Biggar.

To ascertain whether these payments are properly deductible, or whether on the other hand they are barred by the provisions of section 6 (1) (*a*) of The Income War Tax Act as not being wholly, exclusively and necessarily laid out for the purpose of earning the income, it is necessary to attend to the true nature of the expenditure and to consider why the payments were made. Were they laid out as part of the process of profit earning? It was submitted in the Notice of Appeal that in substance that agreement was:

> (*a*) a change in the agency relations of the three members of the firm, whereby J E. M. Fetherstonhaugh became temporarily disentitled to bind the firm, and

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(*b*) a re-arrangement as between two of the members (Smart and J. E. M. Fetherstonhaugh) of their then present and contingent shares in the firm's profits. By this re-arrangement, J. E. M. Fetherstonhaugh, in return for a fixed share of the profits, gave up the fluctuating proportional share to which, in certain events, he might become entitled under clause 12 of the agreement of October 1, 1925.

With neither of these submissions can I agree. There is no evidence to support either of them.

In my opinion this agreement (4) was a sale by J. E. M. Fetherstonhaugh and a purchase by Smart of the former's interest in the business of Fetherstonhaugh and Company, the consideration therefor being the annual payment by Smart to J. E. M. Fetherstonhaugh of the profits of Smart in Fetherstonhaugh and Company up to a maximum amount of $ Upon the execution of that agreement J. E. M. Fetherstonhaugh ceased to be a partner in Fetherstonhaugh and Company, and thereafter was never regarded as such. The partnership accounts, at least for the years in question, show that J. E. M. Fetherstonhaugh was no longer a partner, and the latter's evidence confirms that. And it is also well established that the consideration for such sale was the annual payment of $ by Smart. If it was not paid as consideration for the sale, why else was it paid? Thereafter, J. E. M. Fetherstonhaugh rendered no service to the partnership in respect of these payments and the partnership as such derived no advantage from the payments. It is to be noted also that J. E. M. Fetherstonhaugh's agreement (4) was not with the partnership of Fetherstonhaugh and Company, but with Smart—the other partner, F. B. Fetherstonhaugh, joining therein only to approve of the same. The payments to J. E. M. Fetherstonhaugh were not paid by Fetherstonhaugh and Company out of its profits, but by Smart out of his augmented share of the profits therefrom.

It cannot be successfully contended that these payments to J. E. M. Fetherstonhaugh were, so far as Fetherstonhaugh and Company was concerned wholly, exclusively and necessarily laid out for the purpose of earning the income of Fetherstonhaugh and Company. They were not laid out at all by, or on behalf of, Fetherstonhaugh and Company, and once it was established that they were part of the profits accruing to Smart from his partnership in

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Fetherstonhaugh and Company (and there is no question that such was the case) it is clear that such profits of Smart attracted tax at that point. By the provisions of section 30, under which Smart was assessed, he was liable to be taxed not only on the income he received from Smart and Biggar, but *on all other income*. Unless, therefore, it be established that by reason of the payment of these profits into the account of Smart and Biggar, and the later disposition thereof, that they were no longer taxable, they must remain subject to tax.

It may be advisable to note at this point that, as to Smart, the sum represented by the annual payment to J. E. M. Fetherstonhaugh was not wholly, exclusively and necessarily laid out for the purpose of earning the income. That clause has been interpreted as meaning "expenses incurred in the process of earning the income", *Minister of National Revenue* v. *Dominion Natural Gas Company Ltd.* (1); and reference thereto in *Imperial Oil Limited* v. *Minister of National Revenue* (2). Smart expended these amounts not in the process of earning the income, but after the income had been fully earned, and in fulfillment of the terms on which he purchased the share of J. E. M. Fetherstonhaugh. Reference also may be made to *Minister of National Revenue* v. *Saskatchewan Co-operative Wheat Producers Limited* (3), where Lamont J. stated:

> It is also well established that once the sum assessed has been ascertained to be profits of a trade or business, neither the motive which brought these profits into existence nor their application when made is material.

In *Pondicherry Railway Co.* v. *Income Tax Commissioners* (4), Lord MacMillan, in delivering judgment in the House of Lords, said:

> English authorities can only be utilized with caution in the consideration of Indian income tax cases owing to the differences in the relative legislation, but the principle laid down by Lord Chancellor Halsbury in *Gresham Life Assurance Society* v. *Styles* (1892) A.C. 309 at 315, is of general application unaffected by the specialties of the English Tax System. "The thing to be taxed", said his Lordship, "is the amount of profits or gains." The word "profits" I think is to be understood in its natural and proper sense—in a sense which no commercial man would misunderstand. But when once an individual or a company has in that proper sense ascertained what are the profits of his business or his trade, the destination of those profits or the charge which has been made on

(1) (1941) S.C.R. 17.
(2) (1947) Ex. C.R. 527 at 540.
(3) (1930) S.C.R. 410.
(4) (1931) 58 Indian Appeals 239.

those profits by previous agreement or otherwise is perfectly immaterial. The tax is payable on the profits realized, and the meaning to my mind is rendered plain by the words "payable out of profits".

Nor can it be said Smart did not "receive" these sums. They were unquestionably under his control at all times. By paragraph 11 of the Statement of Claim it is alleged that he deposited all the profits from Fetherstonhaugh and Company in the bank account of Smart and Biggar, thus indicating that even if he did not directly receive the income he did have such control over it as to come within the words "directly or indirectly received" in section 3 of the Act. And by section 30 it is provided that the shares of the partners in the income of the partnership, whether withdrawn or not during the taxation year, shall, in addition to all other income, be income of the partners and taxed accordingly.

It is now necessary to consider what actually did take place with regard to the payments and the effects thereof.

Smart, throughout the years in question, was in personal charge of the Ottawa office of Fetherstonhaugh and Company. He was also an active partner in Smart and Biggar. The profits from the Ottawa branch of Fetherstonhaugh and Company were divided between Smart and F. B. Fetherstonhaugh in the proportions agreed upon and Smart's share thereof, together with all his profits from the other branches of Fetherstonhaugh and Company, was paid into the bank account of Smart and Biggar. Smart—not the other partners in Smart and Biggar—then paid these annual payments to J. E. M. Fetherstonhaugh, as well as the agreed share to F. B. Fetherstonhaugh, from the profits of the other branches of Fetherstonhaugh and Company out of the bank account of Smart and Biggar.

For each of the years in question there is attached to Smart's income tax return a copy of the auditor's reports for both Smart and Biggar and Fetherstonhaugh and Company. The 1942 return is a fair sample of all these reports and indicates how these payments to J. E. M. Fetherstonhaugh were considered by the accountant, and no doubt accepted as correct by the partners of Smart and Biggar. In the report of the accountant to Smart and Biggar in 1942 (dated June 18, 1943), the income of that firm is shown under three headings, one of which is "share

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of net profit—Fetherstonhaugh & Company—$. "

It shows that this amount was arrived at by deducting from the sum of Smart's profits in each of the branches of Fetherstonhaugh and Company the payment of $. to J. E. M. Fetherstonhaugh (as well as another payment with which we are not concerned).

Undoubtedly, the chartered accountant who audited the accounts of Smart and Biggar (he was also the auditor for Fetherstonhaugh and Company—Ottawa Branch) considered that "Smart's net share from time to time in the profits of Fetherstonhaugh and Company," to which the firm of Smart and Biggar was entitled under agreement (3), did not include that annual payment of $ to J. E. M. Fetherstonhaugh. There is no doubt whatever —on the evidence before me—that the partners of Smart and Biggar considered that interpretation of agreement (3) to be correct. A similar set-up appears in each of the years in question and from comments made in the reports it is apparent that the accountant had seen all relevant agreements. There is no evidence that the other partners in Smart and Biggar objected to the payments being made to J. E. M. Fetherstonhaugh, or that they ever made any claim to a personal interest therein as being part of Smart's profits in Fetherstonhaugh and Company to which they were entitled. It is admitted that throughout they accepted Smart's computation as to what was his net share of the profits in Fetherstonhaugh and Company.

And no objection can be taken, I think, to such an interpretation of their rights by the other partners in Smart and Biggar. The partners in that firm were quite entitled to place their own interpretation on their own agreement. They considered Smart's "net share from time to time in Fetherstonhaugh and Company" as being reduced by the payments he was required to make to J. E. M. Fetherstonhaugh. There was nothing in the agreement (3) which in clear terms required Smart to pay to Smart and Biggar all his withdrawals from Fetherstonhaugh and Company, or even all of what might be considered as his share in the taxable profits in Fetherstonhaugh and Company.

Nor do I think that Smart, in turning in his own profits from Fetherstonhaugh and Company to Smart and Biggar,

intended that they should all remain there as being profits divisible between the partners of Smart and Biggar. In each year he (Smart) issued the cheques totalling $ to J. E. M. Fetherstonhaugh. No part of that sum was ever distributed to Smart's partners in Smart and Biggar.

In effect, therefore, Smart, as to the annual payments made to J. E. M. Fetherstonhaugh, retained control thereof until he issued the cheques therefor to J. E. M. Fetherstonhaugh; and those payments were made in each year in satisfaction of Smart's own liability to J. E. M. Fetherstonhaugh. Smart and Biggar were not liable to pay any part of it and there is no evidence to indicate that they derived any benefit from such payments. I think that it must be inferred from these facts that the other partners of Smart and Biggar never beneficially became entitled to these annual sums of $ . .. . or any part thereof. The payment thereof by Smart into the account of Smart and Biggar was nothing more than a convenient way for Smart to handle the matter.

It follows from these conclusions that the payments to J. E. M. Fetherstonhaugh in each year were paid by Smart for his own personal benefit out of his profits arising from the business of Fetherstonhaugh and Company; that they were at no time beneficially received by the firm of Smart and Biggar, and no part thereof was distributed at any time to the other partners in Smart and Biggar. These disbursements, while made out of the bank account of Smart and Biggar, were not wholly, exclusively and necessarily laid out in the process of earning the income of Smart and Biggar. They were paid out to satisfy an antecedent liability of one of the partners.

In the result, therefore, I find that Smart's share in the profits of Fetherstonhaugh and Company to the extent of the payments made therefrom annually to J. E. M. Fetherstonhaugh remained throughout as taxable income in his hands, unaffected as to tax liability by its passing through the bank account of Smart and Biggar. Under the provisions of section 6 (1) (*a*) of the Act, Smart was not entitled to deduct these sums from his annual income. The Department has seen fit to assess him in regard thereto for only his proportionate share thereof in the profits of

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Smart and Biggar—and that is all I am concerned with. On these grounds alone that branch of the appeal must be disallowed.

It is also contended for the respondent that the payments to J. E. M. Fetherstonhaugh were payments on account of capital and were, therefore, barred as deductions under the provisions of section 6 (1) (*b*). I was referred by counsel for both parties to a number of cases in the English Courts, but after considering them all I have come to the conclusion that most of them established no principle which can be applied to an interpretation of section 6 (1) (*b*). Some of them have to do with taxability of payments in the hands of the payee and with that I am not here concerned. Others relate to deductions in the computation of income for Sur-tax purposes based on special provisions in the English Income Tax Act.

My findings have been that the annual payments made to J. E. M. Fetherstonhaugh were made as part of the consideration for the purchase of his share in the business of Fetherstonhaugh and Company. If the consideration or purchase money had been paid in one lump sum, no question would have arisen as it would clearly have been a capital payment.

In the case of *Royal Insurance Company* v. *Watson* (1), it was held that the agreement to pay the commutation money was, in fact, part of the consideration for the transfer of the business, and that the payment was therefore a "sum employed as capital" and could not be deducted. In that case Lord Halsbury, L.C. said at pp. 6 and 7:

> It is often a very difficult question to ascertain, in dealing with a commercial account, what is capital and what is income; but if it is established as a fact that the expenditure is capital, the language of the statute itself determines that that expenditure cannot be deducted from the profits, and that the profits are to be ascertained without reference to the capital expenditure. That appears to me to be decisive of this case, because if I look at the whole circumstances of this transaction and observe that the transfer from the one company to the other is to be upon certain terms . . . . . I can entertain no doubt whatever that the money to be paid, which was the consideration for the transfer of the business from the one company to the other, was capital expenditure of the new company which had received the business, the goodwill, the staff, and all other accessories which made it possible to continue the business; and one of the items was the particular matter which arises here . . . . .

(1) (1897) A.C. 1.

. . . . . but this is clear: the bargain between the two companies involved a liability which was discharged by the payment of this sum; and as a matter of fact I come to the conclusion that this was a part of the purchase-money, and when I use the compendious phrase "purchase-money," of course I include the arrangement made in respect of shares, because it matters not whether it was paid in money or in money's worth. The result is that one of the companies sells to the other, and part of the consideration which was contemplated by both parties, and in respect of which the bargain was made, and without which it would not have been made, was the manager, and all that was incident to the manager, in respect of the payments to be made to him, whether made at once or made in this form of commutation.

My Lords, under these circumstances, it appears to me that this comes within the express language of the statute; it is capital expenditure —it is part of the purchase-money for the concern. It is perfectly immaterial whether it was entirely so or partly so, because if it was partly so it is enough to establish the proposition which I am maintaining.

Konstam, in the 10th edition of The Law of Income Tax, says at p. 114:

Money spent in acquiring a business is no more to be deducted than any other kind of capital expenditure; if a firm of contractors is converted into a company, the company cannot deduct from the profits made out of the contracts acquired from the firm the price paid for acquiring them . . . . . Money paid for acquiring a business or business rights is not the less capital expenditure if it is paid in a series of annual payments.

It is a fact that no fixed sum was ever established as the sale price of J. E. M. Fetherstonhaugh's share in the partnership. But if, as indicated in the *Royal Insurance Case supra,* consideration for the transfer of an interest in the business is a capital expenditure, I can see no reason why an annual payment, in each case representing a part of the consideration, should not also be considered as a payment on account of capital. Smart, by the purchase, had acquired a further share in the business of Fetherstonhaugh and Company—a capital asset—and each annual payment made to the vendor was in partial settlement of the consideration due to him. I can see no advantage in considering the matter from the point of view of the payee, for there are cases in which a payment might be an income payment but a capital receipt, and vice versa. So far as the payments to J. E. M. Fetherstonhaugh are concerned they were, in my view, payments on account of capital and could not therefore be deducted.

Reference may also be made to a decision in the New Zealand Courts which in many ways is similar to the

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instant case—*Commissioner of Taxes* v. *F;* and *E.* v. *Commissioner of Taxes,* (1). That was a sale of a solicitor's business which provided for the payment of the purchase price out of the profits of the business, but subject to certain conditions protecting the purchaser, the effect of which was to make the payments dependent upon the prosperity of the business and the life of the purchaser. It was held that the payments made to the vendor did not constitute an annuity derived from a charge on property, but were payments made for a capital asset out of the purchaser's own profits and could not be regarded as expenditure exclusively incurred by him in the production of assessable income within section 80 (2) of the Land and Income Tax Act, 1923, and consequently that the purchaser had been properly assessed to income tax on all profits made before paying part of them over to the vendor on account of his purchase.

In considering whether the payments were capital or income payments, Smith J., in that case, referred to many of the English cases to which I have also been referred and then stated (p. 142):

> But even if the £1,000 is not to be regarded as such a primary purchase price, I think that both in form and substance the transaction between W E. and the respondent (vendor and purchaser respectively) must be regarded as the realization of a capital asset by the executrix of a deceased estate. The payments which she receives are made in the fulfilment of that purchase. They are not made in the process of earning profits and do not arise out of any of the transactions of a solicitor's business which produce those profits. I think it manifest that those payments cannot be said to be exclusively incurred for the purpose of earning the profits . . . . . In my opinion, then, the respondent is paying for a capital asset out of his own profits and he is properly assessable to income tax upon all the profits which he makes before he pays some of them over in settlement of his purchase. Accordingly, I think that the Commissioner's appeal must be allowed.

It is of interest to note also that in an appeal by the vendor as to her liability to tax it was found that the payments in her hands were capital, and her appeal was allowed.

Most of the essential facts in regard to the payments made to F. B. Fetherstonhaugh have already been set out. No written agreement was entered into between Smart and F. B. Fetherstonhaugh when their differences were

(1) (1941) Vol. 6, A.T.D. 135.

settled in September, 1940. Both are now deceased, and in arriving at a conclusion as to the taxability of Smart in regard to these payments it is necessary to consider what actually took place as shown by the documents filed and also as indicated by the evidence of J. E. M. Fetherstonhaugh.

The settlement between Smart and F. B. Fetherstonhaugh was, I think, in the nature of a compromise. It is probable that owing to F. B. Fetherstonhaugh's inattention to business the goodwill of the business of Fetherstonhaugh and Company was being adversely affected. This is indicated by the evidence of J. E. M. Fetherstonhaugh, but the forfeiture proceedings instituted by Smart were based entirely on the alleged breach of the partnership agreement as set out in Statement of Claim. F. B. Fetherstonhaugh was without doubt unwilling to lose, not only his share in the partnership, but also his income therefrom. What he desired most to retain was an income for his remaining years. He could not transfer or sell his interest in the business as he was precluded from doing so by an agreement with his estranged wife (5) to do nothing which would affect her rights to be paid a proportion of the profits in Fetherstonhaugh and Company after his death. In the result, therefore, a compromise was arrived at, each party securing what he mainly desired. F. B. Fetherstonhaugh was to have an income for life and Smart got rid of a partner whose neglect and inattention were harmful to the business. But that was not all that resulted from the compromise, for Smart became the owner of a very substantial asset, namely F. B. Fetherstonhaugh's share in the partnership, freed, presumably, from any liability to pay to F. B. Fetherstonhaugh's wife any portion of the profits after the death of F. B. Fetherstonhaugh.

It might be argued that the payments to F. B. Fetherstonhaugh were made *ex gratia*. In the correspondence, prior to settlement, Smart intimated that the payments would be so considered. If the payments were, in fact, made *ex gratia*, then they are not permissible deductions under section 6 (1) (*a*). But in paragraph 16 of the Statement of Claim, it is stated that one of the terms of the settlement was that Smart should pay F. B. Fetherston-

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haugh during his lifetime. In my view, this indicates a binding agreement to pay and so the payments made pursuant thereto cannot be considered as made *ex gratia*. It is submitted, however, that the payments can be considered from another angle, namely, that they were made in order to get rid of a partner whose conduct was injurious to the business and that, therefore, the annual disbursements to F. B. Fetherstonhaugh were permissible deductions. Reference was made to the case of *Mitchell* v. *B. W. Noble Limited* (1), where it was held:

that inasmuch as the Commissioners had found that the directors were satisfied that in order to save the company from scandal it was necessary to get rid of the director and to pay him the sum in question, that sum must be regarded as money "wholly and exclusively laid out and expended for the purposes of the trade" of the company within the meaning of r. 3 of the Rules applicable to Cases I and II of Sch. D.

But that case, I think, is readily distinguishable from the present one. In that case the payee was a life director of the firm claiming the deduction. It is apparent that the payment made to him was considered as a payment to get rid of an undesirable *servant* in the course of the business. The principles laid down in that case have been followed in certain cases in Canada, but I have not been referred to any case, nor do I know of one, where a payment made to get rid of an undesirable *partner* has been considered as a deductible expense under section 6 (1) (*a*). As far as I am aware, the principle has been confined to disbursements made to get rid of an undesirable employee or officer, or to secure release from an onerous contract. In the *Mitchell* v. *Noble* Case also, the company secured no asset by reason of the payments, but merely got rid of an undesirable officer or servant. In the instant case, however, Smart acquired an asset of very substantial value. It cannot therefore be said, in any event, that the disbursements, even if made with the object of getting rid of an undesirable partner, were made wholly or exclusively for the purpose of earning the income. It was, in my view, paid out in part, at least, for the acquisition of F. B. Fetherstonhaugh's share in the business.

It is further to be noted that in the case of *Mitchell* v. *Noble supra* the payment was made by the company in which the payee had been the director. In the instant

(1) (1927) 1 K.B. 719.

case the agreement was that Smart—and not Fetherstonhaugh and Company—should make the payment.

I have not overlooked the fact that after September, 1940, the auditors of Fetherstonhaugh and Company continued to regard F. B. Fetherstonhaugh as a partner in that firm. There is no evidence that he had any knowledge of the judgment vesting F. B. Fetherstonhaugh's share in Smart. But that judgment is, I think, conclusive of the fact that, in law, F. B. Fetherstonhaugh thereafter was no longer a partner. Smart, in fact, was the sole owner of the business from September, 1940.

Nor can these payments to F. B. Fetherstonhaugh be regarded as a deductible expense of Smart and Biggar. I need not here repeat in regard to these payments what I have previously said with reference to the payments to J. E. M. Fetherstonhaugh. The only essential difference is that two-thirds of the payments to F. B. Fetherstonhaugh were paid to him by Smart direct from the bank account of Fetherstonhaugh and Company, and never reached the firm of Smart and Biggar. The remaining one-third was paid by Smart into the bank account of Smart and Biggar and was disposed of by him in exactly the same way as the payments made to J. E. M. Fetherstonhaugh. The other members of Smart and Biggar, so far as the evidence before me would indicate, had full knowledge of, and approved of, these payments, accepting Smart's computation of what constituted his net share in the profits of Fetherstonhaugh and Company to which they were entitled. And, as I have already indicated, they were quite entitled to do so. These payments were made, not in the process of earning the income of Smart and Biggar, but in satisfaction of an obligation of one of the partners. They were paid out of Smart's profits in Fetherstonhaugh and Company, and as his profits they remained taxable in his hands. The fact that, in part, they passed through the bank account of Smart and Biggar did not in any way affect the matter.

After consideration of the whole matter, I have reached the conclusion that in substance and effect the settlement between Smart and F. B. Fetherstonhaugh amounted to a sale of F. B. Fetherstonhaugh's share in the business of Fetherstonhaugh and Company, the consideration therefor

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being the receipt annually thereafter by F. B. Fetherstonhaugh of the same income for life as he would have had, had he remained a partner. It is not certain that Smart could have succeeded in his action for forfeiture; certainly, he could not have succeeded without further litigation, for F. B. Fetherstonhaugh was prepared to contest the matter unless he acquired assurance as to future income for his life. It is true that there was no document by which F. B. Fetherstonhaugh sold to Smart, and Smart purchased from F. B. Fetherstonhaugh; and that it was by a judgment that F. B. Fetherstonhaugh lost, and Smart acquired, the former's share of F. B. Fetherstonhaugh. But this was accomplished only by the consent of F. B. Fetherstonhaugh. No fixed sum was agreed upon as a consideration, but it is clear that the consideration for allowing the judgment to go was Smart's agreement to make the annual payment of profits to F. B. Fetherstonhaugh. Because of the agreement relating to the wife of F. B. Fetherstonhaugh, to which I have previously referred, it was not open to the parties to enter into a formal agreement of sale, and for that reason it was necessary to have a court order declaring forfeiture of F. B. Fetherstonhaugh's interest and the vesting thereof in Smart. But in substance, all the essential elements of the sale were here.

My conclusion is that the settlement arrived at in September, 1940, between Smart and F. B. Fetherstonhaugh was, in substance, a sale. For the same reasons, therefore, as I have stated regarding the payments to J. E. M. Fetherstonhaugh, the annual payments to F. B. Fetherstonhaugh were payments on account of capital, and therefore were not permissible deductions under section 6 (1) (*b*).

It is now necessary to refer to another argument advanced by the appellant. Paragraphs 2, 22, 24, and 26 of the Statement of Claim herein are as follows:

21. Before April, 1939, Smart had furnished the Department of National Revenue with copies of the agreements between him and F. B. Fetherstonhaugh and J. E. M. Fetherstonhaugh (Nos. 2 and 4) and between him and O. M. Biggar (No. 3), and with all the information available to him which the Department requested about the payments to J. E. M. Fetherstonhaugh referred to above. On April 26, 1939, the Ottawa Taxation Division prepared notices of reassessment and assessment for the years 1928 to 1937, including, for the years 1928 to 1936, only the taxes in respect of the payments to J. E. M. Fetherstonhaugh in

those years, and for 1937 some other unpaid items as well. No payments were made under these assessments and there were no further proceedings on them.

22. On January 9, 1940, the Ottawa Taxation Division sent Smart notices of assessment and re-assessment for the years 1928 to 1938 including no taxes in respect of the payments to J. E. M. Fetherstonhaugh. These notices showed no unpaid taxes for any of these years except an amount for 1937 which was paid on February 2, 1940.

24. Smart made income tax returns for the years 1939 to 1943, and paid the full amount of tax calculated upon the income so returned. No notice of assessment for any of these years was sent to Smart or to the Appellants until February 15, 1946. Between 1939 and February 15, 1946, the Department neither requested nor obtained from Smart or the Appellant any further information about the payments to J E. M. Fetherstonhaugh.

26 On February 15, 1946, nearly two years after Smart's death, the Ottawa Taxation Division sent to Smart in care of the Appellant, Royal Trust Company as his executors, with the covering explanatory letter (No. 1), revised notices of assessment for the years 1928 to 1938, and "final" notices of assessment for the years 1939 to 1943, assessing Smart for a proportion of the amount paid by him in the said years to J. E. M. Fetherstonhaugh and F. B. Fetherstonhaugh, the proportion assessed against Smart for each year being calculated upon Smart's share in that year in the partnership profits of Smart & Biggar.

The allegations in these paragraphs are all admitted by the respondent.

It is submitted on behalf of the appellant that, inasmuch as the respondent in 1940 had full knowledge of all the relevant facts, and had in that year made assessments and re-assessments for the years 1928 to 1938, including therein no taxes in respect to the payments to J. E. M. Fetherstonhaugh, that the respondent had made a finding that such payments were not part of Smart's taxable income and that he should not now be permitted to take a different view.

In the case of *Gilhooly* v. *The Minister of National Revenue* (1), I said:

> After giving careful consideration to all the cases referred to by counsel, I have reached the conclusion that when the words of an act clearly permit the interpretation placed on them by a government department and that practice has long continued (in this case it continued from the time the act first came into effect in 1917 until 1938) a Court should hesitate to adopt a construction of the statute which would lead to the destruction of a method long followed. See *Steamship Glensloy Company, Limited* v. *Lethem*—Surveyor of Taxes, (1914) 6 T C. 453 at 462.

My decision in that case was founded on my view that the words of the Act clearly permitted the interpretation

(1) (1945) Ex. C.R. 141 at 159.

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placed on them by the officers of the department. In the present case, and on the facts as I have found them, I am quite unable to find any legal basis on which the sums paid to J. E. M. Fetherstonhaugh could ever have been allowed as deductions from Smart's income. By reason of the somewhat complicated nature of the problem, it was no doubt difficult to reach a speedy conclusion, and it is probably the case that, inasmuch as the payee had paid income tax on these payments from 1928 to 1937 without objection, there was some moral ground for omitting these sums from Smart's taxable income in those years. In any event, when the matter was finally and fully considered in 1946, it was not possible to re-assess Smart in respect of the year 1938, and previous years, by reason of the provisions of section 55 (*b*). The appeal, therefore, in respect of those years, was allowed by the Minister. It may here be noted that J. E. M. Fetherstonhaugh has an appeal pending in respect of his income from Smart for the year 1938, and pending the hearing of that appeal, no assessment has been made for any subsequent year.

It is to be noted, also, that the respondent is not estopped by reason of any original assessments. Section 55 provides for a continuing liability to tax and that, notwithstanding any prior assessment, the Minister may, within six years from the day of the original assessment (in cases where there is no fraud), re-assess or make additional assessments upon any person for tax, interest and penalty.

It is also alleged by the appellant that the assessments, as computed by the respondent, include interest at a rate not authorized by the Act. I assume that interest has been and will be computed in accordance with subsections (3) and (4) of section 16, chap. 38, Statutes of Canada, 1936, which were in effect for all the relevant years. These subsections remained unchanged until subsection (3) was amended by section 14 of chap. 43, Statutes of Canada, 1944-45, applicable only to income of the taxation year 1944 and subsequent years. Should any adjustment be necessary, and the parties be unable to agree thereon, the matter may be spoken to.

The appeals will therefore be dismissed, with costs to be taxed.

Judgment accordingly.