BETWEEN:

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

1958 Feb. 5

1958 Feb. 7

AND

JOHN THOMAS BURNS ..... RESPONDENT.

Revenue—Income Tax—The Income Tax Act 1948, S. of C. 1948, c. 52, s. 24, s. 129 s-s. 1(a) and s. 85B enacted by S. of C. 1952-1953, c. 40, s. 73—Mortgages payable five years after created are not securities received "wholly, or partially as or in lieu of payment of or in satisfaction of an interest, dividend or other debt that was then payable"—Amounts received from mortgages expressed in terms of money are to be included in income in the amounts of such money and not the value of the mortgages in terms of money—Allowance by the Minister of National Revenue for setting up reserve within s. 85B (1)(d) of the Act held to be reasonable.

The respondent is the owner of eight second mortgages on real estate which came to him as the result of sales of property on which he had built houses, they representing the balance of the purchased price of the houses. In an amended income tax return for 1953 he showed the total sales of the houses at $55,300 but deducted the sum of $11,125 from income by claiming an item stated to be "less reduction at market value of second mortgages". This was one-half of the face value of the eight second mortgages. In the result he showed a loss of $160.35. This deduction was disallowed in full by the Minister of National Revenue except for allowances made for sale of two mortgages at a loss and for the setting up of a reserve. The Income Tax Appeal Board held that appellant was entitled to value the mortgages at their market value in 1953. The respondent appealed to this Court.

Held: That the second mortgages in question do not fall within the provision of s. 24(1) of the *Income Tax Act* since though undoubtedly securities representing an indebtedness they were clearly not securities received wholly or partially as or in lieu of payment of or in satisfaction of an interest, dividend or other debt that was then payable; prior to the receipt of the mortgages there was no pre-existing right to receive any portion thereof and the mortgages

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themselves created the original right in the respondent to receive payment; providing for small monthly payments and not finally payable until five years later they could not be said to be then payable at the time they were taken even though the mortgagor had the right to accelerate his payments if he desired to do so.

2. That the mortgages in question clearly fall within the provisions of s. 85B, s-s. (1) of the *Income Tax Act* as enacted by S. of C. 1952-1953, c. 40, s. 73, which makes specific provision for including in the computation of income every amount receivable in respect of properties sold in the course of the business in the year, notwithstanding that the amount is not receivable until a subsequent year unless the method adopted by the taxpayer for computing income from the business and accepted for the purpose of Part I, does not require him to include any amount receivable in computing his income for a taxation year unless it had been received in the year; the respondent having adopted a method of computation in which accounts receivable were included and which had been accepted by the Department of National Revenue falls within the requirements of s-s. (b) of 85B (1) and is not entitled to the benefit of the exception provided; therefore in computing his income he is required to include the amounts receivable from the second mortgages and since these amounts are expressed in terms of money, it is the amount of such monies that is to be included and not the value in terms of money of the right or thing.

3. That the amount allowed as a reserve by the appellant as provided for by para. (d) of s. 85B (1) of the Act is in the light of all the facts reasonable.

APPEAL from a decision of the Income Tax Appeal Board.

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

W. D. Parker, Q.C. and *T. Z. Boles* for appellant.

M. J. Moriarity for respondent.

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

CAMERON J. now (February 7, 1958) delivered the following judgment:

This is an appeal by the Minister of National Revenue from a decision of the Income Tax Appeal Board dated December 28, 1956, which allowed in part the respondent's appeal from a re-assessment made upon him for the taxation year 1953.

There is practically no dispute as to the facts. The respondent is a builder residing in Hamilton; he buys lots, erects houses thereon and then sells them. In 1953 he built and sold nine houses, all of which were small five-room,

one-storey cottages without basement, furnace, city water or plumbing fixtures. One was sold for cash. The remaining eight were sold under agreements of sale (Exhibits 1 to 8) at prices ranging from $5,900 to $6,900, in most cases the down payment being $1,200. By these agreements, the purchaser was to arrange and complete a first mortgage "for as large an amount as possible", but for an amount not less than $2,000 or, in some cases, $2,500. The proceeds of these first mortgages were, of course, paid to the respondent. The respondent agreed to take back a second mortgage for the balance of the purchase price, the principal being repayable at a rate of $25 or $30 per month, with the balance payable at the end of five years. Interest was payable semi-annually at 6½ per cent. The purchaser had the right of increasing his payments of principal at any time. When the sales were closed out the respondent received eight second mortgages in amounts varying from $2,700 to $3,000. The two mortgages for $3,000 were sold in December, 1953, for $2,000 each with the assistance of Mr. Biggs, the respondent's auditor.

In his original tax return of 1953, the respondent followed the same practice as he had done since he commenced his business in 1949, and in computing his income, took into account the full selling prices of all houses sold, nothing being said as to the second mortgages and no request being made to consider them as being worth less than their face value. On the basis of that return for 1953, which as in the previous years was on an accrual basis, the tax amounted to $1,229.61, and he was assessed accordingly.

However, in March 1955, he filed an amended return (Exhibit 9) for the year 1953. In the statement of tax attached thereto he showed the total sales of houses at $55,300, but in an item stated to be "Less reduction to market value of second mortgages", deducted $11,125, being one-half of the face value of the eight second mortgages received, and in the result showed a loss of $160.35.

In the re-assessment dated June 10, 1955, the deduction of $11,125 was disallowed in full. However, by the Minister's Notification dated March 6, 1956, following the respondent's Notice of Objections, it is stated:

> The Honourable the Minister of National Revenue having reconsidered the assessment and having considered the facts and reasons set forth in the Notice of Objection hereby agrees to amend the said assess-

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ment to reduce the taxpayer's income by an amount of $2,000 in respect of second mortgages on property situated at East 8th Street and to allow an amount of $2,856.69 as a deduction from income under the provisions of paragraph (b) of subsection (1) of section 85B of the Act and hereby confirms the said assessment in other respects as having been made in accordance with the provisions of the Act and in particular on the ground that the profit on sale of houses has been correctly included in computing the taxpayer's income in accordance with the provisions of paragraph (b) of subsection (1) of section 85B of the Act; that subsection (1) of section 24 of the Act is not applicable as the debt was not "then payable".

The deduction of $2,000 so allowed was in respect of a loss sustained by the respondent when he sold the two second mortgages for $3,000 at a discount of $1,000 each. As stated in the respondent's reply to the Notice of Appeal and admitted at trial, the further deduction of $2,856.69 allowed under s-s. (i)(*d*) of s. 85B of the Act was arrived at by using the following formula:

$$\frac{\$16,250}{\$53,300} \times \$9,369.93 = \$2,856.69$$

The item of $16,250 is the face value of the unsold six mortgages; the item of $53,300 is the total selling price of the eight houses sold in the year and $9,369.93 is the respondent's profit for 1953 as revised substantially by the Minister.

It is to be noted, also, that the respondent arranged for the incorporation of a limited company, John T. Burns & Sons Ltd., in which he holds all the issued stock except for two qualifying shares and of which he has absolute control. That company apparently took over the business assets of the respondent. In Exhibit 20, a letter from the company's auditors to the Department of National Revenue dated February 7, 1956, it is stated that the six remaining mortgages were sold by the respondent to his company at prices representing one-half of their original face value. This statement, however, does not seem to accord with the oral evidence that the sale price was equal to one-half of the principal amount then due, after allowing for all payments previously made thereon. In any event, that transaction by itself, in which the respondent presumably made the final decision both for himself as vendor and for the limited company as purchaser and which was not an arm's length transaction, furnishes no evidence as to the real value of

the mortgages. The respondent thought some of the mortgages had been discharged and that perhaps some allowance had been made to the mortgagors for advancing the payment, but was unable to furnish any details. The auditor, Mr. Biggs, who had the mortgage records only to the end of 1956, stated that all payments of principal and interest required by the mortgages had been regularly met and no evidence was given to indicate that up to the present time there had been any default. All are due before the end of the present year.

The submission on behalf of the respondent on whom the onus lies (see *M. N. R. v. Simpsons Ltd.*[1]) is that under s-s. (1) of s. 24 of *The Income Tax Act*, the respondent is entitled to value the mortgages at their market value in 1953. That submission met with the approval of the Income Tax Appeal Board which, however, was of the opinion that a valuation of 50 per cent. of the face value of the mortgages was too low and referred the matter back to the Minister to value them as at the time they were received and in the manner laid down in *Himmen v. M. N. R.*[2].

For the Minister, it is submitted that the mortgages do not fall within s-s. (1) of s. 24, but are within s. 85B enacted by Statutes of Canada, 1952-1953, c. 40, s. 73, and made applicable to the 1953 and subsequent taxation years. Section 24 is as follows:

24. (1) where a person has received a security or other right or a certificate of indebtedness or other evidence of indebtedness wholly or partially as or in lieu of payment of or in satisfaction of an interest, dividend or other debt that was then payable and the amount of which would be included in computing his income if it had been paid, the value of the security, right or indebtedness or the applicable portion thereof shall, notwithstanding the form or legal effect of the transaction, be included in computing his income for the taxation year in which it was received; and a payment in redemption of the security, satisfaction of the right or discharge of the indebtedness shall not be included in computing the recipient's income.

(2) Where a security or other right or a certificate of indebtedness or other evidence of indebtedness has been received by a person wholly or partially as, or in lieu of payment of or in satisfaction of a debt before the debt was payable, but was not itself payable or redeemable before the day on which the debt was payable, it shall, for the purpose of subsection (1), be deemed to have been received when the debt became payable by the person holding it at that time.

[1] [1953] Ex. C.R. 93. [2] 4 Tax A.B.C. 44.

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(3) This section is enacted for greater certainty and shall not be construed as limiting the generality of the other provisions of this Part by which amounts are required to be included in computing income.

Subsection (1) was derived from s-s. (11) of s. 3 of the *Income War Tax Act,* which subsection was considered in the *Himmen* case (*supra*) where it was held that builders' second mortgages fell within that subsection of the *Income War Tax Act,* and the taxpayer was entitled to have their real value ascertained as at the date they were acquired. But, following the *Himmen* case, there was added to the subsection after the words "or other debt", the words "that was then payable", and s-s. (2) was also added. The addition of the words "that was then payable", in my opinion is of great importance in determining what securities or rights received by a taxpayer fall within the provisions of the subsection. I have read the subsection with great care and have reached the conclusion that it relates only to cases in which the taxpayer who received the security or other right, or a certificate or other evidence of indebtedness, was, by reason of some pre-existing transaction, entitled to receive an interest, dividend or other debt *that was then payable* and the amount of which would have been included in computing his income if it had been paid. The section envisages a situation in which the interest, dividend or other debt then payable is not in fact paid, but, in lieu thereof, the one entitled receives a security or other right, or a certificate or other evidence of indebtedness. Then the subsection provides in such cases the value of what is received shall be taken into account in computing income for the year of its receipt, and when payment is later actually received it is not then to be included in computing income.

It seems to me that the effect of s-s. (1) of s. 24 is to require a taxpayer to be taxed when he receives a security or other right or certificate or other evidence of indebtedness which is wholly or partially in lieu of or in payment of an interest, dividend or other debt which was itself then payable, and which was of an income nature. That would seem to follow if the words "an interest, dividend or other debt" are read *ejusdem generis.* One instance of the application

of the subsection would be that in which a shareholder entitled to dividends which had fallen into arrears, receives in lieu thereof further shares representing the arrears of dividends.

In the instant case the second mortgages in question were doubtless securities representing an indebtedness, but quite clearly they were not securities received wholly or partially as or in lieu of payment of or in satisfaction of an interest, dividend or other debt *that was then payable*. Prior to the receipt of the mortgages there was no pre-existing right to receive any portion thereof and the mortgages themselves created the original right in the respondent to receive payment. I am quite unable to find that mortgages such as these, which provided for small monthly payments and were not finally payable until five years later, could, on any reasonable interpretation, be said to have been "then payable", namely, at the time they were taken, even though the mortgagor had the right to accelerate his payments if he so desired. He could not be compelled to pay any more than the amounts specified.

For these reasons, I am of the opinion that the mortgages in question do not, in the circumstances, fall within the general provisions of s. 24(1). They do come, however, within the specific provisions of s. 85B, s-s. (1), the relevant parts of which are as follows:

> 85B(1) In computing the income of a taxpayer for a taxation year,
>
> (*b*) every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable until a subsequent year unless the method adopted by the taxpayer for computing income from the business and accepted for the purpose of this Part does not require him to include any amount receivable in computing his income for the taxation year unless it has been received in the year;
>
> (*d*) where an amount has been included in computing the taxpayer's income from the business for the year or a previous year in respect of property sold in the course of the business and that amount is not receivable until a day
>
> (i) more than two years after the day on which the property was sold, and
>
> (ii) after the end of the taxation year, there may be deducted a reasonable amount as a reserve in respect of that part of the amount so included in computing the income that can reasonably be regarded as a portion of the profit from the sale; and

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(2) Paragraphs (*a*) and (*b*) of subsection (1) are enacted for greater certainty and shall not be construed as implying that any amount not referred to therein is not to be included in computing the income from a business for a taxation year whether it is received or receivable in the year or not.

Paragraph (*b*) of s-s. (1) makes specific provisions for including in the computation of income every amount receivable in respect of properties sold in the course of the business in the year, notwithstanding that the amount is not receivable until a subsequent year *unless* the method adopted by the taxpayer for computing income from the business, and accepted for the purpose of Part 1, does not require him to include any amount receivable in computing his income for a taxation year unless it had been received in the year. The evidence is clear and undenied that since the respondent commenced his business in 1949 he had adopted a method of computation in which amounts receivable were included—sometimes referred to as the accrual method—and that that method had been accepted by the Department of National Revenue which had assessed him accordingly. The respondent therefore is within the requirements of the first part of the paragraph and is not entitled to the benefit of the exception provided. It follows, therefore, that in computing his income he is required to include the amounts receivable from the second mortgages. As these amounts are expressed in terms of money, it is the amount of such monies that is to be included and not the value in terms of money of the right or thing. (See s. 139, s-s. (1)(*a*), which defines "amount".)

But s. 85B(1), while requiring the full amount of the receivables to be included in circumstances such as are found here, makes provision by which the taxpayer may deduct a reasonable amount as a reserve in respect of that part of the amount so included in computing the income that can reasonably be regarded as a portion of the *profit* from the sale. It was under the provisions of para. (*d*) that the Minister allowed the deduction of a reserve of $2,856.69. The respondent does not contend that he is entitled to establish a reserve under any other provision of the Act and the only submission made in respect of the reserve is that it is inadequate.

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I have above set out the formula used to fix the amount of the reserve which is that proportion which the face value of the six mortgages when related to the total sales bears to the respondent's profit for 1953, as revised by the Minister. By the terms of para. (*d*), the reserve permitted is that which can reasonably be regarded as a portion of the *profit* from the sale, and does not relate in any way to a proportion or percentage of the gross amount of the sale or to the value of the receivables.

It will be recalled that the respondent's own witnesses did not establish that any loss had been incurred in respect of any of the eight mortgages except for the two sold in 1953 and that that loss was allowed in full. The amount allowed as a reserve by the Minister is slightly more than 30 per cent. of the net profit of the business as computed by him, and in my opinion, in the light of all the facts, it may well be considered as reasonable in every way. I am fully satisfied that the re-assessment as varied by the Minister's Notification is in accordance with the provisions of the Act.

In view of my conclusions, I find it unnecessary to consider the evidence led on behalf of the respondent as to the market value of the second mortgages in 1953.

For the reasons which I have stated, the appeal of the Minister will be allowed, the decision of the Income Tax Appeal Board set aside, and the re-assessment made upon the respondent, as amended by the Minister's Notification, will be affirmed. The appellant is also entitled to his costs after taxation.

Judgment accordingly.