BETWEEN:

1958

Jan. 28, 31
Feb. 3

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

Feb. 3

AND

KIRBY MAURICE COMPANY, LIMITED ..... RESPONDENT.

Revenue—Income Tax—The Income Tax Act 1948, S. of C. 1948, c. 52, s. 20, s-s. 4(a), s. 139(5), Regulation 1100 s-s. (1) para. (c) and class 14—Franchise granted for indefinite period not within class 14 of Regulation 1100—Transaction between vendor and purchaser not one at arm's length—Respondent not entitled to any capital cost allowance.

One Maurice in 1951 carried on business as sole proprietor of the Kirby Company of Toronto engaged in the sale of vacuum cleaners and parts thereof. On February 20th, 1951 the Kirby company entered into an agreement with Gelling Industries, Ltd. manufacturers of vacuum cleaners and parts thereof by which the latter company agreed to sell and the Kirby Company agreed to purchase such goods. By clause two of the agreement the Gelling Company granted to the Kirby Company the exclusive right to sell or otherwise market the Kirby Sanitation system in the County of York in the Province of Ontario, without cost to the Kirby Company of Toronto. At the instance of Maurice on September 29, 1952, letters patent under the *Ontario Companies Act* were granted incorporating Kirby Maurice Co. Ltd., the respondent herein. At a meeting of the directors of this company on October 1, 1952, a by-law of the company was passed authorizing it to enter into an agreement with the Kirby Company of Toronto by which that company sold to the respondent company all its assets including "franchise worth $50,000". The consideration of such sale and purchase was the sum of $105,000 a cheque for which amount was paid by the respondent company to the Kirby Company of Toronto. Maurice purchased shares in the respondent company paying $105,000 for them. Respondent deducted $5,000. from its taxable income for 1953 claiming it as ten per cent of the sum of $50,000. said to have been the cost of the "franchise" to the respondent. This was disallowed upon re-assessment and an appeal to the Income Tax Appeal Board was allowed. The Minister appealed to this Court.

Held: That even if the so-called franchise were in fact a franchise it was not such a one as falls within class 14 referred to in para. c. of Regulation 1100 under the Income Tax Act since the right or franchise granted was for an entirely indefinite period *and not for a limited period* as required by the words of class 14.

2. That the respondent is not entitled to any capital cost allowance in respect of the property, the "franchise", since the transaction between the Kirby Company and the respondent was not one deemed to have been at arms length under s.s. 5 of s. 13 of the Act as Maurice indirectly controlled the respondent company, consequently the

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provisions of s-s. 4(a) of s. 20 of the Act apply and the cost to the taxpayer is deemed to be the capital cost of the property to the original owner, the Kirby Company, and that cost was nothing.

APPEAL from a decision of the Income Tax Appeal Board.

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

Gordon Watson, Q.C. and *J. D.C. Boland* for appellant.

W. D. Lyon for respondent.

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

CAMERON J. now (February 3, 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 November 16, 1956, allowing the respondent's appeal from a re-assessment dated December 21, 1955, made upon it for its taxation year ending September 30, 1953. In computing its taxable income, the respondent had deducted $5,000 as a capital cost allowance in respect of a so-called "franchise" said to be for a term of ten years, the deduction being 10 per cent. of $50,000, said to have been the cost of the "franchise" to the respondent. In the re-assesment, the Minister disallowed the deduction in full, but on appeal to the Income Tax Appeal Board the deduction was allowed.

The problem which I have to consider is mainly one of law, but before referring to the relative provisions of *The Income Tax Act* I shall set out the facts which, in the main, are not in dispute.

The only witness heard at the trial was L. A. Maurice, now the president and the controlling shareholder in the respondent company. In 1951 Mr. Maurice carried on business as the sole proprietor of the Kirby Company of Toronto, and was engaged in the sale of vacuum cleaners and parts thereof. On February 20, 1951, the Kirby Company, by Mr. Maurice, entered into an agreement (Exhibit D) with Gelling Industries, Ltd., of Welland, manufacturers of vacuum cleaners and parts thereof, by which the latter

company agreed to sell and the Kirby Company agreed to purchase such goods. The second clause of that agreement reads:

> Upon and subject to the terms and conditions below stated, the Company hereby grants to the Kirby distributor (i.e., the Kirby Company of Toronto) the exclusive right to sell or otherwise market in the following described territory the Kirby Sanitation System, said territory being as follows: The County of York, in the Province of Ontario.

It is common ground that the "right" or "franchise" so acquired was without cost to the Kirby Company of Toronto. It exercised its rights thereunder until the benefit thereof was assigned to the respondent company under the following circumstances: Maurice decided in September, 1952, that he would thereafter operate as a limited company. Accordingly, at his instance and on his instructions, an application was made for the incorporation of Kirby Maurice Co. Ltd. under the *Ontario Companies Act*, as a private company. Such letters patent (Exhibit A) were granted on September 29, 1952. The capital of the company was divided into 20,000 preference shares of a par value of one dollar each, and 20,000 common shares without nominal or par value. By supplementary letters patent dated November 12, 1952 (Exhibit B), the capital stock of the company was increased by the creation of 80,000 additional and similar preferred shares.

Exhibit C contains the minutes of the meetings of the provisional directors, the directors and shareholders. At a meeting of the directors dated October 1, 1952, there was submitted a draft agreement between L. A. Maurice, carrying on business as the Kirby Company of Toronto, as vendor, and the newly formed company as purchaser, providing for the sale of all assets of the company (i.e., the Kirby Company) including "franchise worth $50,000". By-law 3(A) was then passed authorizing the entering into of the said agreement. Schedule 2 to the minutes of that meeting contains an original of the agreement of purchase and sale. It reads in part as follows:

> 1. The Vendor sells and the Company purchases:
> (c) The moneys, bills, notes and other negotiable instruments, book, and other debts of or owing to the Vendor in the said business and all the Vendor's rights, claims and securities in respect of the said debts, and the benefit of all contracts and engagements to which the Vendor is entitled in connection with the said business; provided further that in relation to the agreement made the

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20th day of February, 1951, between Gelling Industries, Limited, and the Kirby Company of Toronto, covering the exclusive right to sell and distribute the Kirby Sanitation System in the County of York, in the Province of Ontario, the Company shall be entitled to all benefits, rights and privileges for a period of ten years under this agreement and as between the parties hereto shall be regarded and construed as a 10 year franchise.

(*d*) All other property and assets, if any, of the Vendor in connection with the said business.

2. As part of the consideration for the said sale, the Company shall undertake, pay, satisfy, discharge, perform and fulfil all debts, liabilities, contracts and engagements of the Vendor, in connection with the said business, and shall indemnify the Vendor, his heirs, executors and administrators against all actions, proceedings, claims and demands in respect thereof, save and except any liability which the Vendor may have by reason of non-payment of personal income tax.

3. As a further part of the consideration for the said sale the company shall forthwith pay to the Vendor the sum of $105,000 of lawful money of Canada.

4. The said sale shall take effect as from the date hereof, and the Vendor shall from the date hereof be deemed to be carrying on the said business on behalf of the company and shall account to the Company and be indemnified accordingly.

It is in evidence that the respondent company paid the Kirby Company of Toronto the expressed consideration of $105,000 by cheque, and that by-law 3(A) of the directors was ratified at a meeting of the shareholders held on October 1, 1952. The minutes also show that at a meeting of the directors dated November 12, 1952 (the same date as the supplementary letters patent were issued), L. A. Maurice had subscribed for 87,000 preference shares at one dollar per share, which he paid for, and which were allotted to him. At the same meeting Maurice subscribed for 17,998 common shares. The Board fixed the aggregate consideration therefor at $17,998 and authorized the issue of such common shares upon payment of that amount. The stock ledger sheets show that they were paid for and issued on the same date. Mr. Maurice also is shown in these ledger sheets to have received two additional common shares on November 13, 1952. It will be seen, therefore, that his total purchase of preferred and common shares was at a cost of $105,000, precisely the same amount as had been paid him by the company for the assets of the Kirby Company of Toronto.

Although the Minister is here the appellant, the onus of proving that the assessment is erroneous, either on the facts or the law, lies on the taxpayer. Reference may be made to *M. N. R. v. Simpsons Ltd.*[1].

By s-s. (1)(*a*) of s. 11, a taxpayer is allowed, in computing income, to deduct "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".

For the respondent it is submitted that the deduction here claimed is allowed under para. (*c*) of s-s. (1) of Regulation 1100, which reads as follows:

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

(*c*) such amount as he may claim in respect of property of Class 14 in Schedule B not exceeding the lesser of

(i) the aggregate of the amounts for the year obtained by apportioning the capital cost to him of each property over the life of the property remaining at the time that the cost was incurred; or

(ii) the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) for property of the class.

And then Class 14 reads:

14. Property that is a patent, franchise, concession or license for a limited period in respect of property . . .

It is not suggested that the property in respect of which the deduction is claimed falls within any other regulation. Unless, therefore, it is within Class 14, the appeal must be allowed.

It is said that the agreement with Gelling Industries, as assigned to the respondent company, was a franchise for a limited period, namely ten years, and that as its cost to the respondent was $50,000, a capital cost allowance of 10 per cent. thereof may be written off annually.

For the Minister it is submitted (1) that the property in respect of which the deduction is claimed is neither a franchise, concession or license, and quite clearly it is not a patent; (2) that even if it be a franchise, concession or license, it is not *for a limited period;* (3) that in any event, as the sale or assignment of the exclusive right to sell the

[1] [1953] Ex. C.R. 93.

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Kirby Sanitation System in the county of York by Maurice to the respondent company was not a transaction at arm's length, the rule provided in clause (*a*) of s-s. (2) of s. 20 is applicable.

In view of the conclusions which I have reached on the other points, I do not find it necessary to reach any concluded opinion as to whether the property in question was or was not a franchise, concession or license. For the purpose of this case, I am prepared to assume—but without deciding—that it was a franchise.

But not all franchises are within Class 14; only those that are "for a limited period" are within the class. The intention of Parliament in using these words "for a limited period" seems to me to be quite clear. Unless the duration of the franchise is definitely ascertained and limited there is no yardstick by which the value of the franchise can be ascertained. Further, it would be impossible to ascertain the life of the property or franchise, a matter which must be known in order to make the computation required in para. (i) of s-s. (*c*) of s. 1 of Regulation 1100, namely:

> By apportioning the capital cost to him of each property over the life of the property remaining at the time the cost was incurred.

The "franchise" came into existence by reason of the agreement of February 20, 1951, between Gelling Industries, Ltd. and the Kirby Company of Toronto. Nothing is stated therein as to the period for which the right of distribution is granted. Not only is it silent on that matter but specific provision is made in s. 20 by which the entire agreement may be terminated by either party by giving thirty days' notice to the other party, and apparently with or without cause assigned. In my view the right or franchise thereby acquired was for an entirely indefinite period, *and not for a limited period* as required by the words of Class 14. It follows, of course, that had the right been retained by the Kirby Company it could not have claimed any capital cost allowance in respect thereof, both on the ground that it was not for a limited period, and also because it had paid nothing for the right or franchise.

It is submitted, however, that by the terms of the agreement dated October 1, 1952, between the Kirby Company and the respondent, the original franchise, which was for

an indefinite and unlimited period, became, in the hands of the respondent, a franchise for a limited period because of the words:

> The Company shall be entitled to all benefits, rights and privileges for a period of ten years under this agreement, and as between the parties hereto shall be regarded and construed as a ten year franchise.

In my view, this submission is untenable. I am quite unable to see how a franchise for an indefinite and unlimited term can by the act of the holder of the franchise only, become one for a period of ten years, or for any stated period of years. It is of significance to note that while the agreement with Gelling Industries provides in s. 19 that the contract is not assignable or transferable without its prior written consent, there is no evidence that such consent was ever given to the agreement of sale and purchase dated October 1, 1952, or to any of its terms. In my opinion, the Kirby Company could not confer on or assign to the respondent something which it did not possess. The rights acquired by the respondent could be no more than those given by Gelling Industries, and that company, under its agreement, could not only cancel the agreement by thirty days' notice, but by Clause 5 could also change the territory allotted to the distributor from time to time and at any time it desired by merely giving notice thereof.

In my opinion, the property, right or franchise was that created by the original agreement of February 20, 1951, and it was both before and after the assignment to the respondent not a right or franchise for a limited period.

I have also reached the conclusion that the Minister's appeal must be allowed for another reason, namely, that the transaction between the Kirby Company and the respondent was not one at arm's length. Subsection (4)(*a*) of s. 20 of the Act is as follows:

> (4) Where depreciable property did, at any time after the commencement of 1949, belong to a person (hereinafter referred to as the original owner) and has, by one or more transactions between persons not dealing at arm's length, become vested in a taxpayer, the following rules are, notwithstanding section 17, applicable for the purposes of this section and regulations made under paragraph (*a*) of subsection (1) of section 11;
>
> (*a*) the capital cost of the property to the taxpayer shall be deemed to be the amount that was the capital cost of the property to the original owner;

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Then by s. 139, s-s. (5), it is provided:

> (5) For the purposes of this Act a corporation and a person or one of several persons by whom it is directly or indirectly controlled, shall, without extending the meaning of the expression "to deal with each other at arm's length" be deemed not to deal with each other at arm's length.

Mr. Watson, counsel for the respondent, submits that on the evidence to which I shall now refer the transaction by which the respondent acquired the franchise was one not at arm's length, either (a) because the respondent company was indirectly controlled by Maurice, who was also the sole proprietor of the Kirby Company, the Vendor, and that therefore they are deemed not to have dealt with each other at arm's length as provided for in s-s. (5) of s. 139; or (b) because, in the transaction, they were not in fact dealing at arm's length, and therefore the provisions of s-s. (4)(*a*) of s. 20 are applicable.

That s-s. (5) of s. 139 does not purport to define all transactions which are not at arm's length is made clear in the case of *M. N. R. v. Sheldon's Engineering, Ltd.* (1) where Locke J., in delivering the judgment for the Court, said at p. 643:

> The words (i.e., to deal with each other at arm's length) do not appear in the *Income War Tax Act,* though the same subject matter is dealt with in s. 6(1)(n) of that Act. In addition to appearing in ss. 20 and 127, the term is employed in ss. 12(3), 17(1), (2) and (3), 36(4) and 125(3) of *The Income Tax Act.* Section 127(5) does not purport to define the meaning of the expression generally; it merely states certain circumstances in which persons are deemed not to deal with each other at arm's length. I think the language of s. 127(5), though in some respects obscure, is intended to indicate that, in dealings between corporations, the meaning to be assigned to the expression elsewhere in the statute is not confined to that expressed in that section.

The evidence of Maurice satisfies me completely that the transaction by which the franchise came into the hands of the respondent was not one at arm's length. The Act does not define the expression, and it would perhaps be unwise for me to attempt to do so. It is sufficient to state that in my opinion, in a vendor and purchaser matter, an arm's length transaction does not take place when the purchaser is merely carrying out the orders of the vendor, and exercising no independent judgment as to the fairness of the terms of the contract, or seeking to get the best possible terms for himself. That was precisely the situation here.

[1] [1955] S.C.R. 637.

In effect, Maurice was both vendor and purchaser, and while he was not actually a shareholder at the time the agreement of October 1, 1952, was signed, he had in fact full control of the entire operation.

As sole proprietor of the Kirby Company he made the decision to incorporate the respondent company and to transfer his assets to it. He chose its name and fixed the sale price. He employed the solicitors who incorporated the company and were its provisional directors, and later its directors until November 13, 1952, the day following his purchase of the vast majority of the shares, at which date he and his wife and one Sayer, an employee (the latter two each holding a relatively minor number of shares) were appointed directors. On the same date Maurice was appointed president, his wife was appointed a director and secretary-treasurer, and Mr. Sayer became a director and vice-president. On January 18, 1953, Maurice was appointed managing-director.

Mr. Maurice said that he made the decision as to placing a value of $50,000 on the franchise; that when the agreement of October 1 was entered into the three directors were acting entirely on his behalf and carrying out his instructions, and not exercising an independent judgment in the matter. At one point he said he was present at all the meetings held on October 1, but later said that as he was not a shareholder he was not present at the shareholders' meeting which affirmed the directors' by-law. It is apparent, too, that in some way he had control of that meeting as well, for he said that if the price had been questioned his decision would have carried. From these bald admissions it is apparent, therefore, that Maurice made all the decisions, both on behalf of the Kirby Company as vendor and the respondent company as purchaser.

Mr. Lyon, on behalf of the respondent, relies on the *Sheldon Engineering Company* case (*supra*), stressing the fact that when the agreement of October 1 was approved, Maurice was not a shareholder of the respondent company, and that is so according to the records. Therefore, it is said, the control of the company was in the hands of the shareholders who were the three solicitors acting on his

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behalf—his wife, and Sayer, his employee. In view of his admission that he did in fact control their actions, the matter of shareholding in this case becomes of little importance.

The *Sheldon Engineering* case is clearly distinguishable on its facts. The transaction there included the sale of the assets of the old company to the new company, and the question there also was whether the transaction was one at arm's length. It was held that at the time the sale of the depreciable property, in respect of which the capital cost was claimed, was made, the old company was completely controlled by the bank which had made advances and taken certain securities. In the circumstances, it was held that s-s. (2) of s. 20, and s-s. (5) of s. 127 had no application, and the parties were at arm's length within the commonly accepted meaning of that expression. In my view, *Sheldon's* case affords no assistance to the respondent.

My conclusion, therefore, for the reasons stated, must be that on the proven facts Maurice did indirectly control the respondent corporation on October 1, 1952, that therefore they are deemed not to have been at arm's length under s-s. (5) of s. 139.

I am also satisfied that the transaction was between persons not dealing at arm's length and that consequently the provisions of s-s. 4(*a*) of s. 20 apply. It follows, therefore, that the capital cost of the property—the franchise—to the taxpayer is deemed to be the capital cost of the property to the original owner, namely, the Kirby Company. As that cost was nothing, the respondent is not entitled to any capital cost allowance in respect of the property, namely, the "franchise".

For these reasons the appeal of the Minister will be allowed, the decision of the Income Tax Appeal Board set aside, and the re-assessment affirmed. The Minister of National Revenue is entitled to costs of this appeal after taxation.

Judgment accordingly.