
BETWEEN:

WILBOUR LEE CRADDOCK .....APPELLANT;

AND

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

Regina 1968 Apr. 23-25

Ottawa Aug. 1

AND BETWEEN:

STANLEY CURTIS ATKINSON .....APPELLANT;

AND

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

Income Tax—Federal—Income Tax Act, R.S.C 1952, c. 148, 137(2)—"Dividend stripping"—"Surplus stripping"—Indirect payments or transfers—Whether taxable benefit conferred on shareholders in series of transactions including sale of their shares with payment therefor being made by the new shareholders with funds withdrawn from the company as liquidating dividends—Whether any legitimate business purpose.

The appellants were shareholders of a Saskatchewan corporation which had undistributed income of $101,448.61. By a series of transactions which took place on May 2, 1963, at Regina, an equivalent sum was paid to the appellants but not directly by the said corporation. This corporation was then wound-up. In the same series of transactions, all the business assets of this corporation were transferred to a newly incorporated corporation which carried on the business and which was under the same management and control as obtained in the corporation which was wound-up

The appellants were re-assessed for income tax purposes on the basis that this constituted a so-called "Dividend Stripping" or a "Surplus Stripping" transaction of the corporation which was wound-up and from that it then resulted a benefit being conferred on the appellants within the meaning of section 137(2) of the *Income Tax Act*.

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Held: That a benefit was conferred on the appellants in 1963 within the meaning of section 137(2) of the *Income Tax Act* and that such benefit was taxable as income under Part I of the *Act;* and that such benefit was equal to the undistributed income of the company which was wound-up namely, $101,448 61 minus the fees paid to the tax advisers employed in the series of transactions, namely, $2,000.00, and minus the share capital, namely, $200.00, or $99,448.61 in all, of which $69,614 03 was conferred on the appellant Craddock and $29,834.58 on the appellant Atkinson.

That the appeals be dismissed with costs.

APPEAL from assessments of the Minister of National Revenue.

Allan D. McEachern and *John G. Smith* for appellant.

W. B. Williston, Q.C., A. D. Givens, Q.C., and *G. W. Ainslie* for respondent.

GIBSON J.:—The appellants appeal from income tax reassessments for the taxation year 1963. The subject matter is a so-called "dividend stripping" or "surplus stripping" transaction of Allied Heating Supply Ltd., (a company incorporated under the laws of the Province of Saskatchewan). The respondent alleges such "stripping" took place on May 2, 1963, at Regina; and that the *quantum* of undistributed surplus involved was $101,448.61.

Prior to May 2, 1963, the appellants held all of the common shares except two in Allied Heating Supply Limited, which had the said undistributed surplus of $101,-448.61. During the early months of 1963, they consulted Mr. Melville Neuman, a lawyer practising in Regina, and an accountant Mr. E. N. Forbes of Clarkson, Gordon & Co., Regina, and employed them to cause this company to distribute its surplus to them without paying income tax.

Mr. Neuman conceived the plan which was finally adopted and he and Mr. Forbes acted as agents for the appellants and the said company in implementing the plan.

The appellant W. L. Craddock also had a subsidiary reason for retaining Mr. Neuman and have him do some of the things he did in this case, and that was to cause certain corporate action to be taken to enable his son and son-in-law each to purchase a greater equity interest in the business carried on through this company. But this matter is of no significance in the adjudication of these appeals.

Pursuant to the plan finally adopted, (a) certain preliminary steps were taken prior to May 2, 1963, and (b) certain steps were taken on May 2, 1963, that is to say:

Steps taken prior to May 2, 1963

1. Early in 1963, the appellant Atkinson (who was going then to Europe for an extended holiday) transferred his shares in Allied Heating Supply Ltd., to his solicitor Robert M. Barr in trust who thereafter held the same for him and acted on his behalf.
2. On April 19, 1963, the appellants caused to be incorporated Allied Heating Supply (1963) Ltd., (herein sometimes called the "new company"), the share ownership of which was substantially the same as that of Allied Heating Supply Ltd. (herein sometimes called the "old company").
3. The preference shares of the old company were redeemed.
4. On April 19, 1963, also, the old company's common shares were split into Class A (voting) and Class B (non-voting), with proportionate ownership unchanged.
5. On April 22, 1963, 19,800 Class B shares of the old company were issued to the holders of the Class A shares in their same respective proportions, namely 13,800 to the appellant Craddock and 5,940 to the appellant Atkinson (per his attorney Barr), such that the issued shares each owned were in substantially the same proportions as before April 1963, except that the shares had been split 100 for 1 and into voting and non-voting classes.
6. On April 22, 1963, also, the old company entered into an agreement with the new company whereby the latter agreed to buy the net assets and undertaking of the former, computed as at April 15, 1963. This price, to be payable in cash when later determined, was established April 30, 1963 by agreement at $101,448.61.

Steps taken on May 22, 1963

1. The new company, even though it had no assets of any substance, in exchange for the former operating assets of the old company, presented to the old company a cheque for $101,448.61, purporting to be in payment for these assets of the old company.

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2. The appellant Craddock and Robert M. Barr transferred their Class A voting shares of the old company to Robert McColl and James Balfour, and their Class B non-voting shares in equal proportions to Kilkenny Enterprises Ltd. and Donegal Enterprises Ltd.

3. The old company distributed its assets (it having discontinued business at April 15, 1963) by way of liquidating dividends, which (after payment of $1,000 fees to Clarkson, Gordon & Co. (auditors) and $1,000 to Neuman, Pierce & Co. (Solicitors)) amounted to $99,448.61.

4. McColl, Balfour, Kilkenny and Donegal aforesaid presented cheques to the appellant Craddock and to Robert M. Barr respectively, for $67,513.60 and $28,934.39, in payment for the shares of the old company. A balance of $3,000.62 remained with McColl, Balfour, Kilkenny and Donegal. This sum was their net fee (after paying out the said $2,000) for carrying out their part of the whole transaction.

5. The appellant Craddock and Robert M. Barr (for the appellant Atkinson) advanced as loans to the new company the amounts of $67,513.60 and $28,934.39 aforesaid.

All the financial arrangements heretofore mentioned were in the complete control of the Bank of Montreal, North End Branch, Regina, Saskatchewan, where this closing on May 2, 1963, took place. New bank accounts at that Branch were opened solely for the closing as needed and, except for the said fees of $3,000.62 (paid for the said services mentioned) and the fees of $2,000 (paid to the said solicitor and accountant to liquidate and wind-up the old company after this closing) no funds were in fact released to any party. No loan in any amount was made by the Bank of Montreal.

The amount of $67,513.60 paid to the appellant Craddock for his shares in the old company was credited to him as the single incoming entry in a new account, and debited as the single outgoing entry on the occasion of the advance by way of loan to the new company. All cheques passing on this closing were exchanged internally by the Bank and remained entirely within its control, which control was

essential to the Bank for its own protection, since in order to accomplish this closing the Bank participated in the creation of a certified cheque drawn on the bank account of the new company which had no funds in it to honour it, and which cheque was intended to be and was offset by a "round-robin" series of cheques, so to speak, through a number of accounts, all of them, at all times in the Bank's control, of the same amount of funds (less $5,000.62 the amount of the total said fees paid to the purchasers for their part in implementing the transactions on May 2, 1963) the final cheque of which series was deposited to the account upon which that certified cheque was first drawn. There was no risk to or loan by the Bank at any time. The entire series of cheques and deposits of them, in terms of dollars was a "wash" transaction, so to speak.

On May 2, 1963, also, the old company after declaring the said liquidating dividend, issued the following dividend cheques to these respective receivers:

Donegal Enterprises Limited	$49,674 58
Kilkenny Enterprises Limited	$49,674 57
Robert A. C. McColl	49 73
R. James Balfour	49 73
	$99,448.61

(See Exhibit A-1)

Recapitulating, therefore, the said undistributed surplus of $101,448.61 of Allied Heating Supply Ltd., in this series of inter-related transactions was used as follows:

1. Allied Heating Supply Ltd., the old company, received a cheque from the new company for $101,448.61 for the sale of its working assets to the latter.

2. The old company issued cheques equivalent to this sum as follows:

Liquidating dividends	$99,448 61
Clarkson, Gordon & Co. (Chartered Accountants)	$ 1,000 00*
Neuman, Pierce & Co. (Solicitors)	$ 1,000 00*

*(These sums were for fees for services rendered in winding-up Allied Heating Supply Ltd., after this series of transactions and were part of the total of $5,000.62 paid in fees.)

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3. Cheques representing $99,448.61, in this said "round-robin" exchange of cheques, were issued and received as follows:

	Donegal Enterprises Ltd.	Kilkenny Enterprises Ltd.	R.A.C. McColl	James Balfour	Total
Cheques for liquidating dividend received	49,674 58	49,674 57	49 73	49 73	99,448 61
Cheques issued for purchase of shares of old company from appellants	48,175.77	48,175.78	48.22	48.22	96,447 99*
Fees received ..	$1,498.81	$1,498 79	$1.51	$1.51	$3,000.62

(See Exhibit R-1, pages 19, 20 and 21)—

*(There was a 62 cent error made).

On these facts, counsel for the appellants submitted, among other things, that it was not necessary to establish a legitimate business reason for these series of transactions but that in any event, there was such a reason in this, namely to enable the said son and said son-in-law of the appellant Craddock to purchase an equity in the business; that the legal form of the transactions should govern, which was critical here because all the transactions were real and none artificial; that the appeals are against the assessments which were based on a deemed dividend under section 81(1) of the *Income Tax Act* and therefore section 137(2) of the Act could not be considered in deciding whether or not the appellants are taxable as a result of what was done here; that alternatively if section 137(2) of the Act could be considered, that subsection was not a "gateway" into section 81(1) of the Act; that alternatively, also, if a "gateway", section 81(1) of the Act was inapplicable because the "benefit" referred to in section 137(2) of the Act must be conferred on shareholders of a corporation and at the time of the liquidation dividend the appellants were not shareholders of Allied Heating Supply Ltd.; that in any event, section 137(2) of the Act deals with taxes on "benefits" and in these inter-related transactions there was either a *quid pro quo* or a loss, and therefore no "benefit"; and that the tax advantage obtained cannot be the "benefit" because a tax advantage cannot be conferred by anyone in that it arises by operation of law.

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The submission of counsel for the respondent, among other things, was that the facts of this case established that the amounts received by the appellants as the result of this series of transactions should be included in their income for the taxation year 1963 on the principles enunciated in *Smythe v. M.N.R.*[1].

The issue for decision in this case, therefore, is whether or not the amounts received by the appellants purporting to be the purchase monies for the shares sold, are to be included in their income in the year 1963, the year of such sale.

In *Smythe v. M.N.R.* (*supra*) I had occasion to consider whether or not monies received in a so-called dividend or surplus "stripping" inter-related transaction was income within the meaning of that term in the *Income Tax Act*. I expressed certain views then, some of them *obiter*. Since, I have had occasion to consider further what I believe to be the applicable principles and have come to certain conclusions. I now state them.

I am of opinion that in any factual situation which may be referred to as a "dividend stripping" or "surplus stripping" transaction, the following propositions should be taken into account for the purpose of determining the income tax consequences of such a transaction.

—A—

1. Firstly, by reason of the words employed in section 137(2) of the *Income Tax Act*, the "result" (or in other words, the financial consequences) should be ascertained.

   The "result" to be ascertained is whether or not a "benefit" is conferred on a person.

   The "benefit" to be looked for is a sum of money equivalent to the monies or other assets that belonged to a company immediately prior to a so-called "dividend stripping" or "surplus stripping" transaction, and which ceased to belong after.

2. Secondly, it should be ascertained whether the following two premises can be established:

   (a) (i) either that the sale of the shares was pursuant to, or as part of, an inter-related transaction;

[1] [1968] 2 Ex. C.R. 189; [1967] C.T.C. 498.

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(ii) that all of the parts of such an inter-related transaction of which the sale of shares was one part, had no legitimate business purpose and had been entered into as a means of avoiding the taxation consequences under other sections of the *Income Tax Act,* (and in that sense were not *bona fide*);

or

(iii) that one or more inter-related parts of such a transaction was entered into between persons not dealing at arm's length.

(See section 137(3) of the Act);

and

(b) that the result of the whole series of inter-related transactions was the same as if the subject company had paid the monies or other assets out to or for the benefit of the persons who were shareholders immediately prior to the commencement of the steps taken to implement the series of inter-related transactions.

(See section 137(2) of the Act).

—B—

1. If the facts of any inter-related transaction lead to the conclusion that the two premises set out in A.2. above have been established and therefore the "result" contemplated by section 137(2) of the Act obtains, then the subject company is the "person" who is deemed to have conferred such "benefit" and the said section 137(2) of the Act has the effect of requiring that such "benefit", be "included in computing the taxpayer's income for the purpose of Part I"; or, alternatively, if the circumstances require it, that such "benefit", be "deemed to be a payment to a non-resident person to which Part III applies"; or, alternatively, if the circumstances require it, that such "benefit" be "deemed to be a disposition by way of gift to which Part IV applies".

2. Because such "benefit", depending on the circumstances of the case, may be treated, for tax purposes, either under Part I, Part III or Part IV of the *Income*

Tax Act, section 137 of the Act appears in a different part of the Act, separate from any of these Parts, namely in Part VI of the *Income Tax Act.*

When the circumstances of the inter-related transactions are such that it is correct to include such "benefit" "in computing the taxpayer's income for the purpose of Part I", then the total of it is included in such taxpayer's income as one of the sources of such taxpayer's income within the meaning of section 3 of the Act in the same manner as if section 137(2) was in one of the series of sections in Part I such as section 6, section 8(1), section 16(1) and section 81(1). But section 137(2) of the Act in any such case is not dependent upon for its efficacy on or connected with any other section or sections in Part I, such as sections 6, 8(1), 16(1) and 81(1) and therefore none of these latter sections are relevant in the adjudication of any case in which section 137(2) is applicable.

(In like manner, if the circumstances of the inter-related transactions are such that it is correct that such "benefit" be "deemed to be a payment to a non-resident person to which Part I applies", then for taxation purposes section 137(2) of the Act should be considered in effect as being a separate section in Part III of the Act.)

(In like manner, if the circumstances are such that it is correct that the "payment" be "deemed to be a disposition by way of gift to which Part IV applies", then for taxation purposes section 137(2) of the Act should be considered in effect as being a separate section in Part IV of the Act.)

—C—

1. Any evidence which is material to establish whether the facts of any case bring it within the provisions of section 137(2) of the Act, are admissible under the general rules of evidence. Specifically, in cases such as this, where there are a series of inter-related transactions, then the details of all the inter-related transactions are admissible and relevant, even though the parties to the appeal are not parties to all such transactions, as for example, in the subject case, when, after the sale transaction of the shares by the appellants, which was one of the inter-related transactions, other persons only and

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not the appellants or either of them were directly involved in carrying out the subsequent inter-related transaction or transactions.

2. Finally, in cases such as this (and generally in all income tax cases), the Minister in his pleadings and evidence at trial, is not bound by the assumptions made by the assessor in making the assessment or re-assessment and the Minister is also not restricted to relying on the reasons stated in the Notices of Assessment or Re-Assessment or the section or sections of the *Income Tax Act* therein relied upon but, instead, is entitled to allege in his pleadings other facts and to plead any other alternative or additional section or sections of the *Income Tax Act,* and to adduce evidence in support thereof, provided however, if the latter situation obtains the onus of proof is on the Minister.

So much for the applicable law, in my view.

Certain of the facts of this case have already been detailed. In addition, however, from a careful consideration of the whole of the evidence, I make these further findings of fact, namely:

1. Melville Neuman, solicitor, acted as agent for the appellants at all material times and specifically in advising, negotiating and completing the series of transactions going to make up the whole transaction between the appellants and R.A.C. McColl, James Balfour, Kilkenny Enterprises Limited and Donegal Enterprises Limited.

2. Ian Forbes, chartered accountant, acted as an agent for the appellants on the closing of the series of transactions going to make up the whole transaction.

3. The appellants personally and through their said solicitor Neuman and their said accountant Forbes, had knowledge that R.A.C. McColl, James Balfour, Kilkenny Enterprises Limited and Donegal Enterprises Limited were engaged at all material times in schemes aimed at the "stripping of surpluses" of companies which had converted their assets into cash by selling their operations and operating assets to a new company.

4. The appellants personally and through their said solicitor Neuman and their said accountant Forbes,

knew that the surplus of Allied Heating Supply Ltd., (the old company) would be "stripped" and paid out to the appellants, less the fees paid for services as heretofore mentioned, without the appellants paying income tax, in the following manner:

(a) A new company would be incorporated.

(b) The assets of Allied Heating Supply Ltd., (the old company) would be sold to the new company.

(c) The issued preference shares of the old company would be redeemed.

(d) The articles of association of the old company would be amended in an appropriate way to facilitate the said "stripping".

(e) Allied Heating Supply Ltd., common shares would be split into Class "A" (voting) and Class "B" (non-voting).

(f) The Class "A" shares would be sold to two individuals and the Class "B" shares would be sold to two corporations.

(g) Allied Heating Supply Ltd., would declare a liquidating dividend equal to the sale price of the assets of the new company less the fees and expenses to Mr. McColl and the others. (These fees were not a profit because there was no risk. These were fees for services.)

(h) Offsetting or compensating cheques would be exchanged on closing.

5. It was always intended that the business would be carried on without disruption, by the new company, and under the same management and control, and this took place.

6. No bank funds would be involved in the inter-related transactions or at risk, by loan or otherwise.

7. The only funds that would be involved in the inter-related transactions were to come from the old company.

8. All of the above steps would be inter-related, each conditional upon the other. They would be instigated, have as their purpose and be part and parcel of a scheme, to appropriate funds or property of Allied Heating Supply Ltd., to and for the benefit of the appellants.

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9. Specifically, in dealing with the sale of shares:

(a) They knew this was not an isolated transaction but was an inter-related part of a scheme aforesaid:

(b) That it was not *bona fide* in that it was not entered into for any legitimate business purpose (in the main before and exclusively after April 24, 1963) but was entered into as a means to avoid the taxation consequences of having funds or property of Allied Heating Supply Ltd., come into the hands of the appellants;

(c) They knew that the sale of shares in Allied Heating Supply Ltd., was not necessary for the implementation of the decision to allow the son and son-in-law to acquire an equity in the business;

(d) They knew all cheques exchanged were uncertified (which was understandable only because it was not important to the appellants that the cheques of the said purchasers of the shares be backed by funds because of this "round-robin" exchange of cheques). They knew that the funds were to come from Allied Heating Supply Ltd., only, which was known to the appellants and to all parties to the transaction.

10. They knew that the above mentioned series of transactions were not entered into by persons dealing at arm's length except in the matter of establishing the *quantum* of the fee. Once the fee required by Mr. McColl and the others had been agreed upon, all of the parties were to act in concert.

Relating these facts to the relevant principles of law as I understand them, as set out above, it is obvious that "the result" that is, the financial consequences of these inter-related transactions was that monies belonging to the old company immediately prior to the so-called dividend stripping or surplus stripping transaction ceased to belong to the old company immediately thereafter and belonged to the appellants in total (except for the $5,000.62 in fees and expenses paid as mentioned); that the following two premises were established, namely, that the sale of the shares was pursuant to or part of an inter-related transaction and that the result of the whole series of the inter-related transactions was the same as if the old company had paid

the monies (less the said fees of $5,000.62) to or for the benefit of the appellants who were shareholders of the old company immediately prior to the commencement of the steps taken to implement the said series of inter-related transactions.

Therefore, the conclusion I reach is that the "result" contemplated by section 137(2) of the *Income Tax Act*, obtains, because as a financial consequence of the above mentioned series of transactions, there took place what is sometimes called a "dividend strip" or "surplus strip" of the earned surplus of Allied Heating Supply Ltd., and that in the process Allied Heating Supply Ltd., conferred a "benefit" on the appellant Craddock of $69,614.03 plus his share of the fee paid, but not including the fees paid for the liquidation of that company, (but both of which were included in the total of $5,000.62 paid for the "dividend strip") namely $2,100.43, and on the appellant Atkinson of $29,834.58, plus his share of the said fees paid, namely, $900.19, all of which sums being prior thereto the assets of Allied Heating Supply Ltd., the total amounting to $99,-448.61; and that the portion of the said amount that should be included in the income of the appellant Craddock for the taxation year 1963 is $69,474.03 (computed as follows:

$\frac{14,000}{20,000}$ shares × $99,448.61 − $200.00 (share capital) = $69,474.03); and the portion that should be included in the income of the appellant Atkinson is $29,774.58 (computed as follows: $\frac{6,000}{20,000}$ shares × $99,448.61 − $200.00 (share capital) = $29,774.58).

The appeals are therefore dismissed with costs, and the re-assessments are referred back for re-consideration and re-assessment not inconsistent with these reasons.