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

AND

THOMAS RODMAN MERRITT, JR. and RICHARD BREDIN STAPELLS, EXECUTORS OF THE ESTATE OF THOMAS RODMAN MERRITT .... RESPONDENTS.

Toronto 1969 Jan. 14-15

Ottawa Feb. 24

Estate tax—"Arm's length", meaning—Debentures issued decedent by company controlled by his children—Valuation—Estate Tax Act, s. 29(1)(b).

Because of *M's* improvidence a plan for supervising his assets was devised by an accountant consulted by *M's* son. Under the plan, which was concurred in by *M*, his son and daughter, and carried out by the accountant and a solicitor, assets of *M* valued at $317,000 were transferred to a newly-incorporated company controlled by *M's* son and daughter *M's* only stipulation was that he receive $1,000 cash per month and he was assured of this sum through the purchase of an annuity at a cost of $110,000 and the issue to him of 3% debentures of the new company of the face value of $207,000 On *M's* death his executors valued the debentures for estate tax purposes at 85% of their face value

Held, s. 29(1)(*b*) of the *Estate Tax Act* required that debentures be valued at their face value because *M* and the company were not

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

dealing at arm's length when the debentures were issued. Where the same person dictates the terms of a bargain on behalf of both parties thereto it cannot be said that those parties are dealing at arm's length. It was immaterial that the plan was devised by *M's* professional advisers and that *M* never completely absorbed its details; it was solely on his instructions that the plan was carried out, and the company, although not controlled by *M*, was bound to issue the debentures in accordance with that plan

M.N.R. v. Sheldon's Engineering Ltd. [1955] S.C.R. 637, applied

APPEAL from estate tax assessment.

M. A. Mogan and *J. M. Halley* for appellant.

R. B. Stapells, Q.C. for respondents

CATTANACH J.:—This is an appeal from a decision of the Tax Appeal Board dated November 7, 1967, whereby an appeal from an assessment by the Minister under the *Estate Tax Act*, S. of C. 1958, c. 29, was allowed.

The Minister, in computing the aggregate taxable value of the estate of the late Thomas Rodman Merritt increased the valuation of debentures of Thombille Investment Limited (hereinafter referred to as Thombille) owned by the deceased at the time of his death by an amount of $31,050. The debentures had a face value of $207,000.

In completing the prescribed estate tax return the executors of the estate in computing the aggregate net value valued the debentures at 85% of their face value resulting in a declared valuation of $175,950 to which was added interest of $203.61 bringing the total to $176,153.61.

The amount of $31,050 added by the Minister resulted in the face value of the debentures of $207,000 being included to compute the aggregate net value of the estate of the property passing on the death of Thomas Rodman Merritt, Sr. in accordance with section 3 of the Act.

In assessing the estate as he did the Minister did so on the assumption that immediately prior to the death of the deceased there was a debt owing to him by Thombille, namely the debentures with a face value of $207,000 and that at the time of the issue of the debentures to the deceased, in return for assets transferred to Thombille, the deceased and Thombille were not persons dealing with each other at arm's length.

Thombille was caused to be incorporated in August 1960, for the purpose of acquiring certain of the assets of T. R.

Merritt, Sr., by his son T. R. Merritt, Jr. and his daughter, Marigold S. Young. The issued and outstanding shares of Thombille were held as follows:

Marigold S Young (deceased's daughter) .	5,000
Thomas Rodman Merritt, Jr (his son) . .	4,998
W. A. Lyttle (a chartered accountant) .	1
R B Stapells (a barrister and solicitor)	1

The shares held by Messrs. Lyttle and Stapells were held for the benefit of T. R. Merritt, Jr. and in order to qualify them as officers and directors of Thombille.

There is no dispute that the shares held by T. R. Merritt, Jr. and Mrs. Young, the only living children of the deceased, vested control of Thombille in them.

The Minister, therefore, says that, since immediately prior to the death of the deceased there remained a debt owing him by a corporation controlled by one or more persons connected with him by blood relationship, the value of the debt is to be determined as though the amount thereof outstanding became due and payable to him at that time and accordingly, the face amount of the debentures must be included in computing the aggregate net value of the estate, the whole in accordance with section 29 of the *Estate Tax Act* which reads as follows:

> 29 (1) Where, immediately prior to the death of a deceased, there remained outstanding a debt owing to the deceased
>
> (a) by any person connected with him by blood relationship, marriage or adoption, or
>
> (b) by any corporation that, at that time, was controlled, whether directly or indirectly and whether through holding a majority of the shares of the corporation or of any other corporation or in any other manner whatever, by the deceased, by one or more persons connected with him by blood relationship, marriage or adoption, by the deceased and such one or more other persons or by any other person on his or their behalf,
>
> the value of the debt shall, unless it is established that at the time of the creation of the debt the deceased and such debtor were persons dealing with each other at arm's length, be determined for the purposes of this Part as though the amount thereof outstanding immediately prior to the death of the deceased had, at that time, become due and payable to him.
>
> (2) In this section, "debt" means a debt of any kind whatever, whether secured or unsecured and whether under seal or otherwise, and includes a bill of exchange or promissory note, whether negotiable or otherwise

The debentures qualify as a debt within the definition of a debt in section 29(2) and, for the purposes of the Act,

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J

persons are connected by blood relationship if *inter alia* one is the child or other descendant of the other (see section 58(3)(*a*). T. R. Merritt, Jr. and Mrs. Young, who controlled Thombille, were so related to the deceased.

The obvious purpose of section 29 is to prevent the value of a debt owed to a deceased by a person connected with him by blood relationship, marriage or adoption, or by a corporation which he or persons so connected with him control, from being reduced by reason of its due date having been set in the future.

However, the respondents seek to take advantage of the saving provision in section 29 reading, "unless it is established that at the time of the creation of the debt the deceased and such debtor were persons dealing with each other at arm's length".

Thus the issue becomes a clearly defined and narrow one of whether, in the circumstances of the transaction between the deceased and Thombille, a corporation controlled by his son and daughter, the parties were dealing with each other at arm's length.

No issue was raised in the pleadings as to the accuracy of the appellant's valuation of the debentures at 85% of their face value as the value of the property passing on death. In the course of the trial counsel for the Minister indicated he was prepared to accept that evaluation if the transaction should be held to be one at arm's length between the parties thereto.

The Estate Tax Act does not contain a provision similar to that in section 135(5)(*a*) of the *Income Tax Act* wherein it is provided that for the purposes of that Act, "related persons shall be deemed not to deal with each other at arm's length". The meaning of the expression "dealing at arm's length" as used in the *Estate Tax Act* must therefore be determined without any such aid.

The facts which gave rise to the transaction in question follow.

The deceased was a member of one of the oldest and most respected families in St. Catharines, Ontario, where he always resided. His annual net income of approximately $15,000 derived from inheritances he had received. He was never employed full time. His occupation was described as that of a gentleman by which I assume is meant that he

was content to live on the income of investments he owned. His annual net income which I intimated above to be approximately $15,000, but which varied from year to year, was for 1960, made up of about $6,900 in dividends from securities, $1,700 interest from bonds, $833 interest from notes and other securities, $9,700 from the estate of Emily Merritt, a great cousin of the deceased, and $585 from income from investments administered by Canada Trust over which the deceased had no control, which total $19,718. From this total there must be deducted an amount of $5,000 which was payable to his wife under a separation agreement. The funds which generated the amount of $5,000 came from the proceeds of the sale of real property known as Park Place which were invested and administered by the Canada Trust. Any surplus over the $5,000 payable to Mrs. Merritt was paid to the deceased. The above figures which I have taken from the 1960 income tax return varied from year to year and are set forth as illustrative of the sources and nature of the deceased's annual income.

The deceased was well known and respected in the community. He was active in the church of the denomination of his choice having served as warden. He had also served as treasurer and director of Niagara Lower Arch Bridge Company.

After being separated from his wife, at a time when his son and daughter had been married and were living their own separate lives, the deceased lived alone in the family home known as Rodman Hall set in an estate of 15 acres.

He was not a prudent business man and exhibited no interest in the management of his affairs. He was considered to be a "soft touch" and was likely to engage in ventures with dubious prospects of returns.

He had served with distinction in the First World War and was particularly generous to any "old sweat" who might importune him. He was prone to make outright gifts to them, loans on worthless promissory notes and loans on mortgages, the collateral for which was worthless.

The normal imprudence of the deceased was compounded by alcoholism which had extended over a number of years. He was frequently obliged to enter Homewood Sanatorium at Guelph, Ontario, for treatment of this affliction. The

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J.

admittances of the deceased to this institution were arranged by his son without the necessity of commitment because he entered voluntarily.

His handling of his financial affairs was a cause of concern to his family and friends. He made highly speculative investments. When he made investments it was his habit to place the share certificates in a safety deposit box and promptly forget their existence. He gave no thought to whether those investments should be realized or changed.

Because of his lack of interest in his own affairs he arranged for a friend, Miss Farmer, an employee of the Imperial Bank, to prepare his personal income tax returns, to pay his personal accounts and to keep track of records.

The relationship between T. R. Merritt, Jr. and his father was always cordial but the son never proffered nor asked for advice from his father on financial and personal affairs. In fact the son never professed any knowledge of investments, but rather an ignorance thereof. His interests lay elsewhere. He was a graduate of the University of Toronto. In 1960 he was head master of Appleby College at Oakville. Later he operated a farm near Guelph. His income from his profession and later from his successful farming operations was ample in addition to which his wife had a substantial income.

The deceased's daughter, Mrs. Young, was married to an electrical engineer. The couple lived in England and were in comfortable financial circumstances.

Mr. Merritt Jr.'s visits to his father were not frequent but occurred when some emergency arose. He never interfered in his father's affairs except when required to do so by dire necessity and then he did so by reason of his father's physical condition.

Mr. Merritt, Sr. sought to derive rental income from Rodman Hall but the venture was a losing one from its inception. He then considered subdividing and selling the property. However in order to preserve the estate intact, perhaps for sentimental reasons, he sold it to the St. Catharines Art Council. The proceeds were used to supplement the funds administered by the Canada Trust for the separation allowance payable to Mrs. Merritt which, in the meantime, had been increased from $5,000 to $6,000.

Mr. Merritt, Jr. took no part in his father's decision to sell Rodman Hall, but he did come to his assistance in

disposing of and distributing the many household effects. If my recollection of the evidence is correct, Mr. Merritt, Sr. lapsed into an alcoholic bout following the sale of the family home and was again confined to Homewood Sanatorium.

Shortly after this incident, Mr. Merritt, Jr. received a telephone call from Miss Farmer advising him that his father again needed help. He had undertaken to donate an organ at a cost of between $25,000 and $30,000 to the church of which he was a member, to be installed in a new church building being erected. He had always been generous to the church making many donations usually about $1,000 but never before had he made a donation of this magnitude. As both Miss Farmer and Mr. Merritt, Jr. knew, his income was not sufficient to make this undertaking.

This incident was climactic. Mr. Merritt, Jr. was desperate. At the suggestion of Miss Farmer he sought the advice of W. A. Lyttle, a chartered accountant practising his profession in St. Catharines.

Mr. Lyttle had known Mr. Merritt, Sr. when he was a warden of the church. Later, as a student accountant, he had business connections with the deceased when he was treasurer of the Niagara Lower Arch Bridge. Still later the deceased engaged Mr. Lyttle to prepare statements of revenue and expenditures with respect to the rental of Rodman Hall. He was also consulted by the deceased with respect to tax aspects involved in the sale of Rodman Hall.

On being consulted by Mr. Merritt, Jr. in January 1960, Mr. Lyttle suggested the incorporation of a company to which all assets under the control of Mr. Merritt, Sr. would be transferred to ensure a supervision of those assets and management of his affairs.

The plan was devised by Mr. Lyttle on his own initiative without suggestions or criticism from Mr. Merritt, Jr. Mrs. Young came to Canada for the express purpose of participating in the arrangement of her father's affairs. She was agreeable to the plan and offered no criticism of it.

The matter was broached to Mr. Merritt, Sr. by Mr. Lyttle. At that time he had just been discharged from Homewood Sanatorium. He was, therefore, "dried out" and in full possession of his faculties. He recognized the advisability of such a plan to which he readily agreed, his sole concern and stipulation being that he should be guaranteed a cash income for his exclusive use of $1,000 per month.

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J

In skeleton form the plan amounted to this.

All securities owned by the deceased and under his control (which excluded assets invested and administered by Canada Trust), which had a value of $317,000, were to be transferred to the company to be incorporated (i.e. Thombille).

In exchange therefor he was to receive, *inter alia,* a single payment life annuity yielding $868 per month to be purchased at a cost of $110,000 from the Manufacturers Life Insurance Company. This annuity was negotiated by Mr. Lyttle and was the best obtainable.

After the purchase of an annuity for $110,000 the value of the securities then remaining would be $207,000. As further consideration for the assets to be transferred to Thombille, Mr. Merritt, Sr. was to receive 25 year debentures of Thombille having the face value of $207,000 and bearing interest at the rate of 3%.

To ensure that the deceased would have $1,000 a month to use as he wished, which was in accordance to his desire and the condition that he laid down, there would be required an annual amount of $30,000 which was needed for the following purposes:

Cash for Mr Merritt's untrammelled use	$12,000
Payment of income tax	4,000
Payment of the separation allowance to Mrs Merritt	5,000
Payment of premiums on life insurance taken out on his life with his son and daughter as beneficiaries	6,000
Payment for a premium for an insurance policy carried on his life	3,000
Total	$30,000

The sources from which this amount were to be derived were two-fold. The first sources were as follows:

From the annuity to pay $868 a month	$10,400 00
Income from the assets administered by Canada Trust surplus to the separation allowance of $5,000 payable to Mrs Merritt, those funds being the proceeds of the sale of Park Place and Rodman Hall, and	2,200 00
From the estate of Emily Merritt	11,041 56
	$23,641.56

The second source, to make up the total of $30,000, would be the interest on the debentures.

The interest rate on the debentures of the face value of $207,000 was struck at 3% to yield $6,210 which when added to the total of $23,641.56 of funds from the first source would bring the total to $29,810.56 which would be sufficiently approximate to the $30,000 needed to meet the requirements of the deceased.

As intimated before, the plan, of which Mr. Lyttle was the author, was acceptable to Mr. Merritt, Sr. and his son and daughter.

The son's only concern, which was shared by his sister, was that his father's assets would be carefully administered to meet his fixed obligations and that he would be generously provided with funds for his immediate needs and to spend according to his whim but in moderation. The son, upon whom the burden of responsibility normally fell, would be relieved of personal involvement of his father's affairs.

The father, in full possession of his faculties and a knowledge of his weaknesses, recognized the benefits of the plan to him and agreed to it. He would receive a certain and regular monthly income equivalent to that he had previously enjoyed but the assets he had previously controlled would be beyond his control. He would receive for the assets he would surrender to Thombille its debentures to the face value of the assets. The debentures constituted a first charge on those assets.

If the situation, as it existed, had been allowed to continue there was every likelihood that the assets owned and controlled by him would be dissipated.

The plan, being agreed upon, R. B. Stapells, Q.C., the son of the deceased's life long friend and solicitor, was engaged to take the necessary legal steps to implement the plan. Mr. Lyttle also took steps to bring the plan to its completion.

Although Mr. Lyttle was consulted in this regard by Mr. Merritt, Jr. he considered Mr. Merritt, Sr. as his client and billed him for professional services which accounts were paid by Mr. Merritt, Sr. However, when Thombille was incorporated in August 1960, the bills for his services were rendered to and paid by Thombille.

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J.

Messrs. Stappells and Lyttle were the only professional advisers involved and I cannot escape the conclusion that they were advisers to both Mr. Merritt, Sr. and Thombille as well as to Mr. Merritt, Jr. and Mrs. Young. I hasten to add that I have no reason to doubt the integrity of either and that their conduct throughout was completely honest and morally irreproachable.

The assets were valued at $317,000 as at August 31, 1960, by two expert appraisers.

The securities, which were registered in the deceased's name, were delivered to Mr. Lyttle in negotiable form who received them as agent for Thombille and transferred them to Thombille.

There was no such thing as a closing date determined upon, although it was understood that $110,000 would be realized and the annuity purchased within 30 days. The annuity was purchased on September 30, 1960. Therefore I assume that the securities were delivered to Mr. Lyttle about August 31, 1960. They were kept in a safety deposit box rented by Thombille.

The by-law creating the debentures was enacted by Thombille on October 28, 1960, so that the debentures were not issued until after that date and the first payments of interest on the debentures and the annuity were made to Mr. Merritt, Sr. shortly after that date.

While the governing factor in fixing the rate of 3% on the debentures was to bring the returns to Mr. Merritt, Sr. up to the estimated $30,000 necessary to meet his obligations and requirement of $1,000 cash per month, Thombille could not pay a higher rate and still meet the obligations (other than the monthly cash payment of $1,000 to Mr. Merritt, Sr. which was covered by the annuity) unless the securities were varied. In the greater part they consisted of shares of Imperial Bank. There was nothing to prevent Thombille from changing the securities. The deceased had not exacted or demanded that the securities to be held should be of any particular type. His condition was that Messrs. Lyttle and Stapells, in whom he placed confidence and trust, should be directors of Thombille. There was no express undertaking, but a tacit understanding that Thombille should hold only trust type securities which under-

standing the directors rigidly honoured. No independent advice was sought to advise upon an appropriate rate of interest on the debentures.

The Minister called as an expert witness an investment consultant who testified that in August the level of government of Canada bonds, the best security in the country to which all other bonds were related, was 4.83%. He expressed the opinion and would so advise a lender who consulted him that the debentures of Thombille should command an interest rate of 6½% or 7%.

When the plan was put into operation the tension and concern eased. Mr. Merritt, Sr. lived his life without causing dire emergencies which required the intervention of his son for a period of four years. He was then stricken with his fatal illness and was confined to a local hospital where he died in 1964.

In *M.N.R. v. Sheldon's Engineering Ltd.*[1] Locke J., delivering the judgment of the Supreme Court of Canada, had occasion to comment upon the expression "dealing at arm's length" as it appeared in a provision in the *Income Tax Act*. He said at page 643:

> The expression is one which is usually employed in cases in which transactions between trustees and *cestuis que trust,* guardians and wards, principals and agents or solicitors and clients are called into question The reasons why transactions between persons standing in these relations to each other may be impeached are pointed out in the judgments of the Lord Chancellor and of Lord Blackburn in *McPherson v. Watts* (1877) 3 App Cas. 254)

He went on to say, however, that "These considerations" i.e., the reasons why transactions between persons standing in such relations as trustee and *cestuis que trust* may be impeached "have no application in considering the meaning to be assigned to the expression in s. 20(2)".

Having thus put aside the principles that had been developed concerning transactions between persons standing in the relationship of trustee and *cestuis que trust* and other relationships giving rise to an implication of undue influence, Locke J. went on to reject the argument that the provision in the *Income Tax Act* at that time whereby certain defined classes of persons were deemed not to deal

[1] [1955] S C R 637

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J.

with each other at arm's length was exhaustive of the classes of persons who could be regarded as not dealing with each other at arm's length for the purposes of that Act. He said:

> 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.

While, therefore, the facts in the *Sheldon's Engineering (supra)* case did not fall within any of the specially enumerated classes of cases where persons were *deemed* not to deal with each other at arm's length, Locke J. concluded that it was still necessary to consider whether, as a matter of fact, the circumstances of the case fell within the meaning of the expression "not dealing at arm's length" within whatever meaning those words have apart from any special deeming provision.

In this appeal, the question is whether the circumstances are such as to fall within the words "persons dealing with each other at arm's length" in section 29(1) of the *Estate Tax Act*. In my view, these words in the *Estate Tax Act* have the same meaning as they had in the income tax provision with which Locke J. was dealing in *Sheldon's Engineering* when those words were considered, as Locke J. had to do, apart from any special "deeming" provision.

It becomes important, therefore, to consider what help can be obtained from the judgment in *Sheldon's Engineering* as to the meaning of the words "persons dealing at arm's length" when taken by themselves. The passage in that judgment from which, in my view, such help can be obtained, is that reading as follows:

> Where corporations are controlled directly or indirectly by the same person, whether that person be an individual or a corporation, they are not by virtue of that section deemed to be dealing with each other at arms length Apart altogether from the provisions of that section, it could not, in my opinion, be fairly contended that, where depreciable assets were sold by a taxpayer to an entity wholly controlled by him or by a corporation controlled by the taxpayer to another corporation controlled by him, the taxpayer as the controlling shareholder dictating the terms of the bargain, the parties were dealing with each other at arms length and that s. 20(2) was inapplicable.

In my view, the basic premise on which this analysis is based is that, where the "mind" by which the bargaining

is directed on behalf of one party to a contract is the same "mind" that directs the bargaining on behalf of the other party, it cannot be said that the parties are dealing at arm's length. In other words where the evidence reveals that the *same* person was "dictating" the "terms of the bargain" on behalf of *both* parties, it cannot be said that the parties were dealing at arm's length.

Applying to this case that view of the tests to be applied, it becomes necessary to consider whether the appellant has discharged the onus of showing that, at the time when the debenture debt was created, the deceased and Thombille were persons dealing with each other at arm's length.

What the respondent has shown is, in effect, that, as a result of advice given to him by a lawyer and an accountant, which advice he accepted, the deceased issued instructions which were, in effect, that a corporation was to be set up in which his son and daughter would own practically all the shares, and that his property was then to be transferred to the corporation on terms that part of it was to be used to buy him a certain annuity and that the corporation would issue to him debentures of specified terms.

In my view, it is immaterial that the whole arrangement was the "brain child" of the professional advisers. It would have been of no effect if the deceased had not accepted their advice, made the scheme his own, and given instructions that it be carried out. It is also immaterial whether he ever completely absorbed the details of the plan. He stipulated the result that he required from the scheme and, in effect, he instructed the carrying out of a scheme so devised as to accomplish that result. The situation is therefore that the corporation was created pursuant to those instructions as the instrumentality to carry out the scheme. Regardless of who had "control" of the corporation at the time that the debentures were authorized and issued, there could have been no dealing between the deceased and the corporation at that time because by that time, having accepted the deceased's property in accordance with the scheme adopted by the deceased, the corporation had no alternative to issuing the debentures as contemplated by the scheme. It cannot therefore be said, in my view, that the deceased and the corporation were at that time persons dealing with each

1969

MINISTER OF NATIONAL REVENUE v. MERRITT et al

Cattanach J.

other at arms' length. The only time when any decision was taken was when the instructions for the scheme as a whole were given, and the decision to give such instructions was a unilateral decision by the deceased. From that time on, everything that was done was done to implement those instructions and there was no part of the arrangement that involved bargaining between parties with independent interests. (I do not overlook the transactions whereby the shareholders acquired their shares or the purchase of the annuity, which were, of course, transactions between parties dealing with each other adversely, but they do not affect the reasoning concerning the creation of the debentures.)

The appeal is, therefore, allowed with costs.