BETWEEN:

CUSTOM GLASS LTD. ..... APPELLANT;

AND

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

Edmonton 1967 June 15-16

Vancouver July 17

Income tax—Window manufacturing business—Warranties to replace defective windows—Insurance to cover cost of warranties—Whether income of business.

In 1959 appellant company purchased the business of a window manufacturing company as a going concern. By the sale contract appellant assumed the vendor's liability on warranties to customers to replace defective windows and obtained the benefit of the vendor's insurance in respect of such warranties. The insurer substituted appellant company as insured in place of the original insured. Up to November 30th 1960 appellant received $61,080 under the policy but the insurer refused to pay further amounts on the ground that the policy was void because of non-disclosure of material facts by the original insured. Ensuing litigation was eventually settled on payment to appellant company in 1962 (a) by the insurer of $81,887 and (b) by the original insured of $12,500. In its accounts appellant credited the $61,080 received under the policy to income account and the $81,887 received in settlement of the litigation to earned surplus.

Held, the sums of $81,887 and $12,500 received by appellant in settlement of the litigation were properly assessed as income. They were not received on account of capital, *viz* goodwill or trade name, but were paid to make good loss of income.

INCOME TAX APPEAL.

A. F. Moir, Q.C. and *S. S. Purvis, Q.C.* for appellant.

D. G. H. Bowman and *S. A. Hynes* for respondent.

SHEPPARD D.J.:—This appeal is by Custom Glass Ltd. against an assessment for the taxation year 1963, by the Minister, of the 24th November, 1964, and a re-assessment affirmed by notice of 30th December, 1965, on the ground of alleged errors, namely, that two sums, received by the appellant and held by the Minister to be taxable income, should have been held to be receipts of capital. The two sums are: $81,887.35 received by the appellant from the Law Union & Rock Insurance Company Ltd. as insurer and $12,500.00 received by the appellant from Philex Sales Ltd.

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The facts follow:

By agreement of the 1st June, 1959 (ASF 1, part of Ex. 1) the appellant (a company known successively as R. H. Palmer (1959) Ltd., Custom Glass (Prairie Division) Ltd. and Custom Glass Ltd.) purchased as of the 1st May, 1959 from R. H. Palmer Ltd., now Philex Sales Ltd. (herein called Palmer Co.) the latter's business as a going concern carried on at Edmonton, Alberta and consisting essentially of the manufacture and sale of windows known as "Red seal double glazing units" with sales limited to Canada west of a line between Ottawa and Kingston, Ontario.

Palmer Co., on the sale of the Red seal units, had given each customer a warranty to replace at the nearest shipping point any unit developing material obstruction of vision within five years (Ex. 1, para. 12). Under policy of the 12th September, 1956 (ASF 3) the Law Union & Rock Insurance Company Ltd. insured Palmer Co. for five years whereby the insurer agreed to indemnify the insured for loss under breaches of the warranty with loss to be based on the actual cost of manufacture and installing or actual cost of manufacture (Clause 3), the policy to be cancellable on 30 days' notice (Clause 4). Under the agreement of 1st June, 1959, Palmer Co. agreed that the appellant should have the benefit of all contracts of Palmer Co. Under date of 22nd May, 1959, the insurer endorsed the policy as follows:

> Notice is hereby received and accepted that the within policy shall hereafter cover in the name of:
>
> R. H. PALMER 1959 Ltd.
>
> and not as heretofore
>
> ALL OTHER TERMS AND CONDITIONS REMAIN UNCHANGED.
>
> (Ex. 1, para. 14)

Thereafter the appellant became the insured.

On 26th May, 1959, the insurer gave notice of cancellation of the policy under Clause 4 whereby the policy expired on the 25th June, 1959. Breaches of the warranty given by Palmer Co. did arise, and the appellant replaced the defective units and filed proofs of loss with the insurer or its adjuster. The insurer paid up to the 30th November, 1960 on such proofs of loss, the sum of $61,080.37 (Ex. 1, para. 20), but later refused to pay further losses amounting to $24,387.70 (Ex. 1, para. 21). In consequence the

appellant brought action in the Supreme Court of Alberta and the insurer counterclaimed for repayment of all monies paid, on the ground that the policy had been avoided from inception by non-disclosure of material facts by Palmer Co., the original insured.

The action and counterclaim were settled by two agreements, namely, of 1st February, 1962 and of 24th May, 1962.

(a) Under agreement of 1st February, 1962 between Palmer Co. (then known as Philex Sales Ltd.) and the appellant (Ex. 1, para. 27, ASF 8) Palmer Co. paid the appellant $12,500.00 by allowing a set-off against a chattel mortgage and rents payable by the appellant (Ex. 1, para. 34).

(b) Under agreement of the 24th May, 1962 between the appellant and the insurer, by the insurer paying $90,000.00. From the receipt of that amount by the appellant there is properly deducted legal fees and other disbursements reducing the receipt by the appellant to $81,887.35 (Ex. 1, paras. 30 and 31). That sum was treated by the Minister as taxable income. In arriving at that sum in settlement, the parties considered (i) the proofs of loss submitted as of the 24th May, 1962, which amounted to $76,856.11 as of 31st March, 1962 (Ex. 1, para. 29); (ii) the estimates of future claims for breach of warranty, and (iii) other considerations, including uncertainty as to the outcome of litigation (Ex. 1, para. 32).

Those amounts, $12,500.00 and $81,887.35 were assessed by the Minister under assessment and re-assessment as income of the appellant, and the appellant has appealed in respect of those two amounts.

The sole issue is whether the sums are taxable income within sections 2 and 3 of the *Income Tax Act*, or as alleged by the appellant, are capital receipts. The onus of proving error is on the appellant: *M.N.R. v. Simpson's Ltd.*[1], cited in *M.N.R. v. Farb Investments Ltd.*[2].

As to the sum of $81,887.35, the appellant contends this was receipt of capital, for the following reason: that under the agreement of the 1st June, 1959 (ASF 1) between

[1] [1953] Ex. C.R. 93. [2] 59 DTC 1058.

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Palmer Co. as seller and the appellant as buyer, the appellant purchased the business of the seller as a going concern, which included (a) the goodwill, (b) the trade names and other assets (Clause 2); that 90% of the seller's business consisted of the manufacture and sale of "Red seal double glazing units" and that the appellant could only get the benefit of the goodwill and trade names if he fulfilled the warranties of Red seal units previously given by the seller, Palmer Co., therefore such payments were made to protect the goodwill and trade name and hence the receipts were of a capital nature, that is, to maintain the goodwill and trade name. That contention should not succeed.

Subsequent to the agreement of the 1st June, 1959 (ASF 1, Ex. 1) the appellant carried on the business formerly that of the Palmer Co. and replaced the defective Red seal units that Palmer Co. had sold under warranty. The outlays by the appellant to replace those defective units were taken from the income derived by the appellant from that business purchased from Palmer Co. (Ex. 1, para. 18). When such outlays were made the appellant filed proofs of loss under the policy of the Law Union and Rock for repayment of such outlays, and pursuant to such policy the appellant received from the insurer the sum of $81,887.35 as an indemnity for the loss involved in such outlays, which outlays in the meantime had been debited and thereby deducted from the income derived by the appellant from its business (Ex. 1, para. 18). As the sum received was a payment for items debited to income, it would appear that such sum received should, by cross entry in the same account, show that the previous outlays had been paid and were no longer a deduction from income. That was the practice adopted by the appellant, as payments of $61,080.37 made by the insurer up to the 30th November, 1960, were included by the appellant in its income for the respective taxation years (Ex. 1. para. 20), and the sum of $81,887.35 was included in the earned surplus account of the appellant and was therefore liable as taxable income.

The appellant contends that, although those monies received from the insurer were credited to the earned surplus account of the appellant, nevertheless that should not be taken as an admission for the reason that "There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the

figure that is arrived at by means of the test": *The Glenboig Union Fireclay Co., Ltd. v. The Commissioners of Inland Revenue*[3], by Lord Buckmaster at p. 464 and cited in *Van Den Berghs Ltd. v. Clark (Inspector of Taxes)*[4], by Lord Macmillan at p. 888. Therefore the credit of the sum to earned surplus should be taken not as an admission of the quality but only as to the amount of the receipt.

Whether a sum is taxable income is a mixed question of law and fact; of law to determine if the facts constitute taxable income within Sections 2 and 3 of the *Income Tax Act*, with other incidental legal problems, such as the meaning of the written agreement (Ex. 1, ASF 1) and also a question of fact, as stated in *Parsons-Steiner, Ltd. v. M.N.R.*[5], where Thurlow J. at p. 1151 said:

> What appears most clearly from these cases is that the question is largely one of degree and depends on the facts of the particular case and the inferences to be drawn therefrom . . .
>
> In *Kelsall Parsons & Co. v. Inland Revenue* (1938) (21 Tax Cas. 608), Lord Normand (Lord President), said at p. 619: ". . . no infallible criterion emerges from a consideration of the case law. Each case depends upon its own facts . . .".

The Court may not be bound by error in an admission by the parties as to the law and such an error appears corrected in the *Glenboig* case, *supra*, but the amount received, the parties paying and receiving and the circumstances surrounding the payment, as for example, payment by an insurer pursuant to a policy, are questions of fact, and in proof of such facts the admissions of the parties, including entries in their books, are relevant evidence of which the weight is for the Court.

Hence the entry of $81,887.35 to the credit of earned surplus is evidence of the fact that that sum was received by the appellant and was in fact credited to earned surplus. As the onus is upon the appellant to prove error, therefore the appellant must demonstrate that the sum should be taken as received on account of goodwill or trade name and not credited to earned surplus. That the appellant has failed to do. The appellant has not established that the outlays by it to replace Red seal units were for capital assets of goodwill and trade name.

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[3] (1922) 12 T.C. 427.
[4] [1935] All E.R. Rep. 874.
[5] 62 DTC 1148.

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Under the agreement of 1st June, 1959 (ASF 1 of Ex. 1) the sale and purchase on the one hand, and the appellant's promise to pay the warranties on the other hand, are in separate and distinct contracts and are separate transactions although contained in the one document. The sale of the business is contained in Clauses 2 and 5 (ASF 1) whereby Palmer Co. transfers its assets in the business (Clause 2) and the appellant pays the creditors of Palmer Co. as set forth in Schedule 3 and to Palmer Co. the sum of $75,000.00 as the excess of the value of the assets over the claims of the creditors in Schedule 3. Those are the values exchanged and the mutual considerations of the sale and purchase as declared in Clauses 2 and 5 and expressly declared in the opening words of Clause 5, "The consideration to be paid by Palmer 1959..." The promise by the appellant to assume the liability under the warranties given by Palmer Co. is contained in Clause 3 (ASF 1) which reads:

> IT IS UNDERSTOOD AND AGREED that Palmer 1959 shall assume liability for payment of all current liabilities of The Company shown on Schedule 3 and shall honour and make good all guarantees and warranties of The Company given by the Company concerning products, manufactured and sold by The Company.

In Clause 3 the appellant assumes liability for "current liabilities" of Palmer Co. "shown on Schedule 3" but that is a mere repetition of the like provision in clauses 2(d) and 5(a), and as such, is part of the consideration for the sale of the business and not part of the following promise of the appellant to assume the warranties. The following promise to honour and make good all guarantees and warranties given by the company (Palmer Co.) concerning the products manufactured and sold by the company, is a separate and distinct transaction from that included in the previous sale.

(1) That promise is not part of the consideration given by the appellant for the purchase of the business; the warranties given by Palmer Co. are not included in Schedule 3. The liabilities under those warranties could not be foreseen at the time of the agreement but were then future and contingent, and only arose as breach later occurred and claim made; moreover the amount of the liability under each warranty would depend upon the outlay later required in replacing the

particular window which had proven defective. On the other hand, the liabilities of Palmer Co. which are included in Schedule 3 and assumed by the appellant as part of the consideration for the purchase of the business were then definite in amount and were paid in advance to the appellant by conveyance of assets of Palmer Co.

(2) Clause 3 (ASF 1) contemplates a future loss in making good such previous warranties of Palmer Co. There could be no legal loss contemplated by the sale and purchase in Clauses 2 and 5. The purchase may be improvident but there could be no legal loss when the promised considerations are made good. On the other hand Clause 3 expresses no consideration as does Clause 5. Under Clause 3 the transaction is similar to *the warranty alleged given in Heilbut, Symons & Co. v. Buckleton*[6], where Lord Moulton at P. 47 said:

> It is evident, both on principle and on authority, that there may be a contract the consideration for which is the making of some other contract. "If you will make such and such a contract I will give you one hundred pounds," is in every sense of the word a complete legal contract. It is collateral to the main contract, but each has an independent existence, and they do not differ in respect of their possessing to the full the character and status of a contract.

Hence here in consideration of Palmer Co. entering into the agreement to sell in Clauses 2 and 5 whereby the appellant would receive the policy of insurance issued by Law Union and Rock, the appellant undertook to honour and make good the warranties of Palmer Co. concerning the products manufactured, and as an indemnity for such outlays the appellant would have received, under Clause 2 (ASF 1) the policy of the Law Union and Rock. The result is that Clause 3 (ASF 1) intended that the liability of Palmer Co. in respect of such warranties be passed over to the appellant, but the appellant was intended to pass such liability over to the insurer as a loss under the policy in question. When a claim was later made by a customer for breach of warranty given by Palmer Co., the appellant would make the outlay for such breach under Clause 3 (ASF 1) which is not part of the purchase price of the goodwill and trade names, as stated in Clauses 2 and

[6] [1913] A.C. 30.

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5 (ASF 1) but being for such breach of warranty, is in performance of that separate contract and distinct transaction contained in Clause 3 (ASF 1).

Further, the appellant, after replacing a Red seal unit warranted by Palmer Co., would file proof of loss claiming under the policy but the policy indemnifies only for loss from breach of warranty of the Red seal units (ASF 3). That claim to be indemnified for loss under the policy cannot be a loss in respect of the goodwill or a trade name, for such items are not within the subject matter of the insurance. Again, any replacement of a unit by the appellant in honouring or making good the warranty of Palmer Co. would be a sale by the appellant to the customer in consideration of the promise by the insurer under the policy. That again would appear to be a sale of a Red seal unit and within the course of business of the appellant in manufacturing and selling Red seal units and therefore properly included in the taxable income of the business.

The fact that such monies are received under the policy of insurance is not material in that insurance monies are treated as income when paid to make good, loss of income: *The King v. B.C. Fir & Cedar Lumber Co., Ltd.*[7], and *J. Gliksten & Son, Limited v. Green*[8].

The appellant also contends that there can be no income as the monies received from the insurance company do not permit any profit, that is the insurance company indemnifies only for the loss, and under Clause 3 of the policy (ASF 3) the loss is computed on the basis of the bare cost for manufacture, delivery and installing; and as there was no profit to the appellant in such payments by the insurance company, therefore there was no income. That objection should not succeed. The issue is the amount of the income of the taxpayer for the taxation year in question (Sec. 2(3), *Income Tax Act*) "from all sources" (Sec. 3, *Income Tax Act*); that is, the total of all income for the taxation year from the business (Sec. 3, *Income Tax Act*) less permitted deductions (Sec. 2(3) *Income Tax Act*). That is not determined by merely taking the total of all profitable items. Assuming there is no profit in replacing a unit warranted by Palmer Co., that does not preclude the sum received from the insurer for such outlay being included in the "taxable income" for the taxation year

[7] [1932] A.C. 441.

[8] [1929] A.C. 381.

(*Income Tax Act*, Sec. 2) otherwise advertising or club entertaining, which produced no profit, would be excluded. The fact that a particular item produces no income is irrelevant: *Royal Trust Co. v. M.N.R.*[9]

As to the further sum of $12,500.00, an action was brought by the appellant against the insurer (ASF 4 and 5) and a counterclaim raised by the insurer (ASF 6) for return of all monies paid to the appellant. That action and counterclaim were settled as follows:

(1) By agreement of the 1st February, 1962, between Palmer Co. (as Philex Sales Ltd.) and the appellant (ASF 8) whereby Palmer Co. agreed to pay $12,-500.00 by reducing payments to be made by the appellant (Clause 2) and the appellant agreed to have the insurer give a general release to Palmer Co. (Clause 5) as a condition of the agreement (Clause 6), and Palmer Co. agreed to give the insurer a general release (Clause 7).

(2) By agreement of 28th May, 1962, between the insurer and the appellant (ASF 9) the Law Union and Rock agreed to pay $90,000.00 and the appellant released the insurer from all liability under the policy.

In arriving at the settlement of $90,000.00 with the insurer, the appellant considered not only the amount of the proofs of loss and the estimate as to the possible future claims, but also "other considerations including uncertainty as to outcome of litigation" (Ex. 1 para. 32). Casey (for the appellant) has testified that if the counterclaim of the insurer succeeded, it would have been ruinous to the appellant. It is evident that the basis of the claim against Palmer Co., settled at $12,500.00, is the defect in title of Palmer Co. to the policy issued by the insurer, Law Union and Rock, by reason of Palmer Co. having allegedly not disclosed material facts, and also by reason of the notice of cancellation of the 26th May, 1959, whereby the policy expired after 30 days (Ex. 1, paras. 15 and 16). After the alleged non-disclosure of material facts and after the notice of cancellation of the 26th May, 1959, Palmer Co. on 1st June, 1959, assigned the policy to the appellant and obtained the undertaking of the appellant

[9] [1956-60] Ex. C.R. 70 at p. 80.

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contained in Clause 3 of the agreement (ASF 1) which was unlimited in point of time. It therefore appears, particularly from Item C, para. 32, Exhibit 1, that the payment of $12,500.00 was made in respect of the sums which the appellant would probably fail to collect from the insurer by reason of the non-disclosure and the cancellation of the policy. Therefore, in substance, Palmer Co. is paying the $12,500.00 on account of the monies which would otherwise have been payable under the policy. If the monies had been paid under the policy they must have been credited to the income derived from the business, and a sum agreed to be paid for loss of income is equally regarded as taxable income: *Burmah Steam Ship Company, Ltd. v. The Commissioners of Inland Revenue*[10]; *M.N.R. v. Bonaventure Investment Co., Ltd.*[11]; *The Commissioners of Inland Revenue v. The Northfleet Coal and Ballast Co., Ltd.*[12]; *Bush, Beach & Gent, Ltd. v. Road (H. M. Inspector of Taxes*[13]); *Wiseburgh v. Domville (H. M. Inspector of Taxes*[14]); *M.N.R. v. Farb Investments Ltd.*[15].

In conclusion the appellant has failed to establish any error in the assessment or re-assessment under appeal and the appeal is dismissed.

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[10] (1930) 16 T.C. 67.
[11] 62 DTC 1083.
[12] (1927) 12 T.C. 1102.
[13] (1939) 22 T.C. 519.
[14] (1953-56) 36 T.C. 527.
[15] 59 DTC 1058.