Victoria 1965

Apr. 22, 23

July 19

BETWEEN:

SEABOARD ADVERTISING CO. LTD. ....APPELLANT;

AND

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

*Income tax—Federal—Income Tax Act, R.S.C., 1952, c. 148, s. 12(1)(a), (b)—Capital outlay—Purchase of business of competitor—Consideration attributed to uncompleted contracts deductible as expense or non-deductible as capital expenditure.*

By an agreement made in 1959 the appellant, an outdoor advertising display company, purchased the business and goodwill of a competitor for $230,000, of which $100,000 was allocated to service contracts then in force with customers.

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

In 1960 and 1961 appellant company sought to deduct amortized portions of the $100,000 paid for the customer contracts. The portions so amortized were disallowed by the Minister as being in the nature of capital expenditures within the meaning of s. 12(1)(*b*) of the *Income Tax Act*. The Tax Appeal Board upheld the assessments.

On appeal to this Court the company argued that the $100,000 was a deductible expense under the Act.

*Held*, that the $100,000 was a capital outlay, the deduction of which was prohibited by s. 12(1)(*b*).

1. That although a price tag was placed on the various assets acquired the agreement clearly stated that the aggregate amount was the consideration for the transaction. It was the intent of appellant to purchase the business of the vendor as a going concern.

2. That the transaction was the purchase of a business, an enduring asset and not the purchase of severable disparate parts.

3. That the $100,000 paid by appellant for the customer contracts was not part of the cost of carrying on a business but part of the cost of acquiring a business.

4. That the appeal was dismissed subject to the assessment for 1960 being varied in accordance with the agreement arrived at between counsel regarding legal and audit fees.

APPEAL from a decision of the Tax Appeal Board.

*C. W. Brazier, Q.C.* and *J. G. Watson* for appellant.

*John G. Gould* and *T. E. Jackson* for respondent.

NOËL J.:—This is an appeal from the decision of the Income Tax Appeal Board[1] dated December 16, 1963, dismissing the appellant's appeals from its income tax assessments for 1960 and 1961 whereby amounts of $12,274.36 and $21,041.66 for the respective years which had been deducted by the taxpayer, were added to its income.

The appellant, a Vancouver, B.C. corporation, was then, and still is, engaged in the business of outdoor advertising by means of poster panels (10 by 2 feet in size, where the copy of advertising material is produced on paper and then pasted on the surface of the panel) and bulletins (10 by 50 feet in size where the advertising message is hand-painted on panels which are then installed in the location) and gets its business by dealing either directly with advertisers or through advertising agencies. The land or the sites upon

[1] 34 Tax A.B.C. 182.

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

Noël J.

which these boards or posters are erected are rented from their owners for varying amounts and periods of time, a matter of negotiation in each case by the appellant's sales agents. Footings are then installed on back braces and then panels are set up with mouldings and electric fixtures. The contract entered into with the advertisers states the length of time the contract is to run, the size and number of panels involved, whether or not it is through an agency, whether or not the panels are illuminated. The normal services rendered during the term of the contract are to insure that proper lighting and structures are maintained and that the bulletins are repainted whenever necessary.

The appellant, in 1959, purchased the assets and the business of a competitor, a corporation called Signkraft Advertising Limited, the second largest in the area after the appellant, because according to the appellant's president, Mr. Don Norris Finlayson, it was difficult to obtain sites at the time. Amongst the assets purchased was a class related to uncompleted bulletin advertising contracts. The appellant submitted that the payment for the acquisition of this class should be deductible under section 12(1) (*a*) of the Act as an expenditure incurred "for the purpose of gaining profit". The respondent, on the other hand, refused deduction on the ground that the payment was a capital expenditure under section 12(1) (*b*) of the Act. The appellant also objects to a net amount of $1,724.35 added to its taxable income for the year 1960 which the taxpayer had deducted, and which represented audit and legal fees, regarding acquisition of business from Signkraft Advertising Limited ($2,000) less *pro rata* portion attributed to inventories and accounts receivable, i.e., $275.65 to which amount the parties agreed at the hearing should be added the sum of $869.60, thus forming a total of $1,145.25 instead of $1,724.35. I assume that this amount was disallowed as an expense on the basis that it related to the capital used in the business.

By an agreement (Ex. A-2) dated September 28, 1959, but effective as of July 31, 1959, the appellant purchased from Signkraft Advertising Limited, as indicated in the preamble of the deed "the business and goodwill of the vendor and the property and assets of the vendor hereinafter set forth..." for the sum of $230,000 (which, accord-

ing to clause 9 of the agreement was "the aggregate consideration for the assets sold hereunder" [herein called the "total price"]):

| | |
|---|---|
| Machinery, equipment and for billboards leased under location leases | $31,500 |
| Inventory | 2,700 |
| Work in progress | 2,200 |
| Customer contracts | 100,000 |
| Location leases | 10,000 |
| Investment | 1,800 |
| Trade accounts | 26,800 |
| Goodwill | 55,000 |
| | $230,000 |

As a matter of fact, the only items the appellant did not purchase were an oil burner, certain amounts due from employees, prepaid expenses, an advance to a director and the real estate consisting of an office factory building which, however, the appellant took over by lease for five years for the purpose of using it but which was not used and was subsequently sublet by the appellant.

With regard to the factory building, the appellant's managing director was asked if the premises had been leased for the appellant's own activities and answered:

> A. Well, at the start we thought that we possibly may run Signkraft as a division but after a short time it became evident that this was not justified so we brought the equipment and everything out back into our own factory and then sublet Signkraft...

The transaction, however, as appears in the above listed items, comprised the goodwill of the Signkraft business as well as a prohibition for the latter to operate in Canada an advertising business for a period of ten years, as set down in clause 7 of the agreement and an undertaking by the vendor that a similar prohibition shall be obtained from its president, Mr. H. V. Hartree, as set down in clause 18 of the agreement. Clauses 7 and 18 read as follows:

> 7. The Vendor doth hereby bargain, sell, assign, transfer and set over unto the Purchaser all of the goodwill attaching to and forming part of its business as a going concern not hereinbefore sold to the Purchaser, including all the Vendor's right in and to the trade name "SignKraft", with the full and exclusive use and benefits and advantages thereof (herein called the "goodwill and name" to hold the unto the Purchaser, its successors and assigns, to and for its and their sole and only use forever, for the consideration of Fifty-five thousand dollars ($55,000), and the Vendor covenants and agrees with the Purchaser that within one month after the execution of these presents it will cause its corporate name to be changed to some name dissimilar to "Signkraft Advertising Limited" and that it will not either by itself or in partnership or in conjunction with any other

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

Noël J.

person or persons, or as agent for any other person, firm or company, for a period of ten (10) years from the date of the execution of these presents, either directly carry on or engage in or be concerned in, in Canada, the business of outdoor advertising.

18. Forthwith upon the execution hereof the Vendor shall cause H. V. Hartree to execute an agreement with the Purchaser whereby he covenants that he will not either by himself or in partnership or in conjunction with any other person or persons or as agent for or employee of any other person, firm or company, for a period of Ten (10) years from the date of execution hereof either directly or indirectly carry on or engage in or be concerned in, in Canada, the business of outdoor advertising.

I might point out here that although, as hereinabove indicated, the appellant had the right to the name "Sign-Kraft" it neglected to properly protect it and eventually lost it to a competitor.

The assets purchased were all incorporated with the appellant's. The equipment was used by the latter until it no longer was useful although there may still be one piece of equipment in operation. The investment of $1,800 was sold. Upon the acquisition by the appellant of the assets of SignKraft, a SignKraft division was created within the appellant's corporation and an attempt was made to account for revenue and expenses of that division as a separate one dealing not only with the uncompleted SignKraft contracts but also with others negotiated by Seaboard under the name "SignKraft Division". This division, however, did not run to the end of the appellant's fiscal period but only from the period August 1, 1959, to February 29, 1960, i.e., seven months after which, as put by the appellant's secretary Mr. Guy James Lewall, (cf. p. 91 of the transcript) "we dumped everything back into the Seaboard accounts and carried on".

Exhibit A-4 comprises a list of the 53 customer contracts purchased by the appellant for the sum of $100,000 and indicates that these contracts, as of July 31, 1959, had a total unearned contract value of $230,709 although the appellant received over the period covered by the unexpired contracts, an amount of $205,764 only due to the fact that some of these contracts did not actually mature such as, for instance, the Blackwall Ferries contract, where the structure blew down and could not be re-erected and one other firm which went into bankruptcy and where a loss was sustained. The difference, however, between the $100,000 expended for these contracts and the $205,764 received

was not clear profit as the appellant, as appears from Ex. A-5, was required to pay the rent on the locations as well as power and other expenditures in a total amount of $77,-649.19 during the unexpired terms of the contracts and the profit on these contracts would be further reduced if a proper allocation of overhead was applied to them. The commencement date of these 53 contracts vary but some started in 1956, 1957, 1958 and 1959 and some expired in 1959, 1960, 1961, 1962, 1963 and even 1964. As a matter of fact, these 53 contracts by their terms expired as follows:

(1) 26 within one year; value $28,252.50

(2) 12 within from one to two years; value $75,354.50

(3) 9 within from two to three years; value $29,673

(4) the remaining 6 within four to five years; value $97,429.

There are in addition 17 renewal contracts (cf. Ex. R-1) of a value of $83,325.19 which with the 53 contracts total $314,034.19. It may also be of some interest to note that of the 53 advertisers, three only had remained with the appellant at the time this appeal was heard (April 1965), the others, according to the president of the appellant, having elected to use other media (cf. p. 69 of the transcript).

The vendor guaranteed the value of the above contracts to be not less than $200,000 and the contract provided for adjustment of the sale price in the event that the total failed to amount to the figure guaranteed.

The two amounts of $12,274.36 for 1960 and $21,040.66 for 1961 which the respondent refused to deduct were the amortized portion of the amounts paid to SignKraft Advertising Limited for these customer bulletin advertising contracts, which portion had been determined by an arbitrary allocation obtained by spreading evenly the income obtained from these contracts over a period of five years at the rate of 1/60 per month.

It appears from the above that although a price tag was placed on the various items purchased by the appellant to make up the aggregate amount, the agreement document clearly states that such aggregate amount is the consideration for the assets sold and further indicates that the intent of the purchaser was clearly to purchase the business of the vendor.

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

Noël J.

Should I have any doubts in this regard, the evidence of the appellant's president, Mr. Don Norrison Finlayson at pp. 67, 80 and 81 of the transcript would dispel them:

p. 67:

Q. Would it be that you were buying the whole business except those personal matters such as loans from employees to the former SignKraft Company, the title to the real estate, other than that you took them over lock, stock and barrel, to use an informal phrase?

A. We bought the assets of the company.

pp. 80-81:

Q. I made a suggestion to you there and I am going to make the same suggestion to you here that you acquired virtually all that was required for a complete signboard business from SignKraft. I use the word "virtually" because we know you did not acquire some things. Let's look at the list now, which is on page 2 of the notice of appeal. You got everything, even the good will for $55,000 00?

A. Yes.

Q. Now, would you agree with me that you did acquire virtually a total operating business from SignKraft?

A. Yes, but we didn't purchase the actual plant, the visible factory.

MR. GOULD: That is covered in the contract.

Q. You also in the acquisition contract made a contract that you would keep secure the employment of every employee except Hartree himself. Perhaps I should show you that.

A. Yes, we did.

...

Q. At any rate you took over in toto the personnel as well except Hartree?

A. Yes.

It is also of some importance to note that the appellant company in purchasing the business and the goodwill of SignKraft and by prohibiting this company, and its president Mr. Hartree, from operating as an advertising firm in Canada for a period of ten years obtained a near complete domination of the market with the exception of the David Hall firm. This appears also from the transcript at p. 69 where the president of the appellant corporation, in cross-examination, stated as follows:

Q. Now, in 1959 when you acquired this business you achieved an overwhelming domination of the market all except for David Hall?

A. Yes.

Q. And would that put you in—I am groping for a figure, 90 to 10, your old complex of the old Seabord and SignKraft, put you in ratio with David Hall?

A. Possibly, yes.

Q. How long did that situation prevail or do you still have an overwhelming share of that particular market?

A. Yes, we do.

Q. Still roughly about the same, 90 to 10?
A. Yes.

The appeal, as already mentioned, involves consideration of section 12(1) (*a*) and (*b*) of the *Income Tax Act* which reads as follows:

12. (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

The issue here is whether the payment of $100,000 made by the appellant to SignKraft Advertising Limited, in the above described circumstances, is deductible under the above section. There are in effect two questions which arise here: (1) was the expenditure of $100,000 (subsequently amortized for the years 1960 and 1961) made for the purpose of gaining or producing income and (2) if it was so made, was such payment an allowable income expense or was it a capital outlay?

Turning to the facts of the present case it is clear that the payment of $100,000 and its amortized portions made by the appellant was for the purpose of gaining or producing income from its business as the income of the appellant is derived from renting sites, obtaining advertisers, erecting thereon advertising boards and to earn this income it must obtain the sites, the advertisers and erect the signs. The appellant in purchasing these unexpired contracts was obtaining thereby the means by which it earned its income and carrying on the object of its business as set down in its memorandum of association (Ex. A-1) in paragraphs (*a*) (1) and (*b*) thereof which read as follows:

(*a*) (1) To carry on a general advertising and commercial display business in all its branches, both as principals and agents;

. . .

(*b*) To purchase or otherwise acquire, manufacture, sell, lease or otherwise deal in, erect, construct, equip, maintain, and operate advertising and other signs illuminated by electricity...

Indeed, whether its means of earning its income was obtained by sending out sales agents to advertisers or dealing with the latter directly at its office, or by purchasing a number of unexpired advertising contracts in bulk, it, in all of these cases, was expending money for the purpose of gaining or producing income from its business.

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

Noël J.

The only point, therefore, remaining is whether the sum so expended is a capital outlay which would be prohibited from deduction within the meaning of section 12 (1) (*b*) of the Act.

The appellant takes the position that the true reason for the purchase made herein was the acquisition of the location leases and that for such purpose it was willing to purchase, in addition to the sites, that portion of the business and goodwill of SignKraft which would readily or conveniently be amalgamated with its own business. Its counsel admitting that although, in fact, the appellant acquired substantially all the business of SignKraft with the exception of a few assets, urged that what must be considered here is what was intended by the agreement, perusal of which he says will show that the real intention was to sell certain assets only upon which prices were placed and that although mention of an aggregate consideration is made in section 9 of the agreement, this merely means that a total of a number of individual items was arrived at for each of which, however, a separate consideration was intended by the parties. This, according to the appellant, is supported by the fact that this is the way the respondent has treated this transaction in allowing the appellant to depreciate the machinery equipment and billboards valued at $31,500, to charge off the inventory at $2,700 and the work in progress at $2,200 and by allowing capital cost allowance for the location leases or the sites at $10,000 whereby the appellant was allowed to write this amount off over the length of the unexpired term of the leases.

The appellant further submitted that whatever was acquired in the nature of acquiring the whole business of SignKraft and for getting rid of a competitor, were paid by the payment for the goodwill in the amount of $55,000 which, of course, was treated as a capital payment.

The argument advanced by the appellant that the true reason for the purchase was the obtention of the sites covered by the 53 contracts, can, however, hardly be accepted in view of the fact that a total of $230,000 was paid and the value attached to the sites by the appellant itself was only in the amount of $10,000. Mr. Don Norrison

Finlayson, president of the appellant, was examined on this point at pp. 79-80 of the transcript:

Q. That was your motivation. Have you any explanation or do you think it necessary to have paid $230,000 for a group of assets when all you really wanted was one valued at ten.
A. I don't know the reason.

In effect, the appellant achieved far more than the acquisition of sites in this transaction, it indeed obtained the elimination of its main competitor thereby gaining a virtual monopoly of the market as well as a number of unexpired contracts, half of which cover more than one accounting period with renewals of same and even possible renewals of renewals, as appears from the evidence of the appellant's president at p. 74 of the transcript:

Q. Of course that doesn't mean the end, what I have in my hand (mind) that doesn't mean the end of these contracts because there would be renewals of renewals in some instances.
A. M'hm.
Q. And there are still three running?
A. Yes.

The appellant here cannot therefore take the position that these contracts were of a limited duration as all these things are, in my view, of a very enduring nature and constitute something which was well worth paying $230,000 for.

Indeed, the object and effect of the payment of this large sum was clarly to obtain for the appellant a substantial and lasting advantage of being in a position through its business life to insure and retain its virtual monopoly of the market as well as an endurable (which does not mean perpetual) advantage or benefit in the long term contracts obtained.

It therefore appears to me that a correct appraisal of the agreement entered into by the appellant with SignKraft, is that by this transaction a business as a going concern was bought as an enduring asset rather than a purchase of severable disparate parts.

There can in effect be no doubt in this regard if proper consideration is given to the following: the agreement recites that the purchaser has agreed to purchase a business and its goodwill as well as the right to the trade name SignKraft; from July to September 1959 the vendor carried on the business as the agent of the purchaser; the vendor

1965

SEABOARD ADVERTISING CO. LTD. v. MINISTER OF NATIONAL REVENUE

Noël J.

as well as its president undertook not to carry on in Canada the business of outdoor advertising for a period of ten years; the purchaser leased the vendor's real property for five years; the purchaser undertook to employ in its service all the present officers and employees of the vendor with the exception of its president, Mr. H. V. Hartree.

The appellant finally took the position that there is essentially no difference between sending out salesmen to acquire contracts, charging the costs thereof to operations or going to an agency such as SignKraft which had accumulated contracts and purchasing them in block for a price and that these 53 contracts purchased are similar to the 1,200 existing contracts of the appellant corporation which, of course, cannot be considered as a capital asset.

It is indeed difficult to see why work in progress in an amount of $2,200 which is simply customer contracts before the display is actually put on the bulletin board or the preliminary work done in order to erect the necessary advertising pursuant to the contract, was allowed by the Minister as a deductible expense and customer contracts disallowed as both deal with the same situation, the work in progress being merely one step back in the same operation. In the work in progress stage, the contract has been obtained but the sign has not been painted nor erected, but it still forms part of the customer's contract which will come into being and from which revenue will be derived at some date in the future.

The difficulty here is that because the contracts so purchased represent the services the appellant renders and sells as a business and the expenditure of $100,000 paid for these contracts bears a fair comparison with a monetary charge on the business production of a given year in view of the definite accounting periods during which these contracts respectively mature and produced income, they could, therefore, be treated as analogous to stock in trade. However, it would seem that it is not possible to treat them as such, where they are acquired by an expenditure made in the process of purchasing a business with the consequent procurement of endurable benefits such as we have here. Such an expenditure must be considered not as part of the cost of carrying on a business, but as part of the cost in

acquiring a business. In *City of London Contract Corporation Limited* v. *Styles*[1], which decision was rendered in 1887 and which was referred to in *John Smith & Son* v. *Moore*[2] by Lord Sumner as never having been questioned, and where a company acquired a business including unexpired income producing construction contracts, that part of the purchase price being allocated to the cost of these contracts was not permitted to be deducted from profits on the basis that it was not deductible as it was part of the capital invested in the business.

It therefore follows that unfortunately for the appellant herein, and until such time that either the general prohibition on the deduction of capital expenditures in section 12(1)(*b*) of the Act is repealed or that deduction of an expenditure such as here is allowed under the capital cost allowance regulations of the Act, deduction of same shall have to be refused.

Subject to the assessment being varied in accordance with the agreement arrived at between counsel regarding audit and legal fees in the amount of $1,145.25 instead of $1,724.35 being added to the appellant's income for the year 1960, the appeal is therefore dismissed with costs.

[1] 2 R.T.C. 239.