Vancouver
1968
Feb. 7-9
Feb. 21

BETWEEN:

TERMINAL DOCK AND WAREHOUSE COMPANY LIMITED . . APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE . . . . RESPONDENT.

Income tax—Subsidiary selling parent's shares to group employees—Contracts for purchase of shares sold to bank at discount—Whether discount deductible—Whether subsidiary in finance business—Income Tax Act, s. 85E(1).

Under a scheme to permit a company's shares to be purchased by its employees and the employees of its subsidiaries, of which appellant was one, appellant (a wharfage company) purchased shares of the parent company at market price and sold them at that price to employees of the parent company and its various subsidiaries over a period of years on certain terms which included an option by the parent company to re-purchase the shares and the payment of interest by the purchasers at 2½% per annum on the balance owing each year.

In 1963, when the amount owing by purchasers of shares was $4,680,631, appellant (which was about to become a public company) sold the purchase agreements to a bank at a discount from their face amount to ensure that the bank would receive interest at 5% per annum on the amount paid. Appellant company sought to deduct the amount of the discount, $292,811, in computing its income.

Held, the amount of the discount was a capital loss and not deductible by appellant.

1. The shares were capital, the relationship between appellant and the employee-purchasers being that of vendor and purchaser and not that of lender and borrower. *Frankel Corp. Ltd. v. M.N.R.* [1959] C.T.C. 244; *Ted Davy Finance Co. v. M.N.R.* [1965] 1 Ex. C.R. 20, referred to.

2. Appellant did not carry on a finance business with respect to the shares since its transactions with respect to them were not for the purpose of gain even though interest was payable on the balance outstanding under the purchase agreements. Hence s. 85E(1) did not apply to enable appellant to treat its agreements with employee-purchasers as inventory of a finance business. Moreover, s. 85E(1) does not permit deduction of a loss sustained on sale of inventory. *Smith v. Anderson* (1880) 15 Ch.D. 247; *Samson v. M.N.R.* [1943] Ex. C.R. 17, referred to; *Irrigation Industries Ltd. v. M.N.R.* [1962] S.C.R. 346; *M.N.R. v. Taylor* [1956-60] Ex. C.R. 3; *M.N.R. v. Curlett* [1967] S.C.R. 280, distinguished.

INCOME TAX APPEAL.

J. G. Alley and *P. N. Thorsteinsson* for appellant.

D. G. H. Bowman and *G. V. Anderson* for respondent.

SHEPPARD D.J.:—In this appeal the appellant contends that the discount charged by a bank in 1963 on the appellant's assignment of certain receivables should be allowed as a deduction from income under sections 85E(1) and 139(1)(*w*) of the *Income Tax Act,* R.S.C. 1952, c. 148 and amendments; on the other hand, the Minister contends that the discount is a loss of capital and not deductible from the taxable income. That is the issue. The facts follow.

The International Milling Company (IMC) of Minneapolis, Minnesota, one of the United States of America, and founded about 1880 as a private company with the objects of milling flour and manufacturing formula feed, has had as subsidiaries Robin Hood Mills Ltd. which (Robin Hood) has, as a subsidiary, the appellant, a British Columbia company incorporated by memorandum. IMC has had also as subsidiaries a Montreal company and a Venezuela company.

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IMC was founded and controlled by Mr. Bean who died about 1930 and was succeeded by his two sons, Francis A. Bean and Atherton Bean, and later by a grandson, John Boynton Bean, one of whom has been president of IMC and of the appellant at all material times. About 1920 the founder decided to admit selected employees of IMC or of one of the subsidiaries, as shareholders of IMC, and that selection was carried out as follows.

The executive committee of IMC would request the executive committees of the subsidiary companies to submit the names of employees who should become shareholders and from that list the executive committee at Minneapolis would approve certain employees and from that approved list the selected employees were ultimately chosen by one of the Bean family. Then the agreements would be entered into.

Exhibit A-3 contains typical examples of agreements outstanding in 1963, namely, No. 589 dated the 26th May, 1947, succeeded by 29th March, 1956; No. 657 of the 4th August, 1948 succeeded by 29th March, 1956; and No. 732 of the 28th September, 1949 succeeded by 29th March, 1956. Each agreement provides for the purchase from the appellant of shares of IMC, the payment by installments over 15 years with interest of 4½%, or 2½% if dividends up to 65% were applied in payment, the pledge of the shares as security and an option back to the vendor.

As business grew and employees increased in number, Robin Hood Mills Ltd. was used to purchase the shares and resell to the employees selected, and later the appellant was substituted for Robin Hood.

By agreement of the 3rd January, 1938 (Ex. R-5) Robin Hood assigned to the appellant all the outstanding agreements to purchase shares and the sums to be paid thereunder subject to the option of repurchase to the Bean family. That substitution made the appellant liable potentially over to Bean for $315,000 which grew in amount to $345,000. That liability arose in that under the respective agreements with the employees the appellant had an option to repurchase the shares at the book value whereas Bean or a foundation held an option over the appellant to repurchase such shares at a fixed price which was less than the book value and resulted in a potential liability of the appellant for the difference.

By agreement of the 24th January, 1938 (Ex. R-6) between the appellant and Francis A. Bean, that potential liability was to be written off over a period of 12 years and by agreement of the 20th August, 1948 (Ex. R-4) the price to Francis A. Bean for his option to repurchase from the appellant was made the equivalent of the appellant's option to purchase from the shareholders.

The parties proceeded in that manner until 1963 and in each year the executive committee at Minneapolis would have the executive committee of the various subsidiary companies select employees as candidates to be shareholders of IMC and these were reviewed by the executive committee of IMC with final selection by one of the Bean family. A day for completion was then fixed and the price of the shares was taken at the book value of the shares on that day. The appellant was notified of such date, the number of the employees purchasing and the amount of the money which the appellant would need to pay for the shares to be and also under successive options from the employee shareholders drawn and signed, and which agreements would ultimately be signed and sealed at Vancouver by the appellant. The appellant would purchase and pay IMC for the shares, the shares would be issued to each employee selected and each employee shareholder would assign and send the share certificate to Minneapolis pursuant to his agreement to give security thereon to the appellant by pledge for the amount payable including interest. The keeping of the share certificates at Minneapolis was merely a matter of convenience. Throughout the same Bean who was president of IMC was also president of the appellant, and also under successive options from the employee shareholder to the appellant and from the appellant to Bean or a foundation, the ownership of the share could revert to the Bean family or a foundation on the shareholder ceasing to be an employee.

The money required by the appellant to purchase such shares was obtained by the appellant selling its own shares to the extent of $2,700,000 and any additional funds required were borrowed from IMC as appears in Exhibit A-6. When a dividend was declared by IMC each employee shareholder was asked to sign a Dividend Disposition Order (Ex. R-1) and if he applied at least 65% of the

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dividend in payment of his purchased shares and interest he was charged 2½% for that year on the outstanding balance, otherwise 4½%.

In 1956 the time for payment by the individual shareholders was extended for 15 years as it was found that by reason of the income tax, some employee shareholders had difficulty in paying the shares within the original 15 years.

In 1963 IMC decided to become a public company, and it was thought preferable not to have the indebtedness of the employee shareholders shown as an asset of the company, as it must appear in a consolidated balance sheet. There was then outstanding, as owing by the employee shareholders, the sum of $4,680,631.60 (Ex. A-2) contained in 819 agreements between the appellant and 355 employees of which employees, 234 were in the United States of America, 108 in Canada, and 13 employees of the Venezuela company. At the time of the discount agreement with the Bank (8th July, 1963, Ex. R-8) the appellant had only two employees with outstanding agreements and the remainder were employees of other companies, either of IMC or of another subsidiary. Thereupon it was decided to sell the agreements between the appellant and the employee shareholders to the First National Bank of Minneapolis, and that was eventually done pursuant to agreement dated 8th July, 1963 (Ex. R-8).

As the agreements by the employee shareholders provided for interest at 2½% (with the possibility of 4½%) the Bank demanded such deduction from the nominal amount owing as would permit it to receive 5% on the price paid. That was eventually agreed to. That discount (being $794,377.80 U.S. funds) with certain offsets, admitted by the appellant, resulted in a net loss of $292,811.40 (Canadian funds) (Ex. A-2).

The appellant contends that the transactions with the employee shareholders were a finance business carried on by the appellant in which business the agreements with the employee shareholders were receivables and inventory, within section 85E(1) as extended by section 139(1)(*w*), therefore there was a loss which should be deducted from the income. On the other hand, the Minister contends that such discount allowed the Bank was a capital loss and not within sections 85E(1) or 139(1)(*w*), and being a capital loss was not to be deducted from income.

The appellant contends as follows:

2. In the years 1963 and prior the Appellant carried on two businesses, being those of wharf operators in the City of Vancouver and the operation of what was referred to in evidence as "the participation business".

3. The latter business consisted of financing the purchase of International Milling Company stock by employees of International Milling Company, Robin Hood and subsidiaries of Robin Hood including the Appellant itself. The financing was effected by the Appellant acquiring blocks of International Milling Company stock from that company for cash and re-selling to the employees on credit terms.

4. The shares were re-sold to employees at the same price as that at which the Appellant had purchased them but while the Appellant paid cash in buying the shares from International Milling Company, it re-sold to the employees on contracts providing for payment of the price by them over a period of fifteen years with interest on the unpaid balance at 2½%. The employee assigned his stock to the Appellant as security for his debt obligation and commonly applied a percentage of the dividends he received on his stock on account of the principal and interest of his debt obligation to the Appellant. The Appellant had at all times until five years after termination of employment the right to re-acquire the shares from the employee upon payment of a formula price the result of which was that any growth in the equity value of the shares during the time it was owned by the employee accrued to him.

* * *

6. The business of financing the share purchases as above described required the Appellant to be regarded as a money lender engaged in such business of financing. Its business in this regard was essentially that of a finance company, analogous to the common form of business carried on by companies engaged in financing purchases of consumer durable goods such as automobiles, appliances and furniture.

To come within section 85E(1) the appellant must prove, amongst other things, "a business" and that the agreements sold to the Bank were "the property included in the inventory of the business". The appellant concedes the shares in the agreements between the appellant and the employee shareholders were capital, that is, the appellant was not in the business of dealing in shares. The business of a dealer in shares, such as that of a broker, may be *ultra vires* of the memorandum (Ex. A-1) of the appellant, leading to those results in *Sinclair v. Brougham*[1]. However that may be, as the shares were capital, then it is difficult to see how the proceeds thereof, the purchase monies, could be other than capital: *Frankel Corporation Limited v. M.N.R.*[2], *Ted Davy Finance Co. Limited v.*

[1] [1914] A.C. 398. [2] [1959] C.T.C. 244.

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M.N.R.[3]. That difficulty the appellant seeks to avoid by contending that the relation between the appellant and each employee shareholder was exclusively that of lender and borrower and not that of vendor and purchaser. That contention is not made good.

The agreement No. 732 of 28th september, 1949 (Ex. A-3) is a typical agreement and refers to the appellant as "Vendor" and the other party as "Employee" and reads: "WITNESSETH: 1. Shares Sold by This Agreement. The Vendor hereby sells to the Employee 400 shares of the common capital stock of International Milling Company", etc., "2. Purchase Price—Payments of Principal and Interest. the Employee hereby purchases said shares subject to the reservations and conditions as herein set forth and agrees to pay the Vendor therefor the sum of $10,485.40", etc. "4. Collateral Security. The Employee shall keep pledged to the Vendor and in the Vendor's possession to secure the payment of any unpaid balance of the purchase price and interest", etc. "7. Vendor's Options to Purchase Stock." which provides in substance an option to the Vendor to repurchase within 5 years of the Employee ceasing to be an Employee.

A similar relation is indicated by the agreement of 29th March, 1956 (Ex. A-3) which extends the time for payment for an additional 15 years.

It therefore follows that the typical agreements indicate that the transaction between the appellant and the employee's that of vendor and purchaser.

In contrast thereto the appellant contends that it was carrying on a financing business, the equivalent of an automobile finance company. In such instances there are two contracts, one between the purchaser and the dealer which provides for payment by the purchaser and a reservation of title to the dealer as security for payment (a conditional purchase), and the second, the assignment by the dealer of the monies payable and the property reserved as security to the automobile finance company, generally with a guarantee by the dealer. The appellant also contends that it carried on a financing business like the loans

3 [1965] 1 Ex. C R. 20; [1964] C.T C 194

by a household finance company but there the individual borrows on the security of a chattel mortgage on his own property.

Here the relationship between the appellant and the employee shareholders is indicated to be that of vendor and purchaser.

(1) The agreements in question (Ex. A-3) declare:—

(a) that the relationship between the appellant and each employee shareholder is that of vendor and purchaser. The agreements do not refer to them as lender and borrower;

(b) that the debt arises by reason of the purchase price of the shares purchased, hence the relationship is not declared that of lender and borrower nor is the debt declared to arise from a loan.

(2) The agreements in question contain an option to the appellant to repurchase the shares in the event of the employee shareholder ceasing to be an employee. That option can be explained in the sale of the shares to the employee as an attempt to keep the shares in the hands of employees only, but no form of security for a loan commonly provides that upon the borrower repaying the loan and interest, the lender will have an option of repurchasing the subject-matter of the security.

(3) The agreements provide for the appellant having a pledge as security for the purchase price of the shares. That is not the form of security by the financing businesses referred to by the appellant. A pledge may be the common security for a pawnbroker, but it is not argued that the appellant was in business as a pawnbroker nor is that tenable.

On the appellant's contention the appellant was carrying on two businesses, namely, (1) that of a dock and wharfage company and (2) the financing business, but the alleged financing was not a business and hence not within Section 85E(1).

The definition of "business" in Section 139(1)(*e*) does enlarge the usual term "business" by the words "an adventure or concern in the nature of trade", but that enlarge-

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ment and its tests as seen in *Irrigation Industries Limited v. M.N.R.*[4] and in *M.N.R. v. Taylor*[5], have no application here, as the appellant must contend for a "business" with an "inventory", and hence the appellant is required to prove a "business" in the usual meaning of that term. That definition is as follows: In *Smith v. Anderson*[6] Jessel, M.R. stated at p. 258:

> That is to say, anything which occupies the time and attention and labour of a man for the purpose of profit is business.

and at p. 260:

> ... and I have no doubt if any one formed a company or association for the purpose of acquiring gain, he must form it for the purpose of carrying on a business by which gain is to be obtained.

In *Frankel Corporation Limited v. M.N.R., (supra)*, Martland J. quoted from *Californian Copper Syndicate v. Harris*[7] and stated at p. 255:

> Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?

In *Samson v. M.N.R.*[8] Thorson P. stated at p. 33:

> ... "the pursuit of a trade or business" involves the pursuit of gain or profit.

and see *M.N.R. v. Spencer*[9].

The transactions between the appellant and the employee shareholders were not for the purpose of gain. There was no intention of making a profit on the sale of the shares as those were sold at the same price as the appellant purchased from IMC. The contention is that the profit was in the interest charged and therefore to be a business the alleged financing business must have been carried on for the purpose of making a profit from the interest charged on monies lent.

The interest is taxable under section 27(1) because it is interest, not because it is a profit derived from "business" nor from the sale of "inventory" as required by section 85E(1). Therefore the fact of interest being taxable does not denote such interest necessarily arises from "business" or from the realizing of inventory; interest is not an absolute test of "business" or of "inventory".

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4 [1962] S.C.R. 346 at p. 352.

5 [1956-60] Ex. C.R. 3; [1956] C.T.C. 189.

6 (1880) 15 Ch. D. 247.

7 (1904), 5 T.C. 159.

8 [1943] Ex. C.R. 17.

9 [1961] C.T.C. 109 at p. 133.

In any event, the appellant's charging of interest to the employee shareholders does not indicate that the appellant entered into a finance business for the purpose of making such a profit by that interest—or that the transactions with the employee shareholders were for a profit from the interest. The interest charged was 2½% if the purchasing employee applied dividends up to 65%, otherwise 4½%. That rate of interest charged was initially the prime rate in Minneapolis but shortly thereafter the prime rate exceeded that charged and in Vancouver where the appellant kept its account in U.S. funds for the purpose of receiving these payments and also for the purpose of purchasing from IMC, the prime rate always exceeded that charged the purchasing employee. If a financing business had been carried on to produce a profit it would be expected that the appellant would have charged at least the prime rate, that is, the going rate, nevertheless the appellant has charged throughout the same rate even when that was less than the prime rate, the reason being, of course, to prevent discriminating against employees. The profit arose by reason of the circumstance that $2,700,000 was raised by the appellant selling its shares and only the balance as needed was borrowed; for borrowed monies the appellant paid interest at a higher rate than that charged to the purchasing employees. Accordingly, the profit is shown by charging only interest paid on the money borrowed but not showing any interest on the $2,700,000 realized from the sale of shares. By such method a profit could have been shown on paper if even a lesser rate than 2½% had been charged. Exhibit A-5 shows the interest income to be $2,183,945.83 and the interest expense, that is, on monies borrowed, $733,853.88. Exhibit A-6 shows the amount of average daily borrowings of the appellant from IMC and the rate of interest paid. The transactions between the appellant and the employee shareholders could not have been undertaken by the appellant for the purpose of gain from the interest charged the employee because:—

(1) The option with the employee shareholder at the book value and the option over to Bean at a stated price would result in a liability immediately of $315,000, later increasing to $345,000 and only later wiped out by Bean (Ex. R-6 and Ex. R-4).

(2) The fixed interest in the agreement between the appellant and the employee shareholder (2½% with a possibility of 4½%) was less than the prime rate at Vancouver, B.C. where the appellant did its banking. The real purpose of the sale of the shares was therefore not profit from the interest charged. There was no profit over the prime rate of interest.

(3) The real purpose of selling shares in IMC to employees of IMC and of a subsidiary was to benefit the employees thereby benefiting the employer company, thereby ultimately benefiting those controlling IMC. But only two of the appellant's employees were shareholders of IMC at the time of the sale to the Bank, therefore there could have been no real or substantial benefit to the appellant through its buying and selling shares in IMC and certainly no such profit as would permit the inference that it was conducting a business, and particularly a financing business.

As the appellant was not carrying on a financing business, therefore by the sale to the First National Bank it was not "ceasing to carry on a business or part of a business" within section 85E(1), nor were these agreements sold to the First National Bank of Minneapolis "included in the inventory of the business" within section 85E(1).

M.N.R. v. Curlett[10], relied upon by this appellant, is distinguishable on the facts; there Curlett "patently was in the money lending business" and here the appellant was not in the money lending business.

Further, as the shares were capital, therefore the purchase price receivable from the employee shareholders was equally capital: *Frankel Corporation Limited v. M.N.R.*, (*supra*). Hence the appellant was selling and the Bank was purchasing a capital asset, therefore the price paid by the Bank resulted in a capital loss to the company, but such a loss is excluded by section 12(1)(*b*).

Section 85E(1) provides for the enlargement of taxable income by the inclusion of the sale of inventory referred to but does not provide for a deduction from taxable income. Therefore there is nothing in section 85E(1) to permit a

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[10] [1967] S.C.R. 280; [1967] C.T.C. 62.

deduction as is contended for by the appellant or to qualify the prohibition of deduction contained in section 12(1)(*b*).

The question whether or not the transactions between the appellant and the employees of other companies were *intra vires* of the appellant was not formally raised nor is it now decided.

In conclusion, the loss complained of by the appellant was a loss of capital and should not be deducted from the income as contended by the appellant.

The appeal is dismissed with costs.