BETWEEN:

GABCO LIMITED ..... APPELLANT;

AND

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

Winnipeg 1968
Apr. 23
Ottawa
May 21

Income tax—Remuneration of employee—Salary and bonus proportionate to shareholding—Whether amount reasonable—Income Tax Act, s. 12(2).

Appellant, a construction company, remunerated its manager and eight other permanent employees, who held 73% of the issued capital stock of the company, in a manner commensurate with their estimated value to the company, by a modest salary plus a bonus proportionate to shareholding. The remaining 27% of the issued capital stock was held in trust for the manager's minor brother, who was not an employee. In 1962 appellant employed the manager's brother with a view to his becoming the manager's principal assistant under the above arrangement as to remuneration. In 1962 he was paid $851 salary and $19,520 bonus for three months' work, and in 1963 he was paid $5,280 salary and $30,393 bonus for a full year's work. In computing appellant's income for those years the Minister, applying s. 12(2) of the *Income Tax Act*, disallowed as an expense remuneration paid the manager's brother in excess of $3,600 in 1962 and of $7,200 for 1963 on the ground that remuneration paid him in excess of those amounts was not reasonable in the circumstances.

Held, allowing the appeal, the evidence as to the considerable value of the services of the manager's brother indicated that his remuneration was reasonable in all the circumstances. It is not for the Minister or the court to substitute its judgment as to what is reasonable remuneration. The question is rather whether a reasonable business man would have paid such an amount having only business considerations in mind.

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In fixing the remuneration at the outset appellant was not restricted to the value of the employee's immediate services but might have future benefits in mind.

INCOME TAX APPEAL.

Walter Newman, Q.C. for appellant.

F. J. Dubrule and *J. M. Halley* for respondent.

CATTANACH J.:—These are appeals from the appellant's assessments to income tax for its 1962 and 1963 taxation years which coincide with the calendar years.

The appellant is a joint stock company incorporated pursuant to the laws of the Province of Manitoba by letters patent dated June 15, 1960, under the name of G. A. Baert Construction (1960) Ltd. By supplementary letters patent dated September 29, 1965, the corporate name was changed to Gabco Limited as is recited in the above style of cause.

The purpose of the incorporation of the appellant was to purchase and carry on a general construction business previously carried on by G. A. Baert Construction Co. Limited. This predecessor company was begun by G. A. Baert who was an immigrant from Belgium with no academic training beyond the equivalent of grade V, but he was a skilled carpenter. He founded the company of which he was the president and general manager and from 1950 forward until 1960 he was assisted in its management by his eldest son, Jules.

The company became one of the five largest and most successful construction businesses in the City of Winnipeg. In every year of its operation it earned a profit in excess of $100,000 and built some of the most imposing edifices in the City of Winnipeg such as the Great West Life Building, the Norquay Building which is a Provincial Government building, some of the buildings of the University of Manitoba and many other buildings.

The father, G. A. Baert was predominant in the management of the company's affairs but came to rely heavily upon his son Jules for assistance who gradually assumed the predominant role.

In 1960 the father suffered a severe coronary attack. Therefore the appellant was incorporated of which Jules became the major shareholder and president and managing

director. By an agreement dated January 1, 1961, the appellant purchased all the assets of G. A. Baert Construction Co., Ltd. and assumed all its liabilities for a total purchase price of $1,243,223.41. The assets so purchased included all contracts, work in progress and accounts receivable to the total value of $1,158,152.32 and the liabilities assumed were in the amount of $841,899.55.

The subscribed and paid up capital of the appellant in 1962 was $500,500 of which $500,000 was for fully paid preferred shares and $500 was for fully paid common shares.

The shareholders were as follows:

	Preferred	Common	Value
Jules Baert	24,300	243	$243,243.00
Robert Baert	12,200	122	122,122.00
John Jackson	5,000	50	50,050.00
Geo. F. Chaput	2,000	20	20,020.00
Alfred Giavendini ..	1,500	15	15,015.00
William A. Balgals ..	1,000	10	10,010.00
Laugi Helgason	1,000	10	10,010.00
Eugene S. Mager ..	1,000	10	10,010.00
Robt. M. Sutton	1,000	10	10,010.00
Romer N. Verrier ..	1,000	10	10,010.00
	50,000	500	$500,500.00

At the inception of the appellant there appears to have been 50 fewer preferred shares issued, but I would assume that they were issued in the interval. The foregoing proportions as above outlined remained constant throughout the taxation years under review.

The sole managerial responsibility in this highly competitive business fell upon Jules Baert. He assumed responsibility for estimating competitive bids to be made for contracts, the purchasing of materials and the supervision of sub-trades and labour relations. If a bid were too high it would be unsuccessful and if it were too low, and it were accepted as would be likely, then disaster would result. In his view he was unable to delegate any of his responsibilities. The next senior employee was John Jackson, who is described as a certified engineer by which I assume is

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meant a person without the academic qualifications of professional engineer but with practical experience. In Jules Baert's opinion Mr. Jackson's capabilities were limited to actual job supervision and he was not qualified by temperament or otherwise to undertake management duties.

When the appellant was organized it was decided as a matter of policy that employees of a permanent nature should be allowed and invited to participate in share ownership undoubtedly as an incentive to greater efforts to further the progress of the appellant. It was also decided as a matter of policy that the extent of share ownership of each particular employee would be limited to a proportion commensurate with that employee's contribution to the welfare of the appellant company. All employees agreed to participate in this arrangement and the implementation thereof is reflected in the list of shareholders and holdings which I have set out above.

The remuneration of the employee-shareholders as listed above was also the subject of a special and somewhat unusual arrangement. Each employee was paid a comparatively modest salary but at the end of each fiscal year a bonus was declared and divided among the employees proportionate to their share ownership. The total of the salary and the share of the bonus constituted the annual remuneration of the employees. I might add that in certain material tendered in evidence, I have observed that the shareholders also received dividends which I presume were declared on the preferred shares although there was no evidence adduced to that effect.

By an agreement dated March 9, 1961, among all the shareholders, Walter C. Newman as trustee for Robert Baert and Elaine Baert and the appellant it was agreed that in the event of termination of the employment of any shareholder, whether voluntarily or involuntarily, other than Jules Baert and the trustee, the shares of that holder should be offered to the other employee-shareholders *pro rata* to the number of shares held, but if any shares so offered are not acquired then those shares would be acquired by Jules Baert. It was also agreed that no additional shares would be issued without the concurrence of all shareholders.

The only shareholder of the appellant who was not an employee at the time of the issue and allotment of shares was Robert Baert, the youngest son of G. A. Baert and a younger brother of Jules.

G. A. Baert subscribed and paid for 12,200 preferred and 122 common shares in the appellant which were held in trust for Robert Baert and his sister Elaine. On January 1, 1962, G. A. Baert arranged that Elaine's shares should be purchased by Robert and the proceeds were used to purchase a revenue bearing property for Elaine thereby affording her a secure income and absolving her from any participation in the contracting company, the appellant. Therefore as at January 1, 1962, Robert became the beneficial owner of all of the shares indicated and for the purposes of these appeals he may be considered as the registered owner which he did in fact become on July 6, 1964, after reaching his majority.

It is quite obvious that G. A. Baert, who was faced with the prospect of imminent death, was making provision for the future of his children during his lifetime.

He advanced funds to Jules which were used by him to acquire controlling ownership of shares in the appellant and all indications were that Jules' success was assured. He had made provision for Elaine so that only Robert's future remained to be considered.

As a child of 10 and onwards through the years he had been temporarily employed in his father's construction businesses in a variety of minor jobs.

In 1960 or thereabouts, he served as "the eyes and ears" of Jules in connection with the construction of Edinburgh House, a $1,600,000 project in a position of nominal subservience to the superintendent on the site. His responsibility was to "finish up" each suite prior to its occupancy which duty he discharged to the satisfaction of his brother and father.

In 1961 he failed his year at St. Paul's College for the second time and was denied admittance to a school in the United States. His academic career was not successful but neither was that of his brother Jules who had failed first year Arts and first year Engineering at University before entering his father's business at age 19.

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Meanwhile Jules, who wished to delegate some of his onerous duties was looking for a number two man, and he saw that man in his brother Robert. Since Jules was willing to accept Robert, the father then arranged for the transfer of Elaine's shares to his brother Robert.

As a step in Robert's preparation for his proposed status in the appellant to which he would be entitled by his share ownership he was employed by the appellant's legal advisors at a monthly salary of $50.00 to learn some of the legal aspects of the construction business.

In October 1962 at the age of 19 Robert entered into full time employment with the appellant at a monthly salary of $300 and participation in the bonus arrangement on the basis of his shareholding with the tacit concurrence of the other shareholders.

His first assignment was as assistant superintendent on the construction of the Winnipeg City Hall, the cost of which was in excess of $6,000,000. The building was completed ahead of schedule and when the building was "closed in" Robert went on to other duties. While at the City Hall site he made innovations in masonry construction which resulted in the speeding up of construction at a substantial saving. Here again he acted as "the eyes and ears" of his brother Jules or as liaison between the site and the office. He was given the title of assistant superintendent as a matter of discretion in deference to age and experience of the superintendent with whom some difficulties were beginning to be encountered.

In 1962 the appellant performed gross contracts in the amount of $4,203,621.09 and in the year 1963 in the amount of $7,800,724.41.

The net profits of the appellant in those two years were respectively $191,131.96 and $211,531.45.

In 1962 salaries and bonuses were in the amount of $128,770.09 and in 1963 in the amount of $173,981.86.

In the year 1962 Robert received $851.39 in salary and $19,520 as bonus for a total remuneration of $20,371.39 which he reported as income and paid tax thereon.

In the year 1963 he received $5,280 in salary and $30,393 as a bonus for a total remuneration of $35,673 which he reported as income and paid tax accordingly.

In assessing the appellant as he did for its 1962 and 1963 taxation years the Minister did so on the assumption set out in his reply to the Notice of Appeal, that

(a) during its 1962 and 1963 taxation years the appellant paid to Robert Baert on account of salary the following amounts:

Year	Months employed	Total salary paid	Average salary per month
1962	3	$20,371.39	$6,790.46
1963	12	35,673 00	2,972.40

(b) the extent to which the salary paid to Robert Baert was reasonable in the circumstances, was as follows:

1962 ..... $1,800 00
1963 ..... 7,200.00

The Minister, therefore, concluded that the deductions claimed by the appellant in respect of an outlay or expense on account of remuneration paid to Robert Baert in 1962 and 1963 for the purpose of gaining income from its business were not reasonable in the circumstances, within the meaning of section 12(2) of the *Income Tax Act* to the extent that they exceeded the sums of $1,800 and $7,200 during the appellant's 1962 and 1963 taxation years.

The Minister re-assessed the appellant by adding back to the appellant's income the amount of remuneration paid to Robert Baert in excess of $3,600 in 1962 (which amount is at variance with the amount of $1,800 set out in the Notice of Reply) being $16,771.39 with the result that the disallowance increased the appellant's tax for that year by $8,553.40 plus $833.62 in interest. Similarly for the year 1963 the Minister added back to the appellant's income for that year, the remuneration paid to Robert Baert in excess of $7,200 being $28,473 which increased the appellant's tax by $14,521.24 plus $811.67 in interest.

Section 12(1)(*a*) of the *Income Tax Act* provides 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.

Subsection (2) of section 12 provides:

> (2) In computing income, no deduction shall be made in respect of an outlay or expense otherwise deductible except to the extent that the outlay or expense was reasonable in the circumstances.

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The appellant contends that the payment of remuneration to Robert Baert was made in the ordinary course of the business of the appellant and was an expense incurred for the purpose of gaining income. This the Minister does not dispute.

The appellant further contends that the remuneration paid to Robert in the taxation years in question was reasonable in all the circumstances, which contention the Minister does emphatically dispute, and herein lies the crux of the issue between the parties.

In support of his submission that the remuneration received by Robert in 1962 and 1963 was unreasonable in the circumstances, counsel for the Minister specifically pointed out Robert's extreme youth, his academic failures, that his compensation for the six months' work he did for appellant in 1961 (i.e. the finishing of Edinburgh House) was only $1,409.80, that he worked for the appellant's solicitors in 1962 for $50 per month and that his remuneration for the last three months of 1962 as assistant superintendent on the construction of the Winnipeg City Hall, was far in excess of that received by John Jackson, the general manager of the appellant and superintendent on that job.

The portion of the remuneration received by Robert in 1962 and 1963 allocated to salary was exceeded by every other employee-shareholder. However the bonus portion of his remuneration in those years based upon share ownership greatly exceeded that of every other employee-shareholder excepting his brother Jules (see Exhibit 9).

I can see no legal impediment to the appellant basing the greater bulk of the remuneration paid to its employees who were shareholders upon a declared bonus in successful years divided among them *pro rata* according to their shareholdings. This was the understanding and agreement on which those employees (including Robert Baert) entered the employ of the appellant. Under ordinary corporate principles I should have thought the same result could have been accomplished by the declaration and payment of dividends on the common shares except that the amount of the dividends declared and paid would be income in the hands of the appellant and taxable accordingly rather than deductible as an expense laid out to earn

income. However it was not raised in argument nor in the pleadings that the appellant was precluded from making the arrangement that it did with its employees.

The ultimate test as to when a payment is *intra vires* a company is when what is done is done *bona fide,* within the ordinary scope of the company's business and reasonably incidental to the carrying on of the company's business for the company's benefit and advantage.

Long ago Bowen L.J. said in *Hutton v. West Cork Co.*[1]:

> A company which always treated its employees with Draconian severity,... would soon find itself deserted.. The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.

The arrangement between the appellant and its employees to pay bonuses according to their shareholdings was, in my view *bona fide,* within the scope of the appellant's business and incidental to the carrying on of that business for the appellant's advantage. I should think that it is for the appellant, through its directors, to decide that such an arrangement was in the interests of the appellant subject only to the limitation that it is reasonable in the management of the appellant's affairs.

The Minister did not attack the arrangement for bonus payments *per se* as being unreasonable, but only the payment to Robert Baert on the grounds that such payment was not commensurate with the value of his services and contribution to the appellant.

The allocation of shares by the appellant to its employees was predicated upon an evaluation of the contribution that each employee would make to the appellant's benefit based upon the performance of such employees in the predecessor company. As intimated before, the only exception to the allocation of shares on such basis was Robert Baert who was not an employee of the appellant at that time. He obtained his shares in the circumstances outlined above that is as a consequence of the purchase of them by his father as a provision for Robert's future and in the contemplation of his eventual participation in the affairs of the appellant subject to his brother Jules' concurrence. It was a term of Robert's

[1] (1883) 23 Ch. 654.

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employment by the appellant in October 1962 that he would participate in any bonuses *pro rata* according to his shareholding and this was with the full approval of his brother Jules and the tacit approval of the other shareholders. It therefore follows that Robert's remuneration by way of bonus would have been the same as it was regardless of the value of his services to the appellant.

For the reasons above indicated, I am of the opinion that the arrangement for the payment of bonuses to the employees of the appellant *pro rata* to their shareholdings is *intra vires* the appellant, that the scheme was a reasonable one within the competence of the appellant or its directors to make and accordingly the bonuses as a whole qualify as a deductible expense within the meaning of section 12(1)(*a*) of the *Income Tax Act*.

However, in my opinion, the Minister is entitled to consider the salaries and bonuses paid individually and separately (he is not restricted to considering the bonuses "in toto") and to enquire if the remuneration paid to Robert was out of proportion to the value of his services to the appellant and if so to disallow the disproportionate part on the ground that such payment was really a distribution of taxable profit in the guise of remuneration for services rendered. On the other hand, reasonable remuneration should not be interfered with.

The greater bulk of the evidence adduced on behalf of the appellant was directed to demonstrating that the value of the services performed by Robert justified the remuneration paid to him.

Jules Baert testified that the services performed by Robert, even from the outset of his employment, were such as could not be performed by any of the other employee-shareholders including the most senior one, John Jackson who held the title of general manager. It was Jules Baert's plan that Robert would serve as backup man to himself and relieve him of much of his responsibility. Even from the beginning of Robert's employment he was with his brother constantly rendering whatever assistance required of him. His initial assignments were on the sites of the appellant's projects to act as an energetic driving force to bring each project to its scheduled completion on or before

the date thereof in which he was successful. While his title may have indicated subservience to the superintendent on a particular job, nevertheless, he was in reality the senior person because of the direct channel between him and his brother.

In 1964 the appellant engaged Profit Counselors Inc. a firm of management consultants to review and advise upon its organizational structure, to evaluate its personnel as well as to install systems of integrated costing and estimating. Arthur Firus, an officer the consultants engaged, conducted the review and his opinion confirmed that of Jules' that Robert was in fact the number two man in the appellant and was functioning as such at that time. His recommendation was that Robert should be confirmed in that position in name as well. This recommendation was implemented and John Jackson was discharged.

Mr. Firus testified in glowing terms of the efficiency and success of this brother team. In his opinion it was the best he had ever encountered. I am conscious of the fact that the opinion of Mr. Firus is self-serving to a certain extent. His employer sold its services to the appellant by solicitation. His recommendations supported the facts as he found them with respect to personnel and with organization as had been instituted by Jules in the top level of management. I cannot disabuse my mind of the impression that the consultants were engaged as a prop to rid the appellant of its general manager who was the nominal number two man and replace him with Robert as was done. However, it is clear from Mr. Firus' evidence that he found the brother team had been extremely successful and had worked harmoniously and that such success was reflected in the continued success of the appellant. I also accept the testimony of Mr. Firus that the salary of the second senior officer of a construction company is normally 70 per cent of that of the senior officer. The remuneration that Jules received in 1962 was approximately $48,000. The remuneration of the second officer on that basis would be approximately $32,600. In 1962 Robert received $20,371.39 made up of $851.39 in salary and a bonus of $19,520 which is less than 70 per cent of the salary of the senior man but I have not overlooked the fact that he was only employed for three months in that year. The explanation for such high

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remuneration for this short period of employment is his proportionate part of the bonus based on his shareholding.

In 1963 Jules received a remuneration of $57,626. Seventy per cent of that figure would be $40,334 and Robert received $35,673 as remuneration.

I have no difficulty in concluding that Robert's remuneration in 1963 was reasonable in all the circumstances.

By means of a graph and working backwards Mr. Firus expressed the opinion that Robert's salary in 1962 on his worth to the appellant would have been about $10,000. The working of such a projection backwards was not explained to my satisfaction. However Jules saw in his brother, Robert, great potential which foresight was demonstrated by subsequent events to have been well founded. While I have no doubt that the likelihood of Robert being employed by the appellant had he not been Jules' brother and G. A. Baert's son was remote and if it were not for the fact that he owned 12,200 preferred and 122 common shares in the appellant, his remuneration in 1962 would not have been $20,371.39, nevertheless, in view of his contemplated status in the appellant company, which he subsequently fulfilled, it cannot be said that his contract of employment with the appellant and the consequent remuneration was unreasonable in all the circumstances. I might add that subsequent to the reorganization of the appellant in 1964, the share bonus arrangement with its employees was abandoned, the shares of the employees other than Jules and Robert were acquired by them so that Jules and Robert held all issued and outstanding shares equally.

It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind. I do not think that in making the arrangement he did with his brother Robert that Jules would be restricted to the consideration of the service of Robert to the appellant in his first three months of employment being strictly commensurate with the pay he would receive. I do think that Jules

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was entitled to have other considerations present in his mind at the time of Robert's engagement such as future benefits to the appellant which he obviously did.

Accordingly, it cannot be said, in view of all the circumstances, that the contract of employment here in question was not a reasonable one actuated by reasonable business considerations and to the ultimate advantage and benefit of the appellant.

It follows that the appeals herein are allowed with costs.