THE McGILL LAW JOURNAL

VOLUME 5 | 1959 | NUMBER 3

CAPITALIZATION OF UNDISTRIBUTED CORPORATE PROFITS

With particular reference to:
Section 105 of *The Income Tax Act,* Chapter 148, Revised Statutes of Canada, 1952.

Harold Buchwald, B.A., LL.M.*

I. INTRODUCTION

The enactment of legislation by the Parliament of Canada in 1950 and 1951, amending The Income Tax Act of 1948 to permit of tax-free distributions of profits by corporations to their shareholders was hailed at the time by some as the biggest step yet in the direction of providing relief to over-taxed citizens in one of the more populated categories of tax assessment. It was labelled a partial solution to what has been called "the high cost of dying" and, along with concurrent legislation,[1] it was a concrete measure to reduce somewhat the process of double taxation of corporate income in Canada.

That it in fact provides relief to the individual taxpayer in these two areas where inequitable and potentially ruinous tax laws existed previously, there can be no doubt. The effect of the legislation is therefore to be welcomed. But the adaptation of the individual corporate situation to bring the company and its shareholders as taxpayers within the four corners of the taxing statute that they may be properly entitled to these advantages is a complex, delicate and intricate manoeuvre requiring a full understanding of corporation and tax law. For the

*Of the Manitoba Bar; lecturer in Corporations at the Manitoba Law School, University of Manitoba.

[1](a) Section 38 — Dividend tax credit of 20% of certain dividend income received or deemed to be received by the taxpayer from taxable corporations resident in Canada; appeared as Section 35 of the 1948 Income Tax Act and in the taxation years 1949 to 1952 the maximum rate of credit was 10%. This was amended to the present 20% for the 1953 and subsequent taxation years.

(b) Section 28(1) — A corporation which is resident in Canada may claim a deduction in respect of dividends received from certain other corporations. The purpose of this section is to reduce the number of taxes on the same corporate earnings.

benefits that accrue are as a result of a curious blending of the tax and company jurisprudences and where they overlap or are inconsistant, it is the law of the method (i.e. Company Law) with its demands of perfect performance by the corporate entity which must govern, no matter what the purpose or intent of the tax legislation may have been.

Carried a step further, it will be seen that even although the tax law provides a certain benefit if the company's corporate acts achieve a designated effect, where that effect is frustrated by inadequacies at company law the taxing legislation, hovering like an omniscient plagne on all "income", may pounce upon the taxpayer affected by the technical flaw to claim its tithe.

This blending has been the cause of considerable litigation and judicial review in the eight short years since the tax legislation received Royal Assent in 1950. Through a multiplicity of references on very similar basic facts courts in several of the provinces have been called upon to guide and direct trustees administrating estates as to which way to treat the benefits of this legislation. "Are these distributions income (for the benefit of life tenants) or are they to be added to the corpus (and ultimately to divest in remaindermen)?" is the question posed. Finding the answer has been the cause for considerable judicial unrest among many of the leading members of the bench, in both trial and appellate divisions. Diverse and not altogether consistent were their various reasons for arriving at one answer or the other, until the Supreme Court of Canada finally resolved the question on October 2, 1956.[2]

A cursory reading of the pertinent legislation, Section 105 of The Income Tax Act, R.S.C. 1952, Cap. 148, will immediately indicate that the principle enunciated is grotesquely encumbered with technical references and formulae for exempting this income from the taxable category in the hands of the shareholder. Several other sections of the Act are called into play, and the whole matter becomes very labyrinthian. For the purposes of this discussion, the writer will presume that corporate taxpayers under review are able to comply with the mathematically technical accounting and auditing requirements of the Act, and will confine himself to discussing the broader principle established, namely the placing of profits earned by a company in the hands of its shareholders, free of income tax to them, by the use of the corporate structure.

It is proposed to first examine the nature of the corporate entity, then explore the specific tax legislation, trace its origin and endeavour to understand its meaning. Several of the Estate income-or-capital decisions will be reviewed to indicate the most major problem yet reported arising from this legislation. And finally the applicable company law legislation will be examined to indicate some of the difficulties and pitfalls incumbent upon implementing the potential tax advantage.

[2]*Re Waters Estate* [1956] S.C.R. 889, 56 D.T.C. 1113; *Re Hardy* [1956] S.C.R. 906, 56 D.T.C. 1121, holding such distributions to be capital.

II. THE NATURE OF THE CORPORATE ENTITY

The limited Company, as we know it today, a separate entity distinct from its shareholders, whose liability in law is limited to its own assets and not those of its members, is a relatively recent actor on the stage of English law. It will celebrate its one-hundredth birthday in 1962, but this youngster has already blossomed into an integral and very much accepted commonplace feature of communal and commercial life.

A brief review of the company's origins and development will serve to better understand those features and facets under review in this study.

Prior to the enactment of the English Companies Act of 1862 — "the Magna Carta of co-operative enterprise"[3] — the law knew various commercial associations:

(a) Ordinary partnerships.

(b) Companies incorporated by Royal Charter (e.g. The Russian Company (1555); The Hudson's Bay Company (1670).

(c) Companies incorporated by special act of Parliament.

(d) Unincorporated Companies constituted by contract. These began to make their appearance in the seventeenth century when, with the growth of commerce and financial enterprise, business men joined together to share the cost of capital investment and at the same time to be in a position to freely transfer to others their interest or shares (of fixed amount) in the association. Obtaining a Royal Charter was too costly and a Special Act of Parliament was impracticable.

> It was a time when men of business began to recognize the advantages derivable from co-operation in commercial enterprise, the advantages which it offered, that is to say, on the one hand, for raising funds for the purposes of large and more or less speculative undertakings by means of contributions from a number of small capitalists ready and willing to co-operate, and on the other hand, of minimizing the risk by spreading the liability... The outcome of these commercial needs was the unincorporated company, the lineal ancestor of the ordinary company under the Companies Act.[4]

The history of these associations was a checkered one, indeed. They ran the full gamet from suffering Parliament's disfavor in 1719, when to suppress fraudulent exploitation by unscrupulous promoters, legislation was enacted to curtail and limit them, to a full recognition of the advantages of the joint stock company principle and the desirability of facilitating the association of persons in commercial undertakings by The Companies Registration Act of 1844. Although registered under this Act and regulated by it, these associations were still regarded in law as nothing but great partnerships with some special features. Their members were held liable for the debts and liabilities to the fullest extent of their personal means.

---

[3]*Palmer's Company Law* (19 edition), by A. F. Topham, K.C., Page 1.

[4]*Ibid.*, page 4.

(e) Companies "incorporated" under the Act of 1844 — This Act essentially facilitated legal proceedings and the holding of property. But it still withheld from the members the crucial feature of limited liability.

With the passage of The Companies Act, 1862,[5] we get the limited company we know today, with subsequent amendments embracing refinements adapted to the demands of commerce and contemporary thinking.

> The main object of the Act of 1862 (a masterpiece of legislation) was to throw open to all the coveted privileges of carrying on business with limited liability. The principle of the Act was to allow the greatest freedom both in the formation and the working of a limited liability company, and at the same time to ensure that those who dealt with such concerns should be informed that the liability of the members was limited... And the great boon of limited liability was secured by the insertion in the memorandum, as part of the name of the Company, the magic word "Limited" together with a clause stating that the liability of the members was to be limited.[6]

It is to be noted that Parliament was most reluctant to grant the status of limited liability to ordinary companies, although associations approximating most of the other features of the corporation existed and participated in business ventures for some two hundred years before the Act of 1862. The main concern of the legislators appears to be a desire to protect creditors — to make sure that assets would be available to them to satisfy obligations incurred by the association as such apart from the members in their respective individual capacities. Up to the time of incorporation under the Act of 1862, anyone doing business with the "company" could first assess the worth of its members and then rest assured that the law protected his claim by enabling him to proceed against them both jointly and severally if the "company" failed.

This underlying philosophy motivated the draftsmen of the Act of 1862 and their statute evidences the strongest possible attempts to protect creditors within the framework of the separate legal entity whose liability is limited. The price the shareholder had to pay for safeguarding his personal holdings through limited liability in commercial ventures was that his invested capital was permanently "locked" in the company. The money he paid for his shares of capital stock could not be returned to him by the Company, except on a winding-up or liquidation where the claims of creditors must first be satisfied. Even a return on his investment — the dividend — was required to come out of clearly ascertained profits. The shares might be sold on the market at an inflated price, but the monies representing their allotment or subscription price, or comparable assets, were to remain always in the company so that the creditor could have this protection in dealing with the company.

Provision was made in the Act for reducing or altering the capital of the company, but these measures required the sanction of the Court before they were effective, and strong penalties attach to directors in their personal capacities for improperly impairing or reducing capital in any manner. The

[5] 25 and 26 Victoria, Chap. 89.

[6] *Palmer's Company Law*, Page 8.

Courts have scrupulously guarded against such conduct in the strongest terms. *In Holmes* v. *Newcastle-Upon-Tyne Freehold Abbatoir Co.,* Hall, V.C. said:

> ...Viewed with reference to the [Companies Act, 1862] it is to my mind *perfectly monstrous* that a company putting itself forward as a company with a capital of a certain amount, in this case admitted to consist simply and solely of so much property which represents £5,000 capital divided into shares, could, immediately after commencing business under this memorandum of association, have sold three-quarters or a larger portion of this property, on the purchase and improvements of which they had absorbed all of their capital, and then said 'Now, we have nothing more to call up'. If they were entitled to do this, creditors and people who trusted them on the faith of their memorandum of association, and of there being £5,000 either to be called up or represented by property which had been acquired through the means of capital found, would be entirely deceived. *It is not denied in this case that the creditors of the company, if it should ever come to be wound-up* (and we must consider that, however solvent it may now be, it may one day be wound up) *would then be entitled to say that this division of a portion of the capital was clearly not good against them, and it must be repaid.*[7]

It was held that an unauthorized (i.e. not provided for in the company's memorandum of association or sanctioned by the Court) reduction of share capital was *ultra vires* the company and not valid.

A distribution of inventory among shareholders in exchange for their shares was held to be actually a reduction of the company's capital, not authorized by the Saskatchewan Companies Act (1920), Section 57 of which required Court sanction which was not present in this case. The Court further held that it would have been *ultra vires* the company to have given the plaintiff (who sued the other shareholders for possession) the goods in exchange for her shares as this was tantamount to a reduction of capital.[8]

Lord Wrenbury in *In re Anglo-French Exploration Co.* remarked that:

> The key to the solution of all questions as to reduction of capital lies in remembering the corporation has a duty, not to its shareholders only, but to the creditors also. On the liability side of the balance sheet will be found amongst other things, the amount of the capital paid up by the shareholders on their shares. This is an amount in respect of which the creditor has certain rights. It must not be used except for capital purposes.[9]

The editor of *Palmer's Company Law* states the underlying principle most concisely:[10]

> The general rule or principle of the Act is, that the capital of a company is not to be reduced without the sanction of the Court in any case where the rights of creditors are affected, and for this reason: the creditors of a company are invited to deal with the company on the footing of its registered capital being a reality, of the registered shareholders being liable for the unpaid portions of their shares, and of the company having received the paid-up portion capital which appears in its register and in the returns to the Registrar of Joint Stock Companies,[11] and

[7][1875] 1 Ch.D. 682, 688; 25 W.R. 505. Italics added.

[8]*Reider* v. *Sair & Sair* [1923] 1 W.W.R. 307.

[9][1902] 2 Ch.D. 845. See also *Trustee of C.E. Plain Ltd.* v. *Kenby* [1931] O.R. 75; [1931] 2 D.L.R. 801.

[10](18th. Edition), at p. 74.

[11]Similar to the annual returns to the Secretary of State under the Dominion Companies Act, and to the Provincial Secretary or Registrar of Joint Stock Companies under the various provincial companies acts.

> if this liability to pay up were released or the paid-up capital returned to the shareholders, or the creditors' security in any other manner given away or tampered with, it would seriously alter their position.

And see, also, the comment of Lord Herschell in *Trevor v. Whitworth:*[12]

> It cannot be questioned, since the case of *Ashbury Railway Carriage and Iron Co. v. Riche,*[13] that a company cannot employ its funds for the purposes of any transactions which do not come within the objects specified in the memorandum... The capital may, no doubt, be diminished by expenditure upon, and reasonably incidental to the objects specified. A part of it may be lost in carrying on the business operations authorized. Of this, all persons trusting the company are aware and take the risk. But I think they have the right to rely on the capital remaining undiminished by any expenditure outside those limits, or by the return of any part of it to the shareholders.

These provisions have been perpetuated, and perhaps improved upon in the subsequent amendments to the English Act, and consolidation Acts of 1908, 1928 and the most recent statute of 1948.[14] Similar provisions were adopted in the various Dominion and provincial companies acts, and appear currently, for example, as Sections 48 to 58 of the former, the Secretary of State being substituted for the Court as the authority to permit or deny reductions.

It is of particular significance to note that the Act of 1862 gave no recognition to the redeemable share. This unique creature does not make its appearance in the general English company law until 1929. It is, in a sense, a departure from the basic philosophy of denying to the shareholder the return of his invested capital, but on closer examination it will be seen that the fundamental principle of the utmost protection of the creditors is preserved and remains intact.

In the development of the corporate entity a method had to be found to provide for the subscription of investment capital which would not have a direct influence in the management of the company's affairs. In the closely-held corporation the method devised to attract "outsiders" was the preferred share — preferred as to dividends and as to return of capital on a winding-up but denied a vote if the company met its obligations by way of stated dividends to these shareholders. Although the legislation in most provinces, and for Dominion Companies, and in Great Britain, make no specific stipulation, the standard provision is that these shares carry voting privileges in the event that the company has been in default of dividend payments for two consecutive years. Each company may set its own rights, privileges and restrictions attaching to the preferred shares it will issue.

It would appear that as the company flourished and no longer had need of the investment capital represented by the non-participating shares, it soon became advantageous to permit a return of this eapital and a eancellation of these shares. It was well established that the company could not buy back its shares as this trafficking would have the effect of reducing or watering-down

[12](1887), 12 A.C. 409 at pp. 414-415.
[13](1875) L.R. 7 H.L. 653.
[14]11 and 12 Geo. 6, Chap. 38.

its capital. Consequently, the redeemable feature was introduced: if the company issued its preferred shares subject to the right to redeem them, it could so redeem them (that is, take them back from the shareholder on payment of the redemption price — usually their par value and perhaps a small premium on redemption) provided the redemption was made out of profits or out of the proceeds of a fresh issue of shares.

Thus, the basic paid-up capital prevails as the redemption is out of profits or out of a fresh issue of shares, and the creditor has the protection of being assured the asset value which prompted him to do business with the company remains after the redemption. At the same time the provision is a reward to the management of a company for it enables an enterprise which flourishes to return investment capital (both interested and aloof) to its shareholders.

The provisions as to redemption of preference shares were first introduced as Section 46 of the English Companies Act of 1929.[15] The power to issue redeemable preference shares had not hitherto existed except where given by special act of Parliament.[16] It had been held that shares redeemed pursuant to the provisions of this section ceased to exist and were no longer part of the company's nominal capital.[17] Accordingly, a legislative amendment was introduced in 1947 and incorporated in The Companies Act of 1948 to the effect that such redemption was not to be taken as reducing the amount of the company's share capital.[18] Section 58 of the 1948 Act corresponds with the former Section 46, with modifications of the requirements of the 1929 Act as to the power of a company, to issue redeemable preferred shares.

Redeemable preference shares first make their appearance in The Dominion Companies Act in 1924, pre-dating their English cousins by some five years. Sections 16 and 17 of Chapter 33 of the Statutes of Canada, 1924 repealed Sections 47 and 48 of the 1906 Companies Act[19] and substituted new sections therefor which were consolidated as Section 56 in the Revised Statutes of Canada, 1927. Subsection 3 of this Section reads:

> 56(3). Unless preference shares or deferred shares are issued subject to redemption or conversion, the same shall not be subject to redemption or conversion without the consent of the holders thereof.

This section is identical with Section 43(3) of the 1924 amendment. The section was expanded in 1930[20] and this expansion in turn consolidated in The Companies Act, 1934. Section 61 of the present Act (1954), setting out the terms and conditions under which a redemption of preferred shares will

[15] 19 and 20 Geo. V., Chap. 23.

[16] *Halsbury's Statutes*, Volume 11, Page 805.

[17] *Re Serpell & Co Ltd.* [1944] Ch. 233.

[18] *Halsbury's Laws of England* (3rd Edition), Vol. 6, Pages 140, 141; Section 58, The Companies Act, 1948.

[19] R.S.C. 1906, Cap. 79.

[20] S.C. 1930, Cap. 9, Section 21.

not be deemed to be a reduction of the paid-up capital of the Company was first enacted as Section 61 of the Act of 1934.[21]

The specific provisions of the various companies acts will be discussed under the heading of "The Company Law: Pitfalls of Implementation" *infra.*

III. SECTION 105 OF THE INCOME TAX ACT, R.S.C. 1952, CAP. 148: EVOLUTION AND INTERPRETATION

Section 105 of The Income Tax Act was enacted as Section 95A of the 1948 Income Act in 1950, effective from June 30, 1950. The section was enacted in order to implement Budget Resolution No. 2 introduced by the Minister of Finance on March 28, 1950:

> 2. Resolved — That in order to permit a private company to pay tax on undistributed income so that it may capitalize the undistributed income, the company may elect
> (a) to pay a tax of 15% on undistributed income held by the corporation at the end of the 1949 taxation year and
> (b) to pay a tax of 15% on undistributed income earned thereafter equal to the dividends distributed from time to time by the corporation during the period when the undistributed income was earned.[22]

This provision was passed to alleviate the situation which arises primarily from the double taxation of corporate income, such income being taxed once in the hands of the corporation and again in the hands of the shareholders when it is distributed to them. The problem becomes particularly acute in the case of closely-held "family" or "private" corporations, the growth of which has been financed, frequently, by the utilization of earnings not for payment of dividends to shareholders, but for expansion.

In such cases, where often the majority of shares were held by one individual and that person died, the double burden of succession duty in respect of the value of the capital stock at date of death (which, of course, included the value of the undistributed income in the company) and the income tax payable by the estate when the surplus profits were distributed to enable the estate to meet succession duties, was ruinous and resulted in virtual disappearance of the estate assets through taxation.

While the principal shareholder was alive and active in the business, as profits accumulated, the high rate of personal taxation discouraged their removal from the company.

> While such profits are often retained within the corporate structure for justifiable business purposes, the ultimate tax ramifications of this action are usually unfortunate, a fact which is a basic characteristic of progressive income tax rates. Where any amount representing the accumulation of several years enters the stream of taxation in a lump sum in one year, the tax payable under graduated rates will be much greater than if the same amount had been taxed in segments over a period of years. Any event, therefore, which occasions the total distribution of earnings accumulated in a corporation over a period of time brings the full shock of progressive rates to bear.[23]

[21] *The Dominion Companies Act,* 1934 Annotated, by W. S. Lighthall, Page 109.

[22] *House of Commons* Debates, March 28, 1950.

[23] J. Harvey Perry, *Taxation in Canada,* at p. 79.

In 1944 the federal government constituted the Royal Commission on the Taxation of Annuities and Family Corporations under the Chairmanship of W.C. Ives to consider this problem among other references. The Commission's report reflected their distress at this situation[24] and recommended legislation to alleviate the situation: (a) permit corporations to pay a surtax on income accumulated to 1939, upon the payment of which the remaining undistributed income should be considered capitalized and might be distributed free of tax; (b) as to post-1939 income, on winding-up or re-organization of a company the portion of undistributed income in excess of original capital returned, which was at the time deemed to be the payment of a dividend, should be reduced by 20% of the surplus so distributed.

In explaining the reasons for these recommendations, the Commission made the following statement in its report:

> Our proposal rests on two fundamental bases. The first is that the solution in respect of past years must be such that it will render to the public treasury an amount of tax approximately that which would have been received had the surplus accomodation been distributed year by year as earned. In dealing with the past we are limited by the tax structure that has been in force, and by the fact that the problem now confronting the companies with which we are concerned varies in degree according to the policies that they have followed in respect of profit distribution. We are satisfied, therefore, that the only equitable solution in respect of the past is one which will, as nearly as may be practical, place all corporations in substantially the same position. With respect to the future, with which we include the war years, we believe that the solution must rest on a recognition in the tax law of the principle that some part of the earnings of a business must be retained for contingencies and for the natural growth and expansion, and that it is, therefore, impractical, under a system of personal taxation based on graduated rates, to consider that all the earnings of the corporation eventually accrue to the shareholders as income. Some part of such earnings, we believe, should upon dissolution be considered as capital accretion, following the principle established under the British tax system.[25]

The recommendation as to pre-1940 undistributed income was adopted by an amendment to The Income War Tax Act in 1945. But the government did not adopt the second recommendation and "it was inevitable that there would someday be a recurrence of the old problem."[26]

In the years just prior to the 1950 legislation the Department of National Revenue was using the powers conferred on the Minister under Section 13 of The Income War Tax Act and Section 9(6) of The Income Tax Act, 1948 to effect tax on portions of undistributed surplus by deeming such portions to be dividends whether actually declared or paid out by the company or received by the shareholder or not. This tax was payable by the shareholder and depending on his personal bracket could be of substantial amount.

---

[24] *Royal Commission on the Taxation of Annuities and Family Corporations,* Report, Ottawa, 1945, p. 61.

[25] Quoted in *Canadian Tax Reporter* (C.C.H. Canadian Ltd.), Vol. 1, Pages 2927 and 2928.

[26] J. Richards Petrie, *The Taxation of Corporate Income in Canada,* at p. 64.

In his 1949 budget speech, the Minister of Finance forecast alleviation of the family-corporation problem, which had again become acute, and in 1950 Section 95A was passed giving private[27] corporations the right to elect to pay a tax of 15% on undistributed earnings on hand at the end of the 1949 taxation year, and to pay a tax of 15% on a portion of the surplus earned after 1949 equal to the amount paid out in dividends in each completed taxation year. The election for 1950 and subsequent taxation years could not be made unless and until the accumulated surplus to the end of 1949 had been "cleaned out". On payment of the 15% tax by the company the undistributed earnings might be capitalized and treated as capital, and hence free of tax in the hands of the shareholder on any subsequent distribution by the Company.

In 1951 Section 95A was amended to embrace all corporations and not just defined private corporations, and, at the same time, the right to elect to capitalize undistributed income earned after 1949 was denied to "subsidiary controlled corporations".[28] In the consolidation of The Income Tax Act under the Revised Statutes of 1952, the amended section appears as 105 under Part II of the Act — "Tax on Undistributed Income".

In introducing this legislation, Parliament for the first time concerned itself with the future as well as the past on this problem of undistributed corporate income.[29]

The 1950 legislation still preserved the principle that all income was taxable save for the one feature that, concurrent with the introduction of Section 95A, the definition of "dividend" in Section 127 (1) (j)[30] was amended to read:

> "'dividend' does not include a stock dividend".

Previously stock dividends had been taxed on their value as an ordinary dividend in the year received.

The crucial section, as it presently appears, is as follows:

105 (1). A corporation may elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount equal to its undistributed income on hand at the end of the 1949 taxation year minus its tax-paid undistributed income as of that time.

---

[27]Two classes: (a) Companies with no more than 75 shareholders, exclusive of employees; and (b) Companies controlled by other companies if such control was acquired after May 10, 1950.

[28]A corporation, 50% of whose issued share capital belongs to the corporation to which it is subsidiary; except a personal corporation.: Section 139(1) (aq).

[29]"If the proposed legislation did no more than take care of past surpluses, a new problem with respect to the future would immediately start developing. I think it desirable, therefore, that the present legislation should provide a comprehensive solution to the problem as a whole rather than merely deal in *ad hoc* fashion with the past": Minister of Finance, *House of Commons Debates*, March 28, 1950, Page 1218.

[30]This section currently appears as Section 139(1)(k).

(2). A corporation other than a subsidiary controlled corporation
  (a) whose undistributed income on hand at the end of its 1949 taxation year, if any, did not exceed its tax-paid undistributed income as of that time, or
  (b) which has paid the tax payable under subsection (1), may elect, in prescribed manner and in prescribed form, to be assessed, and to pay, a tax of 15% on an amount not exceeding
    (1) the aggregate of
      (A) the dividends declared by it that were paid by it in the taxation years beginning with the 1950 taxation year and ending with with the last complete taxation year before the election, and
      (B) the dividends that were, by subsection (3) of section 81, deemed to have been received by shareholders of the corporation in consequence of the corporation having paid a stock dividend in the taxation years referred to in subparagraph (A),

    except such portions thereof as, by virtue of sub-section (4) of section 81 or subsection (1) of section 141, have not been taken into account in computing income of shareholders of the corporation,

minus

    (2) the aggregate of the amounts upon which it has previously paid tax under this subsection or under subsection (2A).

Subsection 2A deals with subsidiary controlled corporations which are subsidiary to personal corporations, mentioned above.

Subsections (3) to (9) inclusive deal with the mechanical features of the election, i.e. payment of the tax with the election, the matter of deficient or excessive payment, departmental assessment of the amount of tax to be paid, deficiency of payment, the time the tax is deemed to be paid, and application of this section to the other parts of the Act relating to assessments and appeals.

Dealing, firstly, with subsection (1), the implementation requires a comparatively simple calculation. "Tax-paid undistributed income as of that time" means that portion of surplus on hand in the company upon which special tax has been paid under Part XVIII of The Income War Tax Act. This is already exempt under section 141 (1) of this Act.

Subsection (2), however, presents considerably more difficulty. Provided all of the accumulated undistributed income on hand at the end of the 1949 taxation year has been dealt with as provided in subsection (1) the company may proceed to pay a further special tax on a portion of undistributed income accumulated since the commencement of the 1950 taxation year. This portion must not exceed the amount of actual cash or stock dividends declared and paid for the period applicable, less any amounts upon which post-1949 special tax has already been paid.

In other words,

> ...a corporation must pay out one dollar of taxable 'true' dividends or stock dividends for every dollar of undistributed income upon which it proposes to pay the special tax ('the 50-50 rule'). The qualified total must be created by payment of the dividends before the end of the last complete taxation year prior to the election. For example, a company operating on a calendar year fiscal period and making a Part II election on December 1st cannot include, in computing the amount on which the 15% tax must be paid, dividends paid between January 1st and November 30th in the year of election.[31]

[31]John G. McDonald, *Canadian Income Tax*, at p. 752.

What then happens to the portion of undistributed income on which the tax has been paid? It now falls into the category of "tax-paid undistributed income" defined in the Act by Section 82 (1) (6) as being, as of any time —

the aggregate of all amounts upon which tax has been, before that time, paid by the corporation under Part II (Section 103 et seq.) or Part XVIII of The Income War Tax Act

— minus the aggregate of —

(i) deemed dividends previously paid that have not been included in computing the income of a corporate shareholder by virtue of sections 81(4) and 28(1), and deemed dividends previously paid to individuals under the tax-paid undistributed income;
(ii) all amounts of special tax paid under the two income tax acts; and
(iii) all amounts of tax-paid undistributed income previously taken into account to offset amounts of redemption or acquisition premium on shares, on which Part IIA tax would otherwise have been payable.[32]

This is, as can readily be seen, an involved, complicated formula, best left to accounting and mathematical wizards to compute and ascertain. Suffice it to reiterate that for the purposes of this study we will presume that these requirements are met and the amount of "tax-paid undistributed income" has been clearly ascertained and is not challenged.

We move to the next stage, which is to find authority in The Income Tax Act to place this tax-paid undistributed income into the shareholder's hands, free of tax to him, which, after all, was the purpose in the first place of the election under Section 105(1) and/or (2).

Section 81(3) furnishes a clue:

81(3). Where the whole or any part of a corporation's undistributed income on hand has been capitalized, a dividend shall be deemed to have been received by each of the persons who held any of its shares immediately before the capitalization equal to *the shareholder's portion of the undistributed income*[33] that was capitalized.

By Section 139(1)(ap) a "Shareholder's portion of the undistributed income of a corporation" has the meaning given to that expression by Section 82(1)(c) to wit:

A shareholder's portion of
(i) a corporation's undistributed income on hand at any time or any portion thereof, or
(ii) *a corporation's tax paid undistributed income as of any time,*
means the amount that would have been payable to him on the winding-up of the corporation at that time if the subscribed capital had been repaid and what remained to be distributed on the winding-up were an amount equal to the undistributed income on hand at that time, the portion of it or the tax-paid undistributed income, as the case may be.[33]

This suggests that the shareholder's portion of the undistributed income is that amount he would be entitled to receive *after* being paid back his subscribed capital, on a winding-up. If he owned common stock this would be the difference between the book value and the par value of his shares, and by Section 81(3), on the creation of a stock dividend he would be deemed to have

[32]*Ibid.*, at p. 754.
[33]Italics added.

received a dividend for this amount immediately before the capitalization that resulted in the issuance of the stock dividend. Consequently,

> ...it would appear that if the holders of shares of stock *other than common stock*[34] are entitled to share in any stock dividend paid by their corporation, while not entitled to share in the proceeds of a winding-up *beyond the amount of their capital subscription*[34] they may receive stock dividends free of tax. Such dividends are not taxable under Section 6(a) ('dividends' are income) because Section 139(1) (k) provides that 'dividend' does not include a stock dividend; they are not taxable under Section 8(1) because of the exception of stock dividends in Section 8(1) (c) (ii); and they are not taxable under Section 8(3) because the shareholders' portion of undistributed income on hand is nil under the notional winding-up definition in Section 82(1)(c).[35]
> Under Section 105 the making of an election and the payment of the 15% tax does not permit a company to pay dividends which would be tax-free in the hands of its shareholders. It does, however, enable the company to distribute to its shareholders tax-free the amount on which the tax has been paid, less the amount of the tax, by means of any procedure which would result in dividends being deemed to the shareholders under Section 81.[36]

Therefore, if the Company capitalizes its tax-paid undistributed income by the issuance of preferred shares limited in the amount returnable to the shareholder on a winding-up equal to the tax-paid undistributed income capitalized, these preferred shares are non-taxable stock dividends in the shareholders' hands, and the proceeds of subsequent redemption, of course, are also free of tax as a return of capital rather than as a payment of income to the shareholders.

At last we have found our way out of the labyrinth of tax legislation and now find ourselves in the comparatively rarefied atmosphere of company law.

IV. THE PROCEEDS OF AN ELECTION UNDER SECTION 105: INCOME OR CAPITAL IN THE HANDS OF A TRUSTEE?

It did not take long after the enactment of Section 95A in 1950 and the subsequent amendment of 1951 for the Courts of Canada to find themselves perplexed by an important reference posed them by trustees of estates or trust deeds as a direct consequence of this legislation.

Many wills or other trust instruments frequently provide that the income of the subject of the trust shall be paid or delivered by the trustee to certain beneficiaries, often for the duration of their lives (life tenants), with the *corpus* or capital to divest to other beneficiaries (remaindermen) on the death of the life tenants. This is the common situation, but there could conceivably be others where the benefit of a trust is to be apportioned through a division of annual profit and remaining capital of the settlor's property.

In most instances it is not too difficult a problem to separate the two categories: for a revenue-bearing item of real estate, obviously rentals would be income and the property itself the capital asset; for bonds and debentures the principal is capital and the interest income; and so on. And the established

---

[34] *Ibid.*

[35] McDonald, *Canadian Income Tax,* at p. 755.

[36] *Canadian Tax Reporter* (C.C.H. Canadian Ltd.), Vol. 1, Pages 2931, 2932.

principle for shares in the capital stock of a corporation was that the shares themselves are capital and any yield or dividend is income.

But the problem that presented itself when a company had taken advantage of the provisions of Section 105 and capitalized the permitted portion of its tax-paid undistributed income does not, from a distribution aspect, resolve itself that simply. That portion of undistributed income which is paid out by way of regular dividends as required by subsection (2)[37] is clearly income and for the benefit of the "income-beneficiaries". But in which category belong the proceeds of the redemption of preferred shares issued as stock dividends as a result of the capitalization of the remaining 42½% of the undistributed profits[38] of the company being dealt with after the company has paid the required 15% surtax? The same question is, of course, posed with regard to the 85% of tax-paid undistributed profits being capitalized as the result of an election under Section 105(1).[39]

At first glance it might appear that these shares or their proceeds on redemption should be regarded as income. After all, do they not represent a distribution of profits of the company? Are they not, in reality, a yield to the shareholder on his capital invested in the company? The basic capital has not been returned and the testator's or settlor's shares still remain intact as part of the *corpus* of the trust; is this not an earning of that capital?

In answering these questions, the relevant company law must be scrutinized, as it is the only source of what a company may or may not do, regardless of what the tax provisions may imply. This was done by the judges seized with this reference and a summary of their findings follows:

(1) *In Re Fleck*[40]

This was the first such case to come under judicial review. The company in this instance, a Dominion company, made a simultaneous redemption of the redeemable preferred shares capitalized and issued to its shareholders, among whom were the Trustees of Mrs. Fleck's will. After reviewing various authorities,[41] Hogg, J. A. of the Supreme Court of Ontario maintained that the essential point was whether the company had actually increased its capital

[37]The "50-50 Rule", discussed on Page 159, supra.

[38]e.g. presuming the company has $100,000.00 of undistributed income available, after complying with the requirements of Section 105:

By dividends	$ 50,000.00
By surtax of 15% on balance of $50,000.00	7,500.00
Capitalized (Redeemable Preferred Share Stock Dividends)	42,500.00
	$100,000.00

[39]Pre-1950 undistributed income.

[40][1952] O.R. 113; (1952), 6 D.T.C. 1050; Appeal at 1077.

[41]*Bouch* v. *Sproule* [1885] A.C. 385; *Hill* v. *Permanent Trustee of New South Wales, Ltd.* [1930] A.C. 720; *In Re Bates* [1928] Ch. 682; *Re Bicknell* and *Re Walker* (1931), 40 O.W.N. 202.

by this manoeuvre, and in determining this the *substance,* not just the *form,* of the transaction governed:

> The conclusive test is whether or not the company has increased its capital in the distribution of the surplus profits. This is a question of fact. The real character of the arrangements made by the company in connection with the distribution of profits, that is to say, the substance and not only the form of the transaction must be taken in account...[42]
> The principle to be deduced from these judgments is that there must be, in fact, a conversion by the company of its profits or surplus into share capital in order that they shall be regarded as corpus and not income in the hands of a trustee, or as between a life tenant and a remainderman. Furthermore, that where a company has the power to deal with profits by converting them into capital of the company such exercise of its power is binding upon the person interested under a trust of the original shares set up by a testator's will.[42]

The major point here was that the directorate did not *intend* to add to the company's paid-up capital by this particular capitalization of surplus:

> In the present instance the preferred shares which were issued... were redeemable in cash by the company at once after their issue was authorized and the money was paid to the trustees. These shares did not form part of the capital of the company and therefore the surplus profits represented by them were not capitalized. The steps taken by the company were induced because of the provisions of *The Income Tax Act.* When redeemable preferred shares are issued pursuant to sec. 59 of the *Dominion Companies Act,* sec. 61 provides that the redemption of such shares is not deemed to be a reduction of the paid-up capital stock of the company if such redemption is made according to the conditions stipulated; Masten and Fraser on Company Law, 1941 Ed. 329. To use the language, in part, of Lord Herschell in *Bouch v. Sproule* and applying it to contrary circumstances, it was obviously contemplated and was, I think, certain that no money would in fact remain in the hands of the company as paid-up capital. The substance of the whole transaction and the intention of the company as well as the form or manner in which it was carried out shows that the balance of surplus profits represented by the $20,000.00 in question, was not converted into capital by newly created shares but was distributed as a dividend to the trustee shareholders. The real value and substance of the arrangements were to distribute the surplus profits of the company in the form of money, and they were not dealt with so that, to use the words of Lord Russell in the *Hill* case, they could 'never be paid to the shareholders except upon a reduction of capital or in a winding-up'. The issue of redeemable preferred shares was in the nature of a conduit pipe to convey or transfer the surplus profits accumulated by the company to the pockets of the shareholders as cash. The sum in question received by the trustees as shareholders of the company is to be held to be income in their hands for the benefit of those entitled to income by the terms of Mrs. Fleck's will.[43]

Extensive detail has been given to Mr. Justice Hogg's reasons for arriving at his conclusion as these form the bases of similar conclusions in a number of subsequently-decided cases. It would appear that he was considerably influenced by the equitable answer to the problem, rather than relying upon a narrow interpretation of the company law. The Income Tax Act is virtually ignored except for the mention that it was the inspiration of the Directors' action. Note, also, that he feels the *intention* of the company is of paramount importance and that this is ascertained from the substance as well as the form of the corporate acts.

[42](1952), 6 D.T.C. 1053.
[43]*Ibid,* at p. 1054.

This decision was affirmed by the Ontario Court of Appeal two months later, on March 20, 1952, without stated reasons.

(2) *In Re Estate of Stanley Mills*[44]

The facts in this case were similar to those in the *Fleck* case, except that the method of redemption was not simultaneous but rather in part one month after declaration of the stock dividend, and the balance about six months later. The intention of the directors of the company in question, a Dominion company also, was identical to that of the directors in the *Fleck* case. Gale, J., of the Supreme Court of Ontario, dealing with the question of intention, says at page 1104 of 7 D.T.C.:

> ... whether shares which come into the hands of trustees in circumstances such as I have outlined above (the facts of this case) as capital or income depends upon the intention of the company affecting delivery of those shares.
> What that intention was is a question of fact in each instance and when it has been ascertained, it is binding upon all persons interested in the trusts.

And at page 1105:

> If a company decides to devote the accrued income to capital purposes, any shares issued by reason of that decision, or the proceeds thereof, will be regarded as a capital accretion to the shareholders no matter what process is employed by the company to achieve its objective. If on the contrary the company resolves to pass the surplus to its shareholders rather than to blend it into its capital fabric, the shareholders will be deemed to receive income and not capital.

Referring to *Re Fleck* in relation to the case being decided by him, he says at page 1106:

> What is conclusive is that both companies decided to transfer the tax paid accumulated income as such to their respective shareholders and they adopted a similar, though not entirely identical, method of ensuring that the shareholders would not be required to pay tax on receipt of that income.

He held the proceeds of the redemption received by the trustee to be income and not capital.

(3) *In the Matter of the Estate of Henry James McIntyre*[45]

An Ontario company capitalized its tax-paid undistributed income and issued stock dividends of redeemable preferred shares as a result of taking out Supplementary Letters Patent to increase its capital. It also issued stock dividends in respect of the profit made on the sale of one of its capital assets, a hotel. The Company, Hamilton Jockey Club Ltd., redeemed the preference shares issued. The company had issued three stock dividends, the first and second representing the capitalized tax-paid undistributed income, and the third representing capital surplus made on the sale of the hotel.

[44][1953] O.R. 197; (1953), 7 D.T.C. 1101.
[45][1953] O.R. 910; (1953), 7 D.T.C. 1194.

McRuer, C.J.H.C. held that the proceeds of the redemption of the third stock dividend was unquestionably capital in the hands of the executors of the deceased shareholder.

He also held the other sums were capital, maintaining that where a company had power to distribute its profits as income in the form of a dividend or as capital in the form of a stock dividend, and elected to do the latter, the sums received upon redemption were capital. He made the distinction between this case and *Re Fleck* and *Re Mills* on the ground that the redemption proceeds were income in those cases because of the provision in sec. 61 of The Dominion Companies Act (under which the companies in those cases were incorporated), to wit: If the formalities of redemption are complied with the redemption is not a reduction of capital. No similar provision exists in The Ontario Companies Act, and hence reduction of capital results from redemption here.

The Chief Justice gave a detailed review of all of the leading authorities on the subject of capitalization of corporate profits. Quoting from Lord Russell of Killowen, in *Hill* v. *Permanent Trustee of New South Wales*:

> ...the company, not by its statements, but by its acts, showed that what the shareholders got from the company was not a share of profits divided by the company, but an interest in moneys which had been converted from divisible profits into moneys capitalized and rendered forever incapable of being divided as profits.[46]

And he does much to dispell the notion enunciated by Hogg, J. A. in *Re Fleck* that the substance of the corporate acts as well as the form must be considered in determining the nature of the redemption proceeds when he says[47]:

> The *ratio decidendi* of (the *Hill* case and *Bouch v. Sproule*) as I conceive it to be is that where a shareholder is a trustee what is in the minds of the directors or shareholders when a distribution is made is not relevant in considering what are the respective rights of life tenant and remainder-man. The company manifests its intentions by its acts and its acts only. Injustice may result but if a testator makes no provision in his will with respect to this aspect of his estate, the law must take its course and it is not for the courts to do other than give effect to the legal acts of the company.

and, quoting from *Commissioner of Income Tax, Bengal* v. *Merchantile Bank of India, Ltd.*[48],

> It is hardly a paradox to say that the *form* of a company's resolution and instruments are their substance.[49]

He also refers to *In re Duff's Settlements*[50], quoting Jenkins, L.J.,:

> The cases to which we have referred show that the character, as a matter of company law, of any given distribution as it leaves a company determines its character in the hands of the recipient.[51]

---

[46] [1930] A.C. 720, at p. 732.
[47] (1953), 7 D.T.C. 1194, at p. 1205, parenthises mine.
[48] [1936] A.C. 478, at p. 496.
[49] (1953), 7 D.T.C. at 1205.
[50] [1951] 1 Ch. 923, at p. 929.
[51] (1953), 7 D.T.C. at 1207

(4) *Toronto General Trusts Corporation v. Bartram et al*[52]

The election in this case was made by a company incorporated under The British Columbia Companies Act and there was an immediate redemption of the stock dividends issued. Coady, J., of the Supreme Court of British Columbia, held this to be a distribution of capital.

> The intention of the company, if capable of intention, must be, it seems to me inferred from what it does. In the present case no inference can be drawn, it seems to me, that the company had any intention of making the distribution in the form of income. On the contrary, since the funds were capitalized, the intention it would seem was to make the distribution capital rather than income. The company was concerned with seeing that the distribution was made in such form as to render these funds when received tax free in the hands of the shareholders. Since stock dividends were exempt under the [Income Tax] Act, it was felt that the requirements of the statute would be satisfied if distribution was made in that form.[53]

As to corporate intention he refers to *Inland Revenue Commissioners* v. *Fisher's Executors*[54], per Lord Summer:

> ...In any case desires and intentions are things of which a company is incapable. These are the mental operations of its shareholders and officers. The only intention which the company has is such as is expressed in or necessarily follows from its proceedings.[55]

In differing with the decisions reached in *Re Fleck* and *Re Mills,* Mr. Justice Coady points out:

> Between what appears to me a clear conflict in the authorities a choice must be made. The reasoning to be found in the English authorities appeals more strongly to me. The form of the transaction, in my view, must govern. I find it impossible to see how the legal consequences of capitalization can be disregarded.[56]

(5) *Re Galt Trusts*[57]

Two owners of all of the capital stock in a company settled it, partly during their lifetime, partly by will in ten trusts for their wives and children as life beneficiaries with the *corpus* partly subject to powers of appointment, and partly as a gift over to their or their children's issue. The settlors died in 1928 and 1933 respectively. The company elected to capitalize its undistributed income at the end of the 1949 taxation year, and redeemable preferred shares held on account of Canadian residents were offered by the trustee to the company for redemption, the offer was accepted, and the trustee paid cash. Shares held for United States residents were not offered for redemption with the others, as opinion received by the trustee and these residents was that a stock dividend was taxable as income in that country if redeemed within the period of two years from the date of distribution.

[52](1954), 11 W.W.R. (N.S.) 409.
[53]*Ibid,* at p. 416. Parenthises author's.
[54][1926] A.C. 395, 411.
[55](1954), 11 W.W.R. (N.S.) 416.
[56]*Ibid,* at pp. 416 and 417.
[57](1955), 63 M.R. 337; (1955), 16 W.W.R. (N.S.) 401; (1955), 9 D.T.C. 1163.

It should also be pointed out that the secretary of the company who was also treasurer of the trustee had prepared a detailed memorandum for directors advising as to the benefits of this procedure, with reference to the *Fleck* decision.

Williams, C.J.Q.B. (Manitoba) held the money to be income. He pointed out that the incidence of this case is different from all previous cases where the courts have come to the same or opposite conclusions in that the company, on capitalizing undistributed income, did nothing on its own part to effect the redemption of the shares, but purchased them when offered.

Because of the situation here with U.S. residents, the company did not commit itself to immediate redemption as was done in *Re Fleck*. But it did the the next most effective thing: It committed itself to redeem on request of the shareholders.[58]

The Chief Justice also found that the company had not made distributions of profits as they were earned because of the high incidence of double taxation. He said that each of the settlors had obviously intended that the various life tenants should receive the full income that would arise from the various capital funds. He further held:

> It was the duty of the trustee, having control of the company, to take advantage of Sec. 95A of *The Income Tax Act* for the benefit of the life tenants who, if it had not been for the double taxation problem, would have received the full income long since. It was justified in not declaring a full dividend on the shares in the company and in accumulating the undistributed profits and not capitalizing them.[59]

And he adopted the words of Pickup, C.J.O. in *Re Waters*:[60]

> In considering this appeal I have endeavoured to consider only the corporate acts of the company where I find both the form and substance as well as the intention of the company. I think, however, one must look at the whole of the form and not just part of it. When one does so, it seems to me to be clear that in the *Fleck* case the company was not in fact capitalizing its accumulated surplus income, but that in the instant case the company was.

Re Fleck and *Re Mills* were followed, accordingly.

(6) *In the Matter of the Estate of Stella Maud Waters*[61]

As in *Re McIntyre* this was an election by an Ontario company. The shares issued as stock dividends to the executors totalled 64,000 redeemable preferred, of which 17,920 had been redeemed in lots of 1,280 shares each at irregular intervals, so that at the date of the trial they still held 46,080 unredeemed preference shares.

In the trial division McLennan, J. distinguished this case from *Re Fleck* and *Re Mills* on the same basis as McRuer, C.J.H.C. in *Re McIntyre* (presumably the differences between the Ontario and Dominion Companies Acts) and found

[58] (1955), 63 M.R. 337, 361.

[59] *Ibid*, headnote.

[60] [1955] O.R. 268, 280. Discussed below.

[61] [1954] O.W.N. 649; (1954), 8 D.T.C. 1177; (1955), 9 D.T.C. 1053 (Ont. C.A.); [1956] S.C.R. 889, (1956), 10 D.T.C. 1113 (Supreme Court of Canada).

himself bound by the latter, holding the proceeds of the redemption to be *corpus* of the estate.

On appeal, this judgment was upheld but for considerably different reasons. Pickup, C.J.O., giving the unanimous judgment of the Ontario Court of Appeal, held that the *Fleck* case was distinguishable as there had been no intention on the part of the company in that case to retain any portion of the undistributed income capitalized,[62] whereas that was not the situation here. Accordingly, the proceeds of the partial redemption were distributions of capital.

He further pointed out that the decisions in *Re Fleck* and *Re Mills* could not be distinguished from the case at bar or others similar to it simply on the grounds that the company concerned was a Dominion company and not an Ontario company. The same corporate acts should mean the same thing in either company, subject to technical interpretation and implementation.[63]

It was left to the highest court in the land to resolve this question once and for all, and this they did with clarity and directness. The answer to the whole question is crystallized by Mr. Justice Rand:[64]

> I take the principle laid down to be that unless the earnings as such actually or constructively pass from the company to the shareholder, there is for all purposes capitalization. But the argument is that the machinery of capitalization and redemption can be used to effect a transfer of earnings as such to the shareholders.
>
> Here the retention of the preferred shares as part of the capital stock is sufficient of itself to negative the conclusion that shares belong to the life interest as dividends: but I have reached the same conclusion on a broader ground.
>
> When earnings are 'capitalized' they cease at that moment to be 'earnings'; they become part of the capital assets; and if the transaction has not the elements of dividend and purchase, the shares, *prima facie* are not income. [It was] urged very plausibly that the company's intention was to release those earnings and pass them to the shareholders as such in a single act consisting of several parts. The fallacy lies in overlooking what has taken place. The company undoubtedly intends by its total act to pass money to the shareholder: but if what the company does converts the earnings into capital, the 'intention' of the company must take account of that fact; it 'intends' that fact; and to carry the intention to a conclusion it intends to distribute capital assets by means of an authorized reduction in capital stock. Here form is substance; and the moment form has changed the character of the earnings as assets, the intention follows that change.
>
> In the absence of a statutory provision, a stock dividend, so called, would not appear to be 'income'; and the exemption from taxation provided for the shares here simply suspends the provision of the *Income Tax Act* imposing tax. From the stand-point of tax, it is indifferent to the company and the shareholders whether the ultimate receipt of money is capital or income: in neither case is it taxable. But its form is fixed and determined: and in the absence of special directions in the will, we are not at liberty to disregard what the testator is to be deemed to have foreseen as the possible action of the company.

---

[62]At 9 D.T.C. 1055: "If one disregards the tax situation which, no doubt, prompted the company's acts to take the form they did, it will be seen that what the company in *Re Fleck* in reality did was to distribute its accumulated surplus income among its shareholders by channelling it through its capital account."

[63]*Ibid*, at pp. 1055-1056.

[64][1956] S.C.R. 889 at 905.

In a judgment delivered by Kellock, J., concurred in by the Chief Justice, Locke and Cartwright, J.J., *Re Fleck* is found to be wrongly decided and "out of harmony" with the earlier authorities.

> In my opinion, the fact that, as Hogg, J. A. says, 'the steps taken by the company were induced because of the provisions of the Income Tax Act' is irrelevant.[65]

and

> Even where redemption takes place out of profits... the capital paid on the shares originally appropriated out of profits remains as capital. This[66] emphasizes, if emphasis be needed, that in the purview of the statute, profits which have been used to pay up an issue of shares become capital and remain so from the moment the shares are so paid up.[67]

Comment will be made following discussion of *Re Hardy* judgment which was delivered contemporaneously by the Supreme Court.

(7) *In the Matter of the Trust Deed of Arthur Sturgis Hardy*[68]

This was a simultaneous redemption by a company incorporated under the Dominion Companies Act of the proceeds of an election.

Following *Re Fleck* and *Re Mills* the trial judge, Ferguson, J. held the proceeds to be income in the trustee's hands. He found himself bound by an earlier decision of a judge of the same court in a reference on shares of the same company. That judge also applied *Fleck.*

The appeal was dismissed by the Ontario Court of Appeal, Pickup, C.J.O. holding that this case was "on all fours" with *Re Fleck* which he had affirmed in the appeal of *Re Waters, supra.*

Coming on the heels of their decision in *Re Waters,* where they said in no uncertain terms that these moneys were capital, no matter what the circumstances, the Supreme Court of Canada allowed the appeal, by another unanimous decision.

Chief Justice Kerwin, in delivering the court's decision, reiterated that unless the will or trust instrument specifically extended the distribution of "income" to include proceeds of stock-dividend redemptions, such proceeds are to be regarded as capital in the hands of the trustee:

> There is nothing in the language of the Trust Deed to indicate an intention that the word 'income' should be given an extended meaning and include distributions of this nature.[69]

And he puts "the frosting on the cake" to the judgments delivered in the *Waters* appeal, and in this case, and resolves the question forever under the present company and tax legislation when he says:

---

[65]*Ibid,* at p. 898.

[66]Section 61 of The Dominion Companies Act.

[67]*Ibid,* at p. 900.

[68][1955] O.W.N. 273; (1955), 9 D.T.C. 1062 (Ont. H.C.); (1955), 9 D.T.C. 1175 (Ont. C.A.); [1956] S.C.R. 906 (Can. S.C.).

[69][1956] S.C.R. 913.

> ...it must be laid down that a capital asset (shares) in the hands of trustees will not be transformed into income merely because a company uses surplus profits to redeem shares. *In fact those undistributed profits do not reach the shareholders as tax-free income, but as non-taxable capital.*[70]

No decision and comment could be more consistent with the provisions of both The Income Tax Act and existing company jurisprudence. The former specifically avoids a definition of "income" and states that "income" is all income. If these moneys are tax-free, obviously they cannot be income under that Act. And the company law is precise in its delineations of permissable corporate distributions of income. The capitalization of redeemable preference shares and their subsequent redemption is not one.

It is interesting to note that of all the judgments in the lower courts, Coady, J. in the *Bartram* case was the only one to touch on the matter of non-taxable capital as opposed to tax-free income, which was so eloquently stated by Chief Justice Kerwin that it must now seem elementary.

By a decision delivered October 31, 1956,[71] following the decisions of the Supreme Court of Canada handed down the previous October 2nd, Williams, C.J.Q.B. reversed his original finding in *Re Galt Trusts* and declared the proceeds of the redemption there to be capital, thus correcting the matter.

V. THE COMPANY LAW: PITFALLS OF IMPLEMENTATION

Notwithstanding the fact that a method has been made available through The Income Tax Act to place some portions of company's undistributed profits in the hands of its shareholders free of tax, the implementation of that method calls for a strict adherence to the requirements of corporation legislation and jurisprudence. A company being a creature of statute, correctness of its corporate acts is demanded of this artificial personality.

Particularly in distributions to shareholders will the company's conduct be most carefully scrutinized. This stems from the origins and nature of the corporate entity itself, already indicated.[72]

For these reasons, writers discussing Section 105 of The Income Tax Act (or its predecessor, Section 95A), repeatedly warn of the company law problems to be considered before an election is proceeded with:

> The present legislation provides an excellent means by which closely held companies may solve or alleviate the tax problems resulting from the accumulation of income in their hands. But it raises numerous questions of company law, which must be given careful consideration before an election is made to pay the 15% tax.[73]

Commencing on the premise that the method decided upon to place the tax-free undistributed income into the hands of the shareholders will be the

---

[70] *Ibid,* at p. 913. Italics added.

[71] [1956] W.W.R. (N.S.) 95; [1956] A.T.C. 1140.

[72] *Supra,* Ch. II.

[73] Stanley E. Edwards, Company Law Problems Arising under Part I A of the Income Tax Act, (1951) 29 Can. B.R. 937 at p. 949.

one of (a) capitalization, (b) declaration and distribution of redeemable preference stock dividends, and (c) redemption of those stock dividends, the first — and perhaps elementary — matter to be determined is: Can the company issue stock dividends?

For companies incorporated under The Dominion Companies Act, Section 83(3), permits the directors to issue shares in lieu of money dividends by by-law, provided that by-law is sanctioned by two-thirds of the votes cast at a special general meeting of the shareholders duly called for that purpose. But the by-law will have no effect after one year of its enactment and if the stock dividends are not paid within that time, appropriate steps will have to be taken by the directors.

Similar provisions are contained in the Quebec and Ontario Companies Acts, but these are the only provincial jurisdictions enjoying their incluson by legislation. Where the governing Act is silent a provision must be introduced in the letters patent of incorporation or articles of association. In Manitoba, for example, where no direct provision appears in The Manitoba Companies Act pertaining to the declaration of stock dividends as such, the accepted interpretation is that expressed by Williams, C.J.Q.B. in *Re Galt Trusts*:[74]

> ... The *Manitoba Companies Act* did not, and does not permit or authorize a stock dividend unless such a right is given by letters patent or supplementary letters patent.

It is understood the uniform Companies Act being proposed by the Conference of Commissioners on Uniformity of Legislation in Canada includes sections authorizing stock dividends.

The next stage, capitalizing the tax-paid undistributed income fund, will be a matter of fact for each company depending on its own particular situation. If there is a sufficient fund of treasury (i.e. unissued) stock to meet the requirements of the fund being capitalized there will be few problems for the company. Unissued preferred stock can be created and unissued common stock can be converted to redeemable preference stock (unless the letters patent provide otherwise) by a by-law sanctioned by two-thirds of the votes cast at a special meeting of shareholders.[75] If there is not sufficient treasury stock available for this purpose, supplementary letters patent will have to be taken out increasing the company's authorized capital.

Having capitalized and issued the stock dividends of redeemable preference shares, the most delicate problem occurs with their redemption — the moment when tax-free dollars will be placed in the shareholders' hands. This arises because of the nature of the provisions permitting redemption.

Section 61 of The Dominion Companies Act:

> 61. The redemption or purchase for cancellation of any fully paid preferred shares whether the same are created by by-law pursuant to section 59, or by letters patent

[74](1956), 63 M.R. 337 at p. 350.

[75]Section 59, subsections (1) and (4) of The Dominion Act; and comparable sections of the various Provincial Acts.

or supplementary letters patent, in accordance with any right of redemption or purchase for cancellation reserved in favour of the company in the provisions attaching to such preferred shares, or the redemption or purchase for cancellation of any fully paid shares of any class, not heing common or ordinary shares, and in respect of which the letters patent or supplementary letters patent or by-laws if the same are created by by-law, provide for such right of redemption or purchase, in accordance with the provisions of such letters patent or supplementary letters patent, or by-laws, shall not be deemed to be a reduction of the paid-up capital of the company, if such redemption or purchase for cancellation is made out of the proceeds of an issue of shares made for the purpose of such redemption or purchase for cancellation, or if

(a) no cumulative dividends, on the preferred shares of the class in respect of which such right of redemption or purchase exists and that are so redeemed or purchased for cancellation, are in arrears; and

(b) if such redemption or purchase for cancellation of such fully paid shares is made without impairment of the company's capital by payments out of the ascertained net profits of the company that have been set aside by the directors for the purposes of such redemption or of such purchase for cancellation, and if such net profits are then available for such application as liquid assets of the company, as shown by the last balance sheet of the company, certified by the company's auditors, and being made up to a date not more than ninety days prior to such redemption or purchase for cancellation, and after giving effect to such redemption or purchase for cancellation;

and subject as aforesaid any such shares may be redeemed or purchased for cancellation by the company on such terms and in such manner as is set forth in the provisions attaching to such shares, and the surplus resulting from such redemption or purchase for cancellation shall be designated as a capital surplus, which shall not be reduced or distributed by the company except as provided in sections 49 to 58.

The Provincial Acts carry somewhat similar conditions.

Although the requirements of the Dominion Act are more rigid than most Provincial Statutes (Section 62 further requires notice of redemption to be filed with the Secretary of State) several features of the various Acts are common. Disregarding the formal or technical requirements, two principle requisites emerge:

(a) the redemption must be out of the profits of the company (or a fresh issue of capital stock);

(b) any redemption which has the effect of impairing or altering the company's capital requires confirmation by supplementary letters patent.

In the rush to get the tax-free money into the shareholders' hands, these features may be obscured or misinterpreted.

Because the company *had* undistributed profits on hand, its directorate might believe it could immediately redeem the preference shares it has just issued as stock dividends. But at the time of issuing the stock dividend the company no longer has this fund of tax-paid undistributed profits as it has capitalized it to create the stock dividend. And the redemption can only be out of profits. Unless the company has *other* "clearly ascertained profits" from which to do so, it cannot redeem these shares, unless it *first* receives authority (usually in the form of supplementary letters patent) to reduce its capital.

The consequence of "redeeming" the proceeds of this stock dividend from the funds capitalized could be far-reaching, indeed:

(1) ULTRA VIRES

The redemption would clearly be a reduction of capital, and unless authorized as such by supplementary letters patent, would be *ultra vires* the company:

> A company cannot, unless it is so authorized by its charter, reduce its capital, such an act being *ultra vires*.[76]
> ...no increase, decrease, subdivision, etc. of the share capital of a company is valid unless the steps prescribed by the statute have been strictly followed.[77]

(2) A VOID ACT

If the redemption is *ultra vires,* than it is a void act. It is not merely voidable, something which might be subsequently corrected, or ratified by the shareholders. It is void *ab initio.*

Per Clifford, L.J. in *Re London, Hamburg and Continental Exchange Bank:*[78]

> I am clearly of the opinion that this transaction[79] is *ultra vires;* and if it is *ultra vires,* it is not a mere voidable transaction, but it is wholly and totally void; it is a transaction which no general meeting could confirm, because it was altogether beyond the power of the company in every sense.

Consequently, subsequent acts based on the void act are of no effect and are themselves void.

(3) THE MONEY DISTRIBUTED MAY HAVE TO BE RESTORED TO THE COMPANY

If the redemption is void then it follows that the moneys paid to the shareholders on redeeming their shares could probably be reclaimed by creditors and would have to be returned to the company.

In *National Trust Co. Ltd.* v. *Gilbart*[80] an unauthorized distribution of a company's capital tantamount to a reduction was dealt with by the Saskatchewan Court of Appeal. The facts, as taken from the headnote, were as follows:

> The only three shareholders, who were also the directors, of a company, without any declaration of dividend, divided among themselves the proceeds... on the sale of its lands... On a subsequent assignment by the company for the benefit of its creditors, *held,* the assignee could recover from the said three members the amount so divided as aforesaid.

Per Newlands, J.A.:[81]

> No dividend was declared, they (the shareholders/directors) simply divided amongst themselves certain assets of the company. They could not, in my opinion, make title to the property in that way, therefore the amount each one took out of

[76]*Ross et al* v. *Fisset* [1882] Q.L.R. 251, per Cassault, J. at p. 256.

[77]Masten and Fraser, *Company Law of Canada* (4th Ed.), p. 307. See also generally *Reider* v. *Sair & Sair* [1923] 1 W.W.R. 307, fn. 8; *Holmes* v. *Newcastle-Upon-Tyne Freehold Abbatoir Co.* [1875] 1 Ch. D. 682.

[78]L.R. 5 Ch. App. 444, at p. 451.

[79]An unauthorized reduction of capital by the purchase of the company's own shares.

[80][1921] 1 W.W.R. 359.

[81]*Ibid,* at p. 359.

> the assets of the company would still be the property of the company, and each of the defendants would hold the amount he obtained in that way in trust for the company.

Per Lamont, J.A.:[82]

> In my opinion the plaintiffs right to bring this action cannot be successfully questioned. The sums which each of the shareholders received out of the purchase price of the lots were not received as dividends of the company declared on its stock. The moneys were part of the assets of the company.

(4) THE DIRECTORS PERSONALLY LIABLE

Section 83(5) of The Dominion Companies Act attaches personal liability, jointly and severally, to directors who pay a dividend out of capital, to the extent of the dividend so paid.

Similar provisions appear in the various Provincial Acts.

(5) THE DISTRIBUTION COULD BE SUBJECT TO INCOME TAX

If the redemption is an unauthorized reduction, then it is not properly a return of capital to the shareholders, but possibly a division of profits. As such, in the shareholders' hands, it would be income and taxable like all other income under the provisions of The Income Tax Act.

Prima facie, a payment made by the company to its shareholders while the company is a going concern, is a dividend.[83] The onus then is on the shareholder-taxpayer to show that the funds in his hands are not income and hence not subject to tax. He may be required to rebut the presumption that the proceeds of the redemption were non-taxable capital and this he will not be successful in doing if the redemption resulted from an unauthorized reduction of the company's capital.

In *McConkey* v. *Minister of National Revenue*,[84] the Minister sought to tax payments to a shareholder while the company was a going concern, which were contended to be payments from capital. Hy-grade Coal Company of Drumheller Ltd. (incorporated under The Alberta Companies Act) paid out the sum of $12,000.00 to its shareholders in May, 1932, alleging this to be a distribution of capital in contemplation of the liquidation and winding-up of the company. There were no surplus funds or profits on hand and the moneys were actually paid out of depletion reserves set aside. McConkey, as a shareholder, received $5,028.00 as his share of the distribution. The company, in fact, did not go into liquidation on until June, 1932.

The Alberta Companies Act did not permit a reduction of capital without amendment of the Company's articles of association. Further, the company's articles prohibited the paying of a dividend out of capital.

[82] *Ibid*, at p. 362.
[83] *Robinson Industries Ltd.* v. *Minister of National Revenue* (1955), 9 D.T.C. 1, at p. 3.
[84] [1937] Ex. Ct. 209.

In holding the moneys received by McConkey were subject to income tax, Angers, J. quoted Lord Russell of Killowen in *Hill* v. *Permanent Trustee Co. of New South Wales Ltd.*:[85]

> A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it parts with money to its shareholders must and can only be made by way of dividing profits...[86]

and the President of the Exchequer Court, MacLean, J., in *Northern Securities Company* v. *The King,* where, dealing with a mining company under The Dominion Companies Act which is permitted to pay dividends out of funds other than profits where wasting assets are involved, said:

> But while this provision of the Companies Act permitted the company to pay a 'dividend' even if it impaired capital that does not make the payment of the 'dividend' a distribution of capital, which might have been done by reducing the capital of the company, if the company had acquired the power to do so; it permits that which was done here, the payment of 'dividends' to shareholders, from funds derived from the mining operations of the company, which, I think, must be held to constitute income in the hands of the shareholders, because it is a dividend upon shares of the capital stock of the company.[87]

and he concludes that the principles which govern are:

> (1) That until a reserve fund is effectively capitalized it retains the characteristics of distributable profits;
> (2) That a corporation not in liquidation can make no payment to its shareholders by way of return of capital except as a step in an authorized reduction of capital and that any other payment made to its shareholders can only be made by way of dividing profits.
>
> A careful perusal of the evidence, oral and literal, as well as of the precedents has led me to conclude, not entirely without hesitation I must admit, that the sum of $12,000.00 distributed to the shareholders in 1932 and of which the appellant received $5,028.00 as his share must be treated as income and not as capital. If this sum had been held by the company until the winding-up and had been distributed to the shareholders by the liquidator, it would very likely, and should in my opinion, have been considered as capital. This sum having been paid by the company while still a going concern the payment cannot, in the face of the decisions (referred to), be considered as a return of capital but must be treated as a distribution of a dividend. The share received by the applicant was accordingly taxable as income.[88]

It is well established that a taxing provision, particularly one that creates an exemption, must he strictly interpreted. This principle was re-emphasized as recently as March 8, 1957, in the case of *Witthuhn* v. *Minister of National Revenue,*[89] where the Income Tax Appeal Board held that the taxpayer was not entitled to a deduction because a rocking chair is not a wheel chair.

In stricly interpretting the privileges flowing from tax-exempt moneys paid by a company, the corporate acts must be perfect:

---

[85][1930] A.C. 720, at p. 731.
[86][1937] Ex. Ct. 209, at 223.
[87][1935] Ex. Ct. 156, 226.
[88]*Ibid,* at p. 229.
[89](1957), 11 D.T.C. 174.

> Taxation of a dividend cannot be avoided by showing that its origin in the hands of the company was a capital gain or some other form of tax-free profit... In *Crasweller* v. *Minister of National Revenue*,[90] for example, the taxpayer's company had received capital gains upon the disposition of fixed assets. The profit was then paid out to the shareholders as a distribution of capital surplus. In holding that the payment was a taxable dividend under s. 3 of the Income War Tax Act, the Board said:—
>
> 'the fact that the company specifically states the funds so distributed to be capital profits or capital surplus may be useful in determining the history of the funds so distributed, but does not for the purposes of the Income War Tax Act determine the nature or taxability of the sums so distributed in the hands of the shareholders receiving them.'[91]

It is submitted that payment of the tax-paid undistributed income to the shareholders to redeem the preference stock issued to them as a result of the election under Section 105 of The Income Tax Act would remove those funds from the category of having been "effectively capitalized" unless such payment had first been confirmed by the taking out of supplementary letters patent making it an "authorized reduction of capital."

VI. SOME CONCLUDING THOUGHTS

Although providing relief from double taxation through the inclusion of Section 105 in The Income Tax Act, the Parliament of Canada has encumbered this benefit with traps and hidden dangers which result from the very nature of the corporate entity.

Writing in 1951, J. Richards Petrie expressed his disappointment in this consequence of the legislation in the following terms:

> Under the 1945 law the normal rule was that earnings on which the special tax had been paid could be distributed to the shareholders as a tax-free dividend, on the theory that the company had paid the shareholder's tax for him. But the new law provides in principle for tax-paid capitalization as distinct from tax-paid distribution, and does not alter the basic rule that all dividends to individuals are taxable without distinction. Consequently, a distribution of tax-paid earnings under the new law must take the form of a distribution or reduction of capital if further taxation in the hands of the shareholders is to be avoided. It was precisely the various transactions of this character that the legal roadblocks noted above were intended to frustrate. All these preventative provisions continue in effect.[92]

As to the dilemma of the trustee-shareholder, under the existing legislation, it would seem that prudence demands the re-writing of existing wills or trust deeds, and the drafting of new testamentary and other instruments dealing with life estates and interests in remainder, to provide that "income" will include the proceeds of the redemption of stock dividends declared on original capital stock already forming part of the corpus at the time of their distribution, unless the testator or settlor specifically intends otherwise.

Showing remarkable clairvoyance when he addressed the Taxation Section of the Canadian Bar Association in September, 1951, Stanley E. Edwards commented:

---

[90][1949] D.T.C. 1.

[91]McDonald, *Canadian Income Tax*, at p. 722.

[92]The Taxation of Corporate Income in Canada, at p. 66.

> Where shares of a closely held company are held by a trustee, it may be advisable for the directors before declaring a stock dividend, to consider its ultimate disposition as between beneficiaries of the trust. One solution of the problem, in the case of a trust which has no infant beneficiaries, might be for the beneficiaries of the trust to agree as to the disposition of the stock dividend. Where a new trust is being established with separate capital and income beneficiaries and the property of the trust includes company shares, specific provision should be made in the trust instrument for the treatment of stock dividends received by the trustee. In drawing wills this question should also be considered and it may be advisable to review existing wills with the point in mind.[93]

Per Lord Russell of Killowen in *Hill* v. *Permanent Trustee Company of New South Wales, Ltd.*:

> In truth the only method by which the rights of the respective *cestuis que trust* can be safeguarded and made incapable of being varied or affected by the conduct of the company, is by insertion of special provisions in the trust instrument clearly defining respective rights of income and corpus in regard to moneys received by the trustee from limited companies, in respect of shares therein held by him as part of the trust estate.[94]

Mr. Edwards' remarks are all the more pertinent since the decisions of the Supreme Court of Canada in the *Waters* and *Hardy* cases, where, incidentally Lord Russell's comment, above, was adopted *in toto*. Both of these decisions reiterate that a settlor or testator is presumed to appreciate the potential situations which may arise from corporate shareholding.

It is submitted that a further amendment to The Income Tax Act excluding from income the payment of a "bonus" distributed from funds on which the company has paid the 15% election tax would, in large part, be an alleviation of the problems and difficulties created by the present legislation. Although this is in reality a dividend, it could be excluded from the definition quite properly because it is the proceeds of funds on which the company has already paid all required tax, and the intention of the present legislation is to place these moneys free-of-tax in the shareholder's pockets. This would not be an altogether unique innovation as stock dividends have already been eliminated from the category of "dividends".

An amendment of this nature would eliminate the necessity of the company undergoing all of the proceedings and formalities in capitalizing and then guarding against an unauthorized reduction of its capital when it distributes the tax-paid undistributed income. The "bonus" would also clearly be "income" in a trustee-shareholder's hands for distribution purposes. It would answer the problem facing trustees administering estates and deeds which pre-date the present legislation where elections by companies whose shares they hold may be subsequently made.

---

[93]Company Law Problems Arising under Part IA of The Income Tax Act, 1951, 29 Canadian Bar Review 948.

[94][1930] A.C. 721, at p. 730.

This suggested amendment should be an alternative to, and not in substitution of, the present privilege of capitalizing tax-paid undistributed profits. In certain instances it may be more advantageous for the company to pay the 15% tax, capitalize and not redeem immediately, being aware of the corporate consequences the choice of this method demands. However, this advantage, if desired, should not be denied.

But, the simpler, more direct method of getting the tax-free profits to the shareholder, if the company so chooses, should also be available.