

1962
 }
 Sept. 11

 1963
 }
 Feb. 5

BETWEEN :

WESTERN WOOD PRODUCTS LIM- }
 ITED } APPELLANT;

AND

THE MINISTER OF NATIONAL }
 REVENUE } RESPONDENT.

Revenue—Income tax—Income Tax Act R.S.C. 1952, c. 148, ss. 11(1)(e), 12(1)(a), 137(1) and 139(c)(i)—Debt owing by subsidiary company to affiliated company transferred to taxpayer pursuant to a guarantee arrangement—Reserve for debts—Appeal dismissed.

Appellant controlled the majority shares of Direct Lumber Co. Ltd. and Sylvan Lumber Co. Ltd. The operations of the latter were financed partly by Direct Lumber Co. Ltd. it being understood that any loss sustained by Direct to be borne by the appellant. An entry was made in appellant's books crediting Direct with \$26,133.39 and reflecting it as an amount due from Sylvan, in respect of which a reserve for bad debts was claimed by appellant in the amount of \$23,000.00. Appellant testified that it from time to time had advanced money to sawmill operators and/or planer operators and/or distributors for the purpose of increasing its purchases and/or sales and/or net

income. It contended that therefore it was entitled to deduct any loss arising therefrom. The Minister contended that the indebtedness in question arose from dealings between Sylvan and Direct which did not involve the appellant and that the transfer of the debt from Direct to the appellant would unduly or artificially reduce the appellant's income within the meaning of s. 137(1) and that appellant was not entitled to the reduction claimed.

1963
WESTERN
WOOD
PRODUCTS
LTD.
v.
MINISTER OF
NATIONAL
REVENUE

Held: That in the absence of documentary evidence, the appellant could not be regarded as a creditor of Sylvan Lumber Co. Ltd. whose indebtedness to Direct Lumber Co. Ltd. arose from transactions which did not involve the appellant.

2. That the appellant therefore is excluded from the scope of the permissive exception in s. 11(1)(e) of the Act.

APPEAL from the Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Dumoulin at Edmonton.

J. A. Matheson for appellant.

W. G. Morrow, Q.C. and *R. L. Radley* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

DUMOULIN J. now (February 5, 1963) delivered the following judgment:

This is an appeal from a decision of the Tax Appeal Board¹, dated November 14, 1960, in respect of appellant's income tax assessment for 1957, disallowing the latter's claim to a deduction of \$23,000, allegedly representing a reserve for bad debts.

The exact nature of Western Wood Products' activities was not precisely revealed, but its Memorandum of Association of April 30, 1946, Province of Alberta (exhibit 9), mentions, amongst its many objects, the following:

- a) To carry on the business of the manufacture and sale of wood veneer and plywood in all its branches and phases.
- b) To carry on the business of wood distillation and the sale of the products and by-products thereof in all phases.
- c) . . .
- d) To carry on the business of logging and lumbering and the sale of lumber by wholesale or retail in all its branches.

¹(1960) 25 Tax A.B.C. 317

1963
 WESTERN
 WOOD
 PRODUCTS
 LTD.
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 ———
 Dumoulin J.
 ———

Further powers worthy of notice are conferred by items (f) and (n):

- f) To enter into partnership or into any arrangement for sharing of profits, union of interests, co-operation, joint adventure, reciprocal concessions, or otherwise with any person or Company, wheresoever incorporated, carrying on or engaged in . . . any business or transaction which the Company is authorized to carry on or engage in . . .
- n) To invest and deal with the moneys of the Company not immediately required in such manner as may from time to time be determined.

Western Wood Products Ltd. has its registered office in the City of Edmonton.

The appellant submits this interpretation of the matter in paragraph (1) of its Notice of Appeal:

- 1) From time to time over a period of ten years the Appellant company has made advances of money to various lumber operators for the purpose of increasing its purchases and/or sales and/or net income. The advances were to sawmill operators and/or planer operators and/or distributors. The principal distributor to which advances of money were made was Direct Lumber Company Ltd. as a result of which the Appellant company received substantial commissions. The Appellant company owns over ninety-nine per cent of the issued shares of Sylvan Lumber Company Limited. The Appellant company made advances of money to Direct Lumber Company Ltd. which in turn made advances of money to Sylvan Company Ltd. with the understanding that the Appellant would absorb any losses incurred by Direct Lumber Company Ltd. resulting from its dealings with Sylvan Lumber Company Ltd. Sylvan Lumber Co. Ltd. sustained substantial losses and was unable to repay Direct Lumber Co. Ltd. and in 1957 pursuant to the previous understanding Direct Lumber Co. Ltd. charged to Western Wood Products Ltd. \$23,000.00 of the amount owing to it by Sylvan Lumber Company Ltd. As the amount was uncollectable from Sylvan Lumber Company Ltd. a Reserve for Bad Debts in the sum of \$23,000.00 was set up in the records of Western Wood Products Limited and the same amount was deducted from Income.

As seen above, this reserve was refused by the Department.

The respondent's disallowance of this reserve fund is motivated quite plainly in paragraphs (1) and (5), respectively, found on pages 12 and 14 of the written argument filed of record in the case; I quote:

- (1) There is no privity of contract in the absence of assignments or guarantees and, hence, no debtor-creditor relationship as between Western Wood and Sylvan Lumber.

(5) The indebtedness of \$26,133.39 (cf. ex. B) arose from dealings between Sylvan Lumber Company Limited and Direct Lumber Ltd. which did not involve the appellant and, accordingly, the appellant would not be entitled to deduct all or any portion thereof.

1963
WESTERN
WOOD
PRODUCTS
LTD.
v.

Respondent's submissions of law pertaining to the above arguments are derived from sections 11(1)(e), 12(1)(a) and 137(1) of the *Income Tax Act*, R.S.C. 1952, c. 148.

MINISTER OF
NATIONAL
REVENUE
Dumoulin J.

At this very point, it is appropriate to note that, notwithstanding the separate legal entity of each of the three firms herein concerned, Western Wood Products acted, so to say, as the fountain-head of the trilogy, owning 99 per cent of Sylvan Lumber's issued shares, and controlling 68 per cent, or slightly more, of Direct Lumber's voting stock. On the left page of exhibit J, appellant's income tax return sheet for 1956, Direct Lumber Co. Ltd. is qualified with the caption "interlocking shareholders", and Sylvan Lumber Co. is styled "subsidiary company".

We are told, with even a flourish of doggerel verse, at pages 1 and 2 of the appellant's brief that:

The operations of W (standing for Western Wood Products) over the years was ("were" would appear better suited to the current grammatical prejudice) moderately profitable. The operations of D (for Direct Lumber Ltd.) over the years was (ditto) moderately profitable. But to paraphrase a favorite song of a famous Canadian:

Tho we worked all night, and we worked all day,
We couldn't make the Sylvan Lumber pay.

A jocose confession of a melancholy result.

At page 2 of its argument, the appellant raises this question: "But, which Company,—D or W was the actual creditor?" of Sylvan Lumber, and suggests a solution which might be somewhat over-simplified, saying that:

From the standpoint of the Respondent there was no material difference. The loss arising from the bad debt would be deductible from the income of either D or W depending on which was the actual creditor in whatever year would suit their purpose and at the same time comply with the *Income Tax Act*, and the net amount collectable by the Respondent ultimately, would for all practical purposes be the same approximate amount.

Some inkling at least about the relative degree of approximation between the "moderately profitable operations" of Western Wood Products and Direct Lumber Co., for taxation year 1957, would have been welcomed, and possibly

1963
 WESTERN
 WOOD
 PRODUCTS
 LTD.
 v.
 MINISTER OF
 NATIONAL
 REVENUE

explained why Western Wood and not Direct Lumber was arbitrarily chosen as Sylvan Lumber's creditor. Moreover, in matters of strict law, the Court can attach but slight concern to "practical purposes", subjectively volunteered by a taxpayer, as compared with its duty to comply with the "legal purposes" prescribed by statute.

Dumoulin J.

In keeping with this norm, three main issues are now singled out for examination, namely: the acceptable plausibility of "the understanding" supposedly assumed by the appellant to secure Direct Lumber against any losses at the hands of Sylvan Lumber; the admissibility, pursuant to the proof adduced, of money advanced by Western Wood to Direct Lumber, or of transactions between Western, Direct and Sylvan; and, lastly, the degree of credence attaching to that roundabout shifting of debts from Sylvan, via Direct Lumber, unto the appellant.

One witness only testified, Mr. Richard Carl D. Ogilvie, who had qualified as chartered accountant in December, 1957, and examined the appellant's books of accounts during 1958, replacing in that task the firm of John B. White.

On this triple score what does the evidence reveal concerning:

- a) An undertaking of guarantee between the appellant and Direct Lumber?

Counsel for the respondent, Mr. W. G. Morrow, Q.C., on cross-examination puts these questions to Mr. Ogilvie (cf. transcript pp. 51 and 62):

Q. Now, in this cheque (should be: check) that you refer to and in your research for preparation for today have you ever seen any documents such as a letter or a document of assignment or anything of that kind passing between one company and another with respect to the \$26,133.00 or with respect to the \$23,000.00?

A. No, I have seen no documents.

Q. And you have not observed any document for example of Western dated December 31st, 1957, or subsequent to that, saying "we have assumed this matter" or "we have allowed this transaction to take place and you can now look to us" or vice versa, none of that?

A. Nothing.

Next on page 62:

Q. Mr. Ogilvie, we have already had you say that insofar as your research is concerned you could find no sign of a guarantee or

any such written undertaking or assumption of an obligation by Western Wood Products to take over the obligations of Sylvan to Direct, we have already got that?

1963
WESTERN
WOOD
PRODUCTS
LTD.

A. That is correct.

Since this lone witness has seen nothing nor found anything to materialize the would-be plea of warranty we are then left with a totally uncorroborated declaration.

v.
MINISTER OF
NATIONAL
REVENUE

Dumoulin J.

b) Advances of money to Direct Lumber or transactions between appellant and the two affiliate companies.

Pursuing his cross-examination, Mr. Morrow, Q.C. asks:

Q. Is it a fair statement, Mr. Ogilvie, that on your examination of all of the records of the three companies that there is no inclusion in the income of Western Wood Products, the Appellant, of these items of debt that show as owing from Sylvan to Direct?

A. I would answer that by saying this. That in my opinion it was included in the calculation of income.

* * *

Q. . . . Now, concern yourself to what you saw on the books, sir. I am suggesting it does not show anywhere?

A. As being included in the income?

Q. Yes?

A. I would say "No".

At page 41:

Q. Now to go back to my question. Except for what you can discern from Exhibits A and B, which presumably took place on December 31st, 1957, in all of your research and preparation and examination of what books you did before you came here can you find anywhere that that \$23,000 or any part of it or even a fraction of it shows on Western's books?

A. This is prior to December 1957 that you are speaking of?

Q. Yes?

A. No, I can't.

On page 46, we find that:

Q. (by Mr. Morrow) Did you ever at any time in any of your research see where it (Sylvan) had invoiced in any way or appeared to have done any work for the Western Wood Company?

A. No. I have examined no records in that regard.

Ogilvie agrees that in his review of whatever records were shown to him he could find no traces of arrangements between Direct Lumber or Sylvan Lumber and the appellant (cf. Transcript p. 47). On the preceding page 46, the witness was reported as stating that he could find no evi-

1963
 WESTERN
 WOOD
 PRODUCTS
 LTD.
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 ———
 Dumoulin J.
 ———

dence of Sylvan Lumber performing any work for Western Wood, nor any entries to such effect in the books of the two companies.

And again on page 57, we read the following questions and replies thereto between the same parties:

Q. And certainly as far as that balance sheet is concerned once again we find nothing indicating an indebtedness from the Sylvan Company to Western?

A. Correct.

* * *

Q. . . . Have you any knowledge yourself of why any advances or payments were made by Direct Lumber to Sylvan?

A. No, I don't know why they were made from Direct Lumber to Sylvan Lumber.

Surely, no material of any convincing worth was adduced in respect of this second point, nothing from which the appellant could possibly derive any assistance for his contention of a bona fide indebtedness, created between Sylvan Lumber and Direct Lumber, guaranteed by Western Wood. Appellant's theory must stand or fall according to the evidence given by his accountant and only witness, who, on cross-examination, has, so far, negatived this basis of his client's plea.

Coming now to the third item:

c) The credibility of the debt transfer from Sylvan to Western Wood, some mention should be made of the pertinent exhibits filed.

One sheet of paper supposedly holds good for five exhibits, viz: A, B, G, H and I. This document, a copy of the appellant's ledger or book of accounts, bears the date of December 31st, 1957, according to information orally imparted, since only the last figure of the year appears.

I do not hesitate to say that, but for explanation obtained at the trial, this more or less glorified scrap of paper might have remained meaningless due to its practically illegible scribbling. Apparently (cf. exhibit B) it debits Sylvan Lumber in the sum of \$26,133.39 and credits Direct Lumber Limited with \$26,133.39. Correspondingly, exhibit A on the left hand column has these entries:

Dr. P. & L. (meaning probably Proprietorship and Liabilities)	\$ 23,000
Cr. Res. Bad Debts	\$ 23,000
Re Sylvan	

I might add that exhibit C Western Wood Products balance sheet for the six months ending June 30, 1956 under the mention "Advances to Affiliated Companies" debits Direct Lumber Company in the sum of \$33,246.16.

1963
WESTERN
WOOD
PRODUCTS
LTD.
v.
MINISTER OF
NATIONAL
REVENUE
Dumoulin J.

The appellant's income tax return for 1957, exhibit I, is no more explicit than exhibits A and B. It lists a first and initial reserve for Bad Debts amounting to \$22,992, subsequently carried over to the round sum of \$23,000. This too unconventional method of bookkeeping led respondent's counsel to probe Mr. Ogilvie on its dubious merits. (cf. Transcript pp. 50-51).

Q. So that another piece of paper still in Western's accounts shows a reserve for, what do you call it, a deposit to cover bad debts of \$23,000.00?

A. Yes.

Q. And it says "re: Sylvan"?

A. That is correct.

Q. And I assume that you have noticed or that there is such a thing, there is a similar type of voucher in Direct's books and in turn in Sylvan's books working this thing back or forwards as the case may be?

A. I have not seen these. However in the audit report of our 1958 examination we did report that the accounts had been checked, the inter-company accounts had been checked from the books of one to the other.

Q. Now, in this cheque (check) that you refer to and in your research for preparation for today have you ever seen any documents such as a letter or a document of assignment or anything of that kind passing between one company and another with respect to the \$26,133.00, or with respect to the \$23,000.00?

A. No, I have seen no documents.

Q. And you have not observed any document for example of Western dated December 31st, 1957 or subsequent to that saying "we have assumed this matter" or "we have allowed this transaction to take place and you can now look to us", or vice versa, none of that?

A. Nothing.

Q. Nothing of that kind. And aside from these two exhibits A and B you have no other knowledge of how the \$23,000.00 got into their books?

A. No.

A few remaining quotations, taken from pages 59 and 62, will suffice to complete this overlong sifting of the evidence.

Mr. Morrow to Ogilvie:

Q. Now would you agree with me that certainly up until one minute before Exhibits A and B took place we have Sylvan as building up an indebtedness and perhaps the other companies building up a profit?

1963
 WESTERN
 WOOD
 PRODUCTS
 LTD.
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 ———
 Dumoulin J.
 ———

- A. This appears to be so.
- Q. Mr. Ogilvie, we have already had you say that insofar as your research is concerned you could find no sign of a guarantee or any such written undertaking or assumption of an obligation by Western Wood Products to take over the obligations of Sylvan to Direct, we have already got that?
- A. That is correct.
- Q. Now starting from that point I am asking you that to transfer over this \$23,000.00 liability to Western Wood Products and thereby reduce Western Wood Products profit for the year is that not in effect an artificial attempt to reduce Western Wood Products income?
- A. I would answer by saying this, that if we assume the guarantee was there it is not.
- Q. Yes, but you have already said that you had no knowledge of a guarantee?
- A. That is correct.
- Q. Well then let us say assuming there is no guarantee?
- A. Assuming there is no guarantee it could be looked upon in that way, yes.

This protracted analysis of the case's factual components scarcely leaves any room for doubt. The unescapable result cannot be any other but that: a) Western Wood Products utterly failed to prove it had undertaken to hold Direct Lumber Ltd. secure against eventual losses in the latter's dealings with the now defunct Sylvan Lumber Co.; b) also failed to establish any debtor-creditor relations between itself and Direct Lumber, resulting from a warranty of Sylvan's debts, and c), did not resort to its so-called book-keeping entries, viz. exhibits A and B to a bare minimum of reliable information. It does appear that the alleged transfers of debts, guessed at more than shown on exhibits A and B, dated Dec. 31, 1957, are nothing better than flimsy traces of an otherwise easily discernible attempt to "unduly or artificially reduce the income" of appellant, in defiance of sec. 137(1). A manipulation of this kind was of course facilitated by the interwoven relationship of the three legal entities concerned, which were not dealing at arm's length (cf. sec. 139(c)(i)).

The paramount motives, however, for waiving aside the appellant's averments are, as stated in respondent's brief, that in the absence of assignments or guarantees Western Wood Products was not a creditor of Sylvan Lumber whose indebtedness to Direct Lumber arose from transactions foreign to Western Wood Products. Therefore, the appellant

is excluded from the scope of sec. 11(1) and the permissive exception of its s-s. (e)(i) thus worded:

(1) Notwithstanding paragraphs (a), (b) and (h) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

- (e) Reserve for doubtful debts.—a reasonable amount as a reserve for
 - (i) doubtful debts that have been included in computing the income of the taxpayer for that year or a previous year.

1963
WESTERN
WOOD
PRODUCTS
LTD.
v.
MINISTER OF
NATIONAL
REVENUE
Dumoulin J.

For the reasons above, the appeal is dismissed with all taxable costs allowed to the respondent.

Judgment accordingly.