BETWEEN:

JOHN S. DAVIDSON ..... APPELLANT;

AND

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

Vancouver 1968
March 7-9
March 20

Income tax—Capital or income—Private company formed to finance building companies—Shares received from building companies as compensation—Conversion to public company—Sale of shareholders' shares—Whether shareholders' profit taxable.

Appellant, an insurance broker, and five other men were the sole shareholders and directors of the W company, a private company incorporated in British Columbia in 1954 which advanced money to a number of corporations each of which was set up by W company's directors to construct an apartment block or commercial building. The separate companies obtained some of their funds from the W company which in turn borrowed money from a bank on its shareholders' guarantees. As consideration for the loans the W company received 10% of the shares of each of the separate companies. Such shares were intended to pay an 8% annual dividend. By December 1958 the W company had received nearly 462,000 shares in 19 separate companies and had received dividends from such shares though no dividends were paid by the W company to its own shareholders. In October 1958 one of W company's shareholders died and because of ensuing difficulties in carrying on the above arrangement the W company was converted to a public company and its shareholders' shares sold. Appellant was assessed to income tax on the proceeds of the sale of his shares in W company, *viz* $67,546.

Held, in selling his shares appellant was realizing an investment and the gain thereon was not subject to income tax. Appellant did not acquire the shares with the intention of selling them at a profit and hence they did not become inventory in a business.

Irrigation Industries Ltd. v. M.N.R. [1962] S.C.R. 346; *Moluch v. M.N.R.* [1967] 2 Ex. C.R. 158; [1966] C.T.C. 712; *M.N.R. v. Firestone Management Ltd.* [1967] 1 Ex. C.R. 340; [1966] C.T.C. 771, referred to.

INCOME TAX APPEAL.

P. N. Thorsteinsson for appellant.

T. E. Jackson and *S. A. Hynes* for respondent.

SHEPPARD D.J.:—The appellant, John S. Davidson, contends that the sum of $67,546.74 received in 1959 from the sale of shares in Combined Estates Ltd. (formerly Welfar Holdings Ltd.) was capital, and the Minister was in error in including that amount in the appellant's taxable income. On the other hand, the Minister contends that the sum was taxable income. That is the issue. The facts follow.

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In 1935 the appellant moved from Calgary, Alberta, his birth place, to Vancouver, B.C. From 1936 to 1938 he was employed by H. A. Roberts Ltd. of Vancouver in their real estate business. In 1938 he joined Parsons, Brown Ltd., Vancouver, to sell insurance and apart from being in the army has since been engaged in insurance, formerly in selling for an agent, latterly as insurance broker. During the war he was in the army and in 1946 he rejoined Parsons, Brown Ltd. managing their sales agency. Later he was associated with R. M. Abernathy (Alberta) Ltd. and Abernathy Insurance Associates Ltd., Vancouver, with B. L. Johnson Walton (Alberta) Ltd. and B. L. Johnson Walton Co. Ltd. That is, the appellant was associated for some years with the Abernathy Companies of which he was a member and they subsequently combined with the Johnson Walton Companies. In 1959 Johnson Walton Companies merged with Reid, Shaw & McNaught, insurance brokers, and the appellant has since continued as a partner of that firm.

On 10th December, 1954 Welfar Holdings Ltd. (later Combined Estates Ltd.) and also B. C. Estates Ltd. were incorporated. The appellant was acquainted with all of those who became shareholders and directors other than Whitelaw and was approached to join the Company (Welfar) by Donald Farris. Welfar Holdings Ltd. was incorporated as a private company with the objects in the Memorandum of Association (Ex. A-1, Item 21); the initial shareholders were Donald Farris, the appellant, Ralph K. Farris, Frank S. Welters and James S. McKee, each holding 200 shares purchased at a dollar per share. B.C. Estates Ltd. was incorporated with the same shareholders holding the same number of common shares, and in addition, preference shares to the amount of $4,600, and was formed to purchase shares in other companies and to resell to the public. In March, 1956 each of the five shareholders issued 20 shares to Geoffrey H. Whitelaw in each of the companies at the original subscription price of one dollar per share.

The business of the two companies, Welfar and B.C. Estates, was to finance each of other companies called "little companies" to build an apartment block or commercial building in Vancouver, and the business was carried out as follows: Whitelaw would select a property suitable

for building and if approved by the directors of Welfar, a little company would be formed to purchase the property and to build thereon an apartment block or commercial building. The little company would obtain the funds, by mortgage of the property, and the balance by borrowing from Welfar on promissory note. That balance was borrowed by Welfar from a bank on the guarantee of each of the six directors and then lent by Welfar to the little company for which loan Welfar would receive 10% of the shares in the little company (Ex. A-2, para. 5). Thereupon the little company would enter into an underwriting agreement to sell B.C. Estates Ltd. its shares at 85 or 90 cents. The shares of the little company were then sold by B.C. Estates Ltd. at par ($1.00) and the monies received by the little company would be used to repay the advance from Welfar. The shares of the little company were made saleable by the prospect of receiving 8% in dividends; typical prospectuses are Exhibit A-1, Items 6, 7 and 8. Welfar had with the bank an authorized credit of $165,000 of which $146,000 was the most outstanding, and on 20th October, 1958 the bank loan was $115,000. Those represented loans to little companies and each director of Welfar was liable to the bank jointly and severally.

As the result of this plan, by December, 1958 Welfar had received 461,912 shares in 19 little companies which shares were placed in escrow by the Registrar of Companies (Ex. A-2, Supplementary Agreement, p. 3), and Welfar received dividends from the little companies to the amount appearing in Exhibit A-1, Items 1 and 2, but Welfar had paid no dividends to its shareholders. At no time were any of the shares in Welfar or in any of the little companies listed, and all the little company shares were sold through B.C. Estates Ltd., of which the shareholders were those in Welfar.

On 21st October, 1958, James S. McKee, one of the shareholders of Welfar and B.C. Estates, died, and this death resulted in difficulty in proceeding with the plan of Welfar as it involved Welfar borrowing from the bank on the guarantee of the five directors. The estate of McKee wished to liquidate the assets, and the surviving directors, including the appellant, were not prepared to guarantee the loans and so carry the estate. As a result, the outstand-

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ing shares in Welfar, which were owned respectively by the estate of McKee and the other five (including therein Whitelaw) were sold through B.C. Estates Ltd. as follows:

22nd December, 1958—9,000 unissued shares in Welfar were cancelled and the 1,000 shares issued were divided into 420,000 shares at a nominal or par value (Ex. A-1, Item 9) and the Registrar of Companies authorized the issuing of 420,000 shares at a nominal or par value (Ex. A-1, Item 11);

15th January, 1959—Welfar's name was changed to Combined Estates Ltd. (Ex. A-1, Item 12);

26th January, 1959—Combined Estates Ltd. converted itself from a private company into a public company (Ex. A-1, Item 13). Thereupon the shareholders in Combined Estates Ltd. sold their shares to B.C. Estates Ltd. (Ex. A-1, Item 17) and B.C. Estates Ltd. sold them to the public, and from the proceeds of the sale the share of the appellant amounting to $67,546.74 was assessed by the Minister as taxable income.

Following the sale the five surviving directors, the appellant and four others, including Whitelaw, incorporated Farwel Holdings Ltd. for the purpose of continuing the same plan which had been followed by Welfar (Ex. A-2, Supplementary Agreement, para. 5) and Farwel thereupon, according to the plan, financed three little companies to build three buildings. It was learned that the price of lots had increased to such an extent that it was necessary to build highrise apartments to produce a return of 8% on the investment, but the building of the highrise apartments increased the loan from the bank and the amount to be guaranteed by the directors; as a result, Farwel did not continue financing other little companies.

The issue results in the ultimate question whether the shares of the appellant in Welfar were an investment and the proceeds capital, as the appellant contends, or whether the shares were inventory in a business of the appellant and therefore the profit taxable income as the Minister contends.

The appellant has testified that the shares in Welfar were an investment, that his business was selling insurance

and the proceeds from the shares were the realizing of an investment and therefore capital. His testimony is:

(a) that his business throughout was insurance, commencing with Parsons, Brown, and through other associations until 1959 when he joined Reid, Shaw & McNaught, therefore throughout he was selling insurance, latterly as insurance broker;

(b) that the shares in Welfar were an investment as they were bought for dividends. No dividends were declared by Welfar. However it did receive dividends at the rate of 8% from the various little companies in each of which it held 10% of the shares (Ex. A-1, Items 1 and 2). It is immaterial that Welfar paid no dividends as its shares were capable of producing dividends: *M.N.R. v. Valclair Investment Company Limited*[1]; and that the shares were purchased for the income which they could produce and were therefore an investment;

(c) that the sale was caused by the death of McKee on the 21st October, 1958, that is, by the desire of the personal representatives to administer the estate and the reluctance of the surviving directors to become personally liable under the guarantee for the benefit of the estate.

The death of McKee produced reasons for not continuing the former plan to a degree more substantial than the appellant had considered. The death of McKee caused the continuing directors to lose a right of contribution against McKee as a continuing director—and raised the question whether the estate or the personal representative would be liable to the bank for future advances on previous guarantees, which would depend on when the bank had notice of the death (18 *Halsbury* (3rd Ed.) p. 526, para. 869), and the further question whether there was any right of contribution against the estate for any future advance (*Labouchere v. Tupper*)[2]. Moreover, in continuing with a legal representative there is always the potential liability for knowingly participating with the legal representa-

[1] [1964] Ex. C.R. 466; [1964] C.T.C. 22.
[2] (1857) 11 Moo. P.C. 198 at p. 211; 14 E.R. 670 at p. 679.

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tive in a breach of trust: *Barnes v. Addy*[3] and *Keeton on Trusts* (8th Ed.) p. 850. Hence the death of McKee was an adequate reason for not continuing with the initial plan.

On the appellant's evidence, the shares in Welfar were bought to be held for their income and not for resale and that is corroborated by the fact that Welfar Holdings Ltd. was a private company and under the *Companies Act*, R.S.B.C. 1948, c. 58, sec. 2, continued in 1960, c. 67, sec. 2, a private company means a company that by its memorandum or articles:

(a) restricts the right to transfer its shares, and

(b) limits the number of its members to 50 or less (other than employees, actual or past), and

(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

It is not contended that it was impossible for the appellant to have sold his shares in a private company, but the right to transfer the shares was restricted. What that restriction was we do not know, as the memorandum only was produced, but a private company may be popularly regarded as equivalent to an incorporated partnership; that is, a transferee is admitted at the discretion of the continuing members. In any event, Welfar was not initially a public company and therefore the shares were not of a nature to be offered generally to the public. After deciding upon the sale of the shares, Welfar was turned into a public company in order to avoid the restrictions imposed upon a private company. That sale was merely a means of realizing on an investment: *M.N.R. v. Firestone Management Limited*[4], and the proceeds from the sale to B.C. Estates Ltd., being proceeds of an investment would be likewise capital: *Frankel Corporation Ltd. v. M.N.R.*[5]

On that evidence the shares were an investment and hence a capital asset; that, of course, is subject to other evidence establishing that the proceeds should be treated as taxable income. The Minister contends that the profit of the shares is taxable income within sections 3 and 4, being

[3] [1874] L R. 9 Ch. A. 244.

[4] [1967] 1 Ex.C R. 340; [1966] C.T.C. 771.

[5] [1959] S.C R. 713; [1959] C.T.C. 244.

profit derived from a business within section 139(1)(*e*), which extends "business" to include "an adventure...in the nature of trade".

To prove taxable income it is not enough in particular instances to prove a business, in that a business does not preclude there being capital assets, such as the building premises of a department store or of a brokerage company, and the proceeds of which in general will not be taxable income. In some instances the proof of a business within Section 139(1)(*e*) is sufficient to prove an inventory by reason of the implied intent of the taxpayer or by reason of the nature of the property. Two positive tests of carrying on business are set out in *Irrigation Industries Ltd. v. M.N.R.*[6] (cited for the Minister) where Martland J. stated at p. 352:

> The positive tests to which he refers as being derived from the decided cases as indicative of an adventure in the nature of trade are: (1) Whether the person dealt with the property purchased by him in the same way as a dealer would ordinarily do and (2) whether the nature and quantity of the subject-matter of the transaction may exclude the possibility that its sale was the realization of an investment, or otherwise of a capital nature, or that it could have been disposed of otherwise than as a trade transaction.
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> I will deal first with the second of these tests, which, if applied to the circumstances of the present case, would not, in my opinion, indicate that there had been an adventure in the nature of trade.
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> The nature of the property in question here is shares issued from the treasury of a corporation and we have not been referred to any reported case in which profit from one isolated purchase and sale of shares, by a person not engaged in the business of trading in securities, has been claimed to be taxable.
>
> Cases in which the nature and quantity of the property purchased and sold have indicated an adventure in the nature of trade include *The Commissioners of Inland Revenue v. Livingston* ((1926), 11 Tax Cas. 538) (a cargo vessel); *Rutledge v. The Commissioners of Inland Revenue* (1929), 14 Tax Cas. 490) (a large quantity of toilet paper); *Lindsay v. The Commissioners of Inland Revenue* ((1932), 18 Tax Cas. 43) and *Commissioners of Inland Revenue v. Fraser* ((1942), 24 Tax Cas. 498) (a large quantity of whisky); *Edwards v. Bairstow* ([1956] A.C. 14) (a complete spinning plant) and *Regal Heights Ltd. v. Minister of National Revenue* ([1960] S.C.R. 902) (40 acres of vacant city land).
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> Corporate shares are in a different position because they constitute something the purchase of which is, in itself, an investment. They are not, in themselves, articles of commerce, but represent an interest in a corporation which is itself created for the purpose of doing business. Their acquisition is a well-recognized method of investing capital in a business enterprise.

[6] [1962] S.C.R. 346

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and at p. 353:

> Furthermore, the quantity of shares purchased by the appellant in the present case would not, in my opinion, be indicative of an adventure in the nature of trade, as it constituted only 4,000 out of a total issue of 500,000 shares.

The first test set out in *Irrigation Industries Ltd. v. M.N.R.* is dealt with in *M.N.R. v. Taylor*[7], where the subject matter was 1,500 tons or 22 carloads of lead, and its kind and quantity implied an intent to sell to the employer. For the second test, cases are referred to in *Irrigation Industries Ltd. v. M.N.R.*

It would appear that when either test is applicable then the subject matter is denoted as inventory. Hence, if a person bought property with the intention of selling at a profit then he has dealt in general with it in the same way as a trader and impliedly has treated it as inventory by intending to make a profit by the purchase and sale. On the other hand, as stated in the *Irrigation* case at p. 352: "Corporate shares are in a different position because they constitute something the purchase of which is, in itself, an investment."

Therefore these tests do not apply to shares as they may be an investment, and to make the proceeds of shares taxable income the circumstances must indicate:

(1) That there was a business within section 139(1)(*e*);

(2) That the shares were properly treated as inventory in the business.

An instance of the converting of capital to inventory appears in *Moluch v. M.N.R.*[8] where the taxpayer bought farmland which was used initially for his home and as a farm and therefore was a capital asset, but later was subdivided to be sold for building lots. There Cattanach J. said:[9]

> If, at some subsequent point in time, the appellant embarked upon a business using the lands as *inventory* in the business of land subdividing for profit, then clearly the resultant profits would not be merely the realization of an enhancement in value, but rather profits from a business and so assessable to income tax in accordance with Sections 3 and 4 of the *Income Tax Act*, R.S.C. 1952, chapter 148.

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[7] [1956-60] Ex.C.R. 3.

[8] [1967] 2 Ex. C.R. 158; [1966] C.T.C. 712.

[9] [1967] 2 Ex. C.R. at p. 165; [1966] C.T.C. at p. 718.

That judgment was approved in *M.N.R. v. Firestone Management Limited* (*supra*), by Jackett P.[10] Hence the profits in the proceeds of the appellant's shares in Welfar are taxable income only if there was a business in which such shares were inventory.

The Minister contends that the profits are taxable income for the following reasons:

(1) That the plan of business adopted by Welfar, B.C. Estates and the little companies and adopted by the appellant and other directors by giving guarantees was of a complex and detailed nature which could be nothing but a business by the appellant and whoever entered into it. Exhibit 2-A, para. 5 shows the complex working out of the plan through the companies, Welfar, B.C. Estates Ltd. and the little companies, which resulted in Welfar obtaining 10% of the outstanding shares in the 19 companies referred to in Exhibit A-2 (Supplementary Agreement, p. 3), and in B.C. Estates Ltd. receiving a commission on the shares sold to the public and later a fee for managing the properties of the little companies.

It is not a question whether Welfar and associated companies were in business: that is evident, but the appellant being a shareholder: *Macaura v. Northern Assurance Company Limited*[11], or a director: *Parker v. McKenna*[12], would give him no proprietary interest in the companies' business. The question here is whether the appellant in purchasing his shares from Welfar, did so in the business of buying and selling such shares so as to make them an inventory. That is excluded by the fact that Welfar was a private company; the evidence is rather consistent with such shares being an investment.

(2) That such a promotion of Welfar must give rise to income receipts by the appellant, for the following reasons:

(a) The appellant was a partner in a stockbrokerage firm, Locke, Grey & Co., 1958, and he received

[10] [1967] 1 Ex C.R. at p. 345; [1966] C.T.C. at pp 774-5.
[11] [1925] A.C. 619 [12] (1875) 10 Ch. App. 96

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therefrom net profits of $3,851.97 (Ex. R-1), therefore his purchasing shares from Welfar was the mere continuing of his operations as broker. That does not follow. The appellant was a silent partner and took no active part in the management. As partner, though silent, he had an interest in any shares purchased by that firm because such purchase would be a joint purchase on behalf of all the partners. His shares in Welfar were not purchased by or for Locke, Grey & Co., nor was it a joint purchase, but a several purchase by the appellant for himself. That was not "an adventure... in the nature of trade" for the reasons given in *Irrigation Industries Ltd. v. M.N.R.* (*supra*).

(b) The appellant made money in companies engaged in many lines of business, therefore the variety of companies in which he was interested indicated that he was engaged in this instance in a further business (Ex. A-1, Item 16). On the other hand, throughout, the appellant has continued in the business of selling insurance and the amount he would have for investment would be derived from his profits in selling insurance and also the profits derived from investments. The number of investments does not exclude their being capital investments. Also there is no evidence that the quantity of shares held by the appellant gave him the control of any of those other companies. The absence of such control did indicate there was no adventure in the nature of trade and there was an investment in *Irrigation Industries Ltd. v. M.N.R.* (*supra*), at p. 353, and the fact that active control was exercised was considered relevant in *Mainwaring v. M.N.R.*[13] and *Robertson v. M.N.R.*[14]. In any event, we are not here concerned with the nature of the appellant's interests in other companies but with the nature of his

[13] [1965] 1 Ex.C.R. 271; 64 DTC 5214.

[14] [1964] Ex.C.R. 444; 63 DTC 1367; (affirmed 64 DTC 5113).

interest in his shares in Welfar, a private company, which were presumably not purchased for the purpose of resale and were not inventory.

(3) That the appellant in joining Welfar has become associated with persons in the business of buying and selling shares and therefore, because of his association, he must be known as a person who is so engaged in buying and selling shares. As a partner in Locke, Grey & Co. he was undoubtedly interested in those purchases made by the firm on behalf of the firm, but in this instance it was not a joint purchase but a several purchase by the appellant for himself and he is not concerned with the motives in which other members may have purchased their shares, whether with an "alternative intention" as in *Regal Heights Ltd. v. M.N.R.*[15], or even with a multiple of intentions.

The minister has cited the following additional cases which are distinguishable on the facts. In each case it was held that the transaction was part of a business and invariably that the subject matter was purchased for the purpose of the taxpayer selling at a profit.

In two cases the shares were bought for the purpose of selling at a profit and the control and management indicated a business to promote the value of the shares: *Mainwaring v. M.N.R., (supra); Robertson v. M.N.R. (supra)*. On the other hand, in *Gladys Mainwaring v. M.N.R.*[16], it was held that her purchase of shares was not part of a business and presumably not part of the business of her husband.

In other instances, the taxpayer had a business for dealing in the subject matter and he was held to have purchased and sold the subject matter as a continuation of that business: *Whittall v. M.N.R.*[17]; *Gairdner Securities Ltd. v. M.N.R.*[18]; *McMahon and Burns Limited v. M.N.R.*[19]; *Stuyvesant-North Limited v. M.N.R.*[20]; *Ritchie v. M.N.R.*[21]; *Osler, Hammond & Nanton Ltd. v. M.N.R.*[22].

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15 [1960] S C R 902 16 63 DTC 1029.
17 [1965] 1 Ex C R. 342; 64 DTC 5266; 67 DTC 5264.
18 [1952] Ex C R. 448. 19 56 DTC 1092.
20 [1958] Ex C.R. 230; 58 DTC 1092.
21 60 DTC 595.
22 [1963] S.C.R. 432; 61 DTC 595; 63 DTC 1119.

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In *Morrison v. M.N.R.*[23], the subject matter was grain purchased for resale at a profit by one who was in the business of buying and selling grain.

In *M.N.R. v. Spencer*[24], the acquiring by a solicitor of mortgages was held to be so close to the normal practice of a solicitor as to be part thereof and therefore the profits were taxable income under Sections 3 and 4.

Land purchased to be sold for one purpose and sold for another was held to be included in the business by reason of the doctrine of frustration and the rule of alternative intentions and hence the profit was taxable income: *Regal Heights Ltd. v. M.N.R., (supra); Rothenberg v. M.N.R.*[25], *Slater et al. v. M.N.R.*[26]; *Diamond v. M.N.R.*[27]; *Farris v. M.N.R.*[28]

In *Mikula v. M.N.R.*[29], the appellant a nurse, was in partnership with her brother who purchased for the firm for the purpose of selling for a profit, and which she, as a partner, was held to have acquired as part of that business and was therefore taxable on the income.

In *Campbell v. M.N.R.*[30], the sale of shares in a private company was held to be merely a means of selling the apartment building which the company and also the taxpayer were in the business of constructing.

Basically those cases depend on a finding of fact, in effect, that the taxpayer acquired the subject matter with the intent of selling at a profit. Whether or not that intent existed was a question of fact, and on that finding, depended the conclusion in law that the profit was derived from inventory, and therefore was taxable income.

That distinguishes the case at bar as here the initial intention of the appellant was to hold the shares in the private company, Welfar, to produce dividends and there was no intent to sell until that intent was necessitated by the subsequent death of McKee.

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[23] [1928] Ex.C.R. 75; (1927) 1 DTC 113.
[24] 61 DTC 1079 at p. 1092.
[25] [1965] 1 Ex.C.R. 849; 65 DTC 5001.
[26] [1966] Ex.C.R. 387; 66 DTC 5047; [1966] CTC 53.
[27] [1967] 1 Ex.C.R. 541; 66 DTC 5434.
[28] 63 DTC 1221.
[29] 66 DTC 636.
[30] [1953] 1 S.C.R. 3; 52 DTC 1187.

On the 21st October, 1958, the death of McKee occurred and that fortuitous event resulted for the first time, so far as the appellant was concerned, in deciding not to continue the association but to sell his shares in the company, and the subsequent steps were consistent with realizing on an investment; namely, the converting to a public company so that the shares could be sold unfettered, and the subdividing of the shares into their approximate book value so that the full value could be received.

The evidence therefore does not establish that the appellant: (1) entered into the business of dealing in those shares, (2) nor that such shares became an inventory in such business. The realizing of a profit on the shares as an investment is immaterial: *Irrigation Industries Ltd. v. M.N.R.* (*supra*), at pp. 350 and 354-5, citing *Californian Copper Syndicate v. Harris*[31].

In the result the appeal is allowed with costs to the appellant. The assessment by the Minister is vacated and the matter referred back for reassessment in accordance with:—

(a) The agreement (Ex. A-3) that $7,485, being 50% of the amount of $14,970 received from Western Technical Consultants be included in the income;

(b) That the sum of $67,546.74, the amount here in question, be considered as capital and not as taxable income.

[31] (1904) 5 T.C 159.