BETWEEN:

CONN STAFFORD SMYTHE .....APPELLANT,

AND

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

AND BETWEEN:

CONN SMYTHE .....APPELLANT,

AND

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

AND BETWEEN:

CLARENCE H. DAY .....APPELLANT,

AND

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

Toronto 1967

Sept. 18-22, 25-26.

Ottawa Dec. 14

Income Tax Act, c. 148, R.S.C. 1952, sections 105-105B—Transactions "dividend stripping" or "surplus stripping"—"Daylight loan"—Applicability of section 137(2)—Not a "bona fide" transaction.

These appeals tried together on common evidence from re-assessments on income tax for the taxation year 1961 relate to the categorization of the receipts of monies received by the appellants as a result of series of transactions in December 1961 concerning the shares held by each of them in an Ontario corporation by the name of C. Smythe Limited. The series of transactions are sometimes referred to as "dividend stripping" or "surplus stripping".

In December 1961, C. Smythe Limited has undistributed earned surplus of approximately $728,652.

As a result of the series of transactions carried out in December 1961, this said undistributed earned surplus was paid or appropriated to the shareholders of C. Smythe Limited of which the appellants were three of them. This payment or appropriation was in the form of $275,336 cash and $423,316 worth of non-interest bearing debenture certificates in a newly incorporated company known as C. Smythe For Sand Limited.

The appellants contended that the receipts were capital receipts and not income.

There were no business reasons for entering into these transactions.

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The relevant transactions in the said series of transactions were as follows:

In December 1961, the appellants caused a new Ontario corporation to be incorporated under the name of C. Smythe For Sand Limited, of which they became the owners of the issued shares (which were common shares).

All assets of C. Smythe Limited were then transferred to C. Smythe For Sand Limited in exchange for a promissory note to the value thereof, *viz.* $2,611,769.

On December 28, 1961, all the shares of C. Smythe Limited were sold to F. H. Cameron Limited and Dabne Enterprises, two Vancouver based corporations, incorporated under the British Columbia *Companies Act*. To accomplish this, certain transactions were entered into practically simultaneously: the appellants caused a temporary loan to be made to C. Smythe For Sand Limited by the Toronto-Dominion Bank, Toronto Branch, in order to pay off the said promissory note to C. Smythe Limited, thereby putting its assets in cash form; and F. H. Cameron Limited and Dabne Enterprises Limited obtained a temporary loan—"daylight loan" from the Bank of Montreal, Vancouver, B.C., to pay the appellants and A. M. Boyd for their shares in C. Smythe Limited; F. H. Cameron Limited and Dabne Enterprises Limited (*qua* new and then only shareholders of C. Smythe Limited) caused C. Smythe Limited to invest in preferred shares of F. H. Cameron Limited and Dabne Enterprises Limited equal to the amount (i.e. $2,611,769) of its cash assets, thereby putting cash in F. H. Cameron Limited and Dabne Enterprises Limited to enable them to pay off their "daylight loan" from the Bank of Montreal; and the appellants subscribed and paid for certain common shares in C. Smythe For Sand Limited and loaned it certain monies, from the monies they received from this sale of their shares in C. Smythe Limited; and then the temporary loans were respectively repaid to the said banks by C. Smythe For Sand Limited and F. H. Cameron Limited and Dabne Enterprises Limited.

The net cash assets of C. Smythe Limited after this temporary bank loan was made, as stated, had a value of $2,611,769. The appellants and A. M. Boyd sold their shares for $2,570,336 or $41,433 less than the book value of these shares at the time.

The said sum of $41,433 was 5 per cent of $728,752. (The undistributed earned surplus of C. Smythe Limited) namely, $36,433 plus $5,000.

Held, that these payments or appropriations were income in the hands of the appellants and that section 137(2) of the *Income Tax Act* applied to the facts of these cases in that the "result" of these transactions was that a "benefit" was conferred on the appellants and the other shareholders of C. Smythe Limited by disposal of its assets and that person "who conferred this said 'benefit' was C. Smythe Limited" with the help of and as "parties thereto", the following and others, namely, F. H. Cameron Limited, Dabne Enterprises Limited, F. H. Cameron personally, the Bank of Montreal, British Columbia, and the Toronto-Dominion Bank at Toronto and at Vancouver, "notwithstanding and the form or legal effect of the transactions".

Held also, that section 137(3) is no defence in this case as the applicability of s. 137(2) of the *Income Tax Act*, in that (1) this transaction was pursuant to and part of other transactions; (2) was not a *bona*

fide transaction and (3) that, *inter alia,* one part of the series of transactions was not a transaction entered into by persons dealing at arm's length.

Appeals dismissed with costs.

INCOME TAX APPEALS.

Terence Sheard, Q.C. for appellants Conn Smythe and Clarence H. Day. *John G. Edison, Q.C.* for appellant Conn Stafford Smythe.

W. B. Williston, Q.C., A. D. Givens, G. W. Ainslie and *Peter F. Cumyn* for respondent.

GIBSON J.:—These three appeals are from the respective assessments for income tax made against the appellants contained in Notices of Re-Assessment dated 1966 for the taxation year 1961 and on consent were tried together on common evidence.

In each of the Notices of Re-Assessment and in the explanation of the changes from the prior assessments, the increase in taxes assessed and claimed was stated to be made on the premise that each of the appellants was deemed to have received a dividend arising out of what they received as a result of transactions in December 1961 concerning the shares held by each of them in the Ontario corporation known as C. Smythe Limited.

In December 1961, the common shares (which were the only shares) of C. Smythe Limited were owned and in the following proportions by:

Conn Smythe	52%
Conn Stafford Smythe	30.8%
Clarence H. Day	16%
and A. M. Boyd	1.2%

No proceedings have been taken by the respondent against A. M. Boyd in respect to this matter.

In December 1961 C. Smythe Limited had undistributed earned surplus of approximately $728,652 and capital gains which, when realized, might approximate $1,800,000.

The said shareholders of C. Smythe Limited before causing to be done any of the things that were done here, were aware of the incidence of income tax if any of this undistributed earned surplus or capital gains was paid to

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them or appropriated for their benefit by employing and complying with the provisions of either section 105[1] or 105B[2] of the *Income Tax Act*.

These appeals relate to what was done by a series of transactions in December 1961 in respect to the undistributed earned surplus of approximately $728,652 in C. Smythe Limited.

By these transactions, this said undistributed earned surplus was paid or appropriated to the shareholders of C. Smythe Limited, namely, the three appellants Conn Smythe, C. Stafford Smythe, Clarence H. Day, and A. M. Boyd (who was not a party to these proceedings). This payment or appropriation was in the form of $275,336 cash and $453,316 worth of non-interest-bearing debenture certificates in a newly incorporated company known as C. Smythe For Sand Limited.

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[1] 105. Corporation election.

(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.

(1a) In lieu of making any election under subsection (1), a corporation may, in any taxation year at a time when

(*a*) its undistributed income on hand at the end of the immediately preceding taxation year minus its tax-paid undistributed income as of the end of that immediately preceding taxation year.

is less than

(*b*) its undistributed income on hand at the end of the 1949 taxation year minus its tax-paid undistributed income as of the end of that taxation year,

elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount equal to the amount determined under paragraph (*a*).

(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*) that has paid the tax payable by virtue of having made an election under subsection (1) or (1a),

may elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount not exceeding

(*c*) the aggregate of

(i) the dividends declared by it that were paid by it in the taxation years beginning with the 1950 taxation year and ending with the last complete taxation year before the election under this subsection, and

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In respect to this payment or appropriation, no income tax was paid by either C. Smythe Limited or by any of its said shareholders or A. M. Boyd personally.

There was no business reason for entering into these said transactions.

This series of transactions for all practical purposes began on November 17, 1961 when at a meeting of the directors of C. Smythe Limited authority was given to the President (Conn Smythe) to arrange for the distribution of $375,000 of this undistributed earned surplus of approximately $728,652 to the shareholders of C. Smythe Limited; and Mr. S. E. V. Smith of Price Waterhouse & Co., chartered accountants, Toronto Office, was employed to arrange for this to be done.

The said Mr. S. E. V. Smith acted as agent for the appellants (and A. M. Boyd) at all material times, and specifically in advising, negotiating and completing the preliminary transactions and the transaction between the appellants and two British Columbia companies by the names of F. H. Cameron Limited and Dabne Enterprises Limited, concerning the sale of the said shares held by each of them in C. Smythe Limited.

(ii) the dividends that were, by section 81, deemed to have been received by shareholders of the corporation in the taxation years referred to in subparagraph (i),

except such portions thereof as, by virtue of subsection (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

(*d*) the aggregate of the amounts under which it has previously paid tax under this subsection or under subsection (2a) or (2b).

(2a) A subsidiary controlled corporation that is subsidiary to a personal corporation and

(*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*) that has paid the tax payable by virtue of having made an election under subsection (1) or (1a),

may elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount not exceeding

(*c*) the aggregate of

(i) the dividends declared by it that were paid by it in the taxation years beginning with the 1950 taxation year and ending with the last complete taxation year before the election under this subsection, and

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Certain steps had been taken earlier in 1961 to put the assets of C. Smythe Limited in more liquid form so that some form of corporate distribution could be made to its shareholders and this made possible the implementation of the said directors' decision of November 17, 1961 to distribute $375,000.

Up until about the middle of December 1961, a transaction invoking and pursuant to section 105B of the *Income Tax Act* with Greenshields Inc., Montreal Office, was being considered, but on December 20, 1961, the appellants finally decided to enter into the said transaction for the sale of their shares in C. Smythe Limited (which was eventually completed) with F. H. Cameron Limited and Dabne Enterprises Limited. Prior to that day, the appellants *qua* shareholders of C. Smythe Limited had caused it to enter into and complete other transactions, which enabled the appellants to make this decision and election on that day.

(ii) the dividends that were, by section 81, deemed to have been received by shareholders of the corporation in the taxation years referred to in subparagraph (i),

except such portions thereof as, by virtue of subsection (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

(*d*) the aggregate of the amounts upon which it has previously paid tax under this subsection or under subsection (2) or (2b), and

(*e*) such part of the dividends described in subparagraphs (i) and (ii) of paragraph (c) as were paid by it, or were deemed to have been received by its shareholders, as the case may be, when it was a subsidiary controlled corporation and was not subsidiary to a personal corporation.

(2b) Other subsidiary controlled corporations. A subsidiary controlled corporation that is not subsidiary to a personal corporation and

(*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*) that has paid the tax payable by virtue of having made an election under subsection (1) or (1a),

may elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount not exceeding

(*c*) the amount determined under subsection (2) on which it would have been entitled to pay tax if, immediately before becoming a subsidiary controlled corporation, it had made an election under subsection (2) to pay tax thereunder,

minus

The relevant transactions which the appellants caused C. Smythe Limited to enter into and complete in December 1961 and the other transactions in 1962 were as follows:

In December 1961, the appellants caused a new Ontario corporation to be incorporated under the name of C. Smythe For Sand Limited of which they became the owners of the issued shares (which were common shares).

All assets of C. Smythe Limited were then transferred to C. Smythe For Sand Limited in exchange for a promissory note to the value thereof, *viz.*, $2,611,769.

On December 28, 1961, all the shares of C. Smythe Limited were sold to F. H. Cameron Limited and Dabne Enterprises Limited, two Vancouver-based corporations, incorporated under the British Columbia *Companies Act*. To accomplish this, certain transactions were entered into practically simultaneously: the appellants caused a temporary loan to be made to C. Smythe For Sand Limited

(*d*) the aggregate of the amounts on which it has previously paid tax under this subsection.

(3) Payment of tax with election. An election under this Part is null and void unless, when the election was made, there was paid to the Receiver General of Canada

(*a*) if the election was made under subsection (1) or (1a), the amount of the tax as estimated by the corporation in the election, and

(*b*) if the election was made under subsection (2), (2a) or (2b), the amount of the tax that the corporation elected to pay.

(4) Deficient or excessive payments. Where an election was made under subsection (2), (2a) or (2b) and the amount of the tax paid with the election is in excess of or less than 15% of the amount on which, according to the election, the corporation elected to pay tax, the corporation shall be deemed to have elected to be assessed and to pay tax under that subsection on an amount equal to the lesser of

(*a*) 100/15 of the amount of the tax so paid, or

(*b*) the maximum amount on which it was entitled, at the time the election was made, to elect under subsection (2), (2a) or (2b), as the case may be, to be assessed and to pay tax.

(5) Where the estimated amount of tax under subsection (1) or (1a) that was paid with an election was in excess of or less than the amount payable under that subsection, tax shall be deemed to have been paid under this Part on an amount equal to the lesser of

(*a*) 100/15 of the estimated amount of tax so paid, or

(*b*) the amount on which the corporation was entitled, at the time the election was made, to elect under subsection (1) or (1a), as the case may be, to be assessed and to pay tax.

(6) Assessment. The Minister shall, with all due dispatch, examine each election made under this section, assess the tax payable and send a notice of assessment to the corporation.

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by the Toronto-Dominion Branch, Toronto, in order to pay off the said promissory note to C. Smythe Limited, thereby putting its assets in cash form; and F. H. Cameron Limited and Dabne Enterprises Limited obtained a temporary loan—"daylight loan" from the Bank of Montreal, Vancouver, B.C. to pay the appellants and A. M. Boyd for their shares in C. Smythe Limited; F. H. Cameron Limited and Dabne Enterprises Limited (*qua* new and then only shareholders of C. Smythe Limited) caused C. Smythe Limited to invest in preferred shares of F. H. Cameron Limited and Dabne Enterprises Limited equal to the amount (i.e., $2,611,769) of its cash assets, thereby putting cash in F. H. Cameron Limited and Dabne Enterprises Limited to enable them to pay off their "daylight" loan from the Bank of Montreal; and the appellants subscribed and paid for certain common shares and non-interest-bearing debentures of C. Smythe For Sand Lim-

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(7) Payment of deficiency Where an election was made under subsection (1) or (1a), the corporation shall, within 30 days from the day of mailing of the notice of assessment, pay to the Receiver General of Canada an amount equal to the amount by which the tax payable exceeds the tax as estimated in the election, whether or not an objection to or an appeal from the assessment is outstanding, and shall, in addition, pay interest on that amount at 6% per annum from the day of the election until the day of payment whether or not it was paid within the period of 30 days.

(8) Time tax deemed to have been paid. Where the balance of the tax payable under subsection (1) or (1a) has been paid within 30 days of the day of mailing of the notice of assessment and interest, if any, payable under subsection (7) has also been paid within that time, the whole amount of the tax payable shall be deemed to have been paid under this Part on the day of the election.

(9) Application. Subsection (4) of section 46 and sections 58 to 61 are applicable *mutatis mutandis* to this Part.

[2] 105B Dividends paid out of designated surplus.

(1) Tax. Where a corporation other than a non-resident-owned investment corporation has in a taxation year paid a dividend the whole or any part of which would, if section 28 were applicable, be regarded as having been paid out of designated surplus of the corporation as determined under that section, and the corporation was, at the time the dividend was paid, controlled by

(*a*) a non-resident corporation,

(*b*) a person exempt from tax under section 62 other than a personal corporation, or

(*c*) a trader or dealer in securities,

the corporation shall, on or before the day on or before which it is required to file a return of income under Part I for the taxation year in which the dividend was paid, pay a tax equal to

ited, with some of the money they received from this sale of their shares in C. Smythe Limited; and then both temporary loans were respectively repaid to the said banks by C. Smythe For Sand Limited and F. H. Cameron Limited and Dabne Enterprises Limited.

The net cash assets of C. Smythe Limited after this temporary bank loan was made, as stated, had a value of $2,611,769. The appellants and A. M. Boyd sold their shares for $2,570,336, or $41,433 less than the book value of these shares at the time.

The said sum of $41,433 was 5 per cent of $728,652 (the undistributed earned surplus of C. Smythe Limited) namely, $36,433, plus $5,000.

This $5,000 was added after Mr. S. E. V. Smith of Price Waterhouse & Co. had advised Mr. Conn Smythe that the exact computation at the time of the undistributed earned surplus of C. Smythe Limited was difficult, and Mr. Smythe had instructed that the shares of

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(*d*) 15%, in any case where paragraph (*a*) or (*b*) applies, or

(*e*) 20%, in any other case,

of the amount of the dividend or, as the case may be, the part thereof that would, if section 28 were applicable, be regarded as having been so paid.

(2) Determination of payment of dividend. For the purpose of determining whether or not a dividend or any part thereof would, if section 28 were applicable, be regarded as having been paid out of designated surplus of the corporation as determined under that section, if the corporation was controlled by a person described in paragraph (*b*) or (*c*) of subsection (1), such person shall, at all times relevant to that determination, be deemed to have been a corporation.

(3) Dividends deemed to have been paid. For the purposes of this section, dividends deemed by this Act to have been received from the payer corporation and that are required by this Act to be included in computing the recipient's income (or that would be so required if the recipient were resident in Canada at the time the dividends were so deemed to have been received) shall be deemed to have been paid by the payer corporation.

(4) Controlled corporation. For the purposes of this section, a corporation is controlled by a person described in paragraph (*a*), (*b*) or (*c*) of subsection (1) if more than 50% of its issued share capital (having full voting rights under all circumstances) belongs to that person, or to that person and to persons with whom that person does not deal at arm's length.

(5) For the purposes of subsection (4),

(*a*) issued share capital of a corporation belonging to or held by a trustee or one or more other persons beneficially for owners or members of an organization, club, society or other unincorporated association that is a person exempt from tax under section 62 shall be deemed to be issued share capital

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C. Smythe Limited were to be offered for sale to F. H. Cameron Limited and Dabne Enterprises Limited at a flat price not subject to any negotiation based on the exact computation at the time of sale of the amount of this undistributed earned surplus.

As a result of these transactions, the appellants and A. M. Boyd received the following amounts in cash and in non-interest-bearing debentures of C. Smythe For Sand Limited:

	Cash Paid	*Amount of non-interest-bearing debentures of C. Smythe For Sand Limited received*
Conn Smythe	$ 143,175	$ 1,193,400
Conn Stafford Smythe ..	84,763	706,900
Clarence H. Day	44,054	367,200
A. M. Boyd	3,344	27,500
TOTAL	$ 275,336	$ 2,295,000

In respect to the said sum of $275,336 in cash received by them and $453,316 of the total of non-interest-bearing-debenture certificates, which amounts together equal

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of the corporation belonging to the organization, club, society or other association, as the case may be, as a person so exempt; and

(*b*) members of a partnership shall be deemed not to deal with each other at arm's length.

(6) Exception where shares acquired by gift or bequest. No tax is payable under subsection (1) where the payer corporation was, at the time a particular dividend was paid by it, controlled by a person exempt from tax under section 62, if all of the issued share capital of the corporation (having full voting rights under all circumstances) that, during the period defined in subsection (4) of section 28 as the "control period", belonged to that person or to that person and persons with whom that person did not deal at arm's length, was acquired by that person (or by that person and persons with whom that person did not deal at arm's length) by way of unconditional gift or unconditional bequest.

(7) Interest. Where a corporation is liable to pay tax under subsection (1) and has failed to pay all or any part thereof on or before the day on or before which it was required to pay the tax, it shall, on payment of the amount in default, pay interest at 6% per annum from the day on or before which it was required to make the payment to the day of payment.

(8) Return. Every corporation that is liable to pay tax under subsection (1) shall, on or before a day on or before which it is required to pay the tax, file a return of information in prescribed form relevant to the transaction or transactions giving rise to such tax.

(9) Section 46 and sections 55 to 61 are applicable *mutatis mutandis* to this Part.

$728,652, the amount of the said undistributed earned surplus of C. Smythe Limited, the appellants and A. M. Boyd as stated did not consider any part of the same as income within the meaning of the *Income Tax Act*, and accordingly did not declare their respective shares of these monies and debentures received as income in their individual tax returns for 1961, and in consequence, no income tax was paid by any of them in respect of the receipt of these monies and debentures.

In respect to these said receipts of cash and non-interest-bearing debentures in C. Smythe For Sand Limited, each of the appellants in May 1966 received Notices of Re-Assessment, increasing their respective income tax for the year 1961, and demanding such increase in tax as follows, (exclusive of interest also demanded):

Mr. Conn Smythe	$203,205.18
Mr. C. Stafford Smythe	$110,581.65
Mr. C. H. Day	$ 41,714.70

Counsel for the appellants have made the following calculation of the income tax assessed by each of these reassessments as follows:

CONN SMYTHE
CALCULATION OF INCOME TAX ASSESSED
ON MAY 25, 1966 IN RESPECT OF 1961

Revised taxable income per re-assessment		$468,227.82
	Taxable Income	
Tax per form	$400,000.00	$269,160.00
	68,227.82	54,582 26
	$468,227.82	323,742.26
Less:		
Dividend tax credit—20% of $424,574.79		84,914.95
Dividends—per return	$ 45,675.75	
per re-assessment	378,899.04	
	$424,574.79	
Tax per re-assessment notice		$238,827.30
Undistributed income on hand of C. Smythe Limited at December 28, 1961 per balance sheet at that date and detailed schedules		$728,652.00
52% (Conn Smythe share)		$378,899.04

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C. STAFFORD SMYTHE
CALCULATION OF INCOME TAX ASSESSED
ON MAY 30, 1966 in respect of 1961

Taxable income declared and as re-assessed 1962		$ 37,355 61
Added by Re-Assessment 1966		233,168 64
Revised taxable income per re-assessment		$270,524 25
	Taxable Income	
Tax (at 1961 rates)		
on first	$225,000.00 =	$137,910 00
on balance of	45,524 25 =	34,143 19
	$270,524.25	$172,053 19
Less:		
Dividend tax credit—20% of $244,773 39		48,954 68
Dividends—per Return	$ 11,604.75	
—per re-assessment	233,168 64	
	$244,773 39	
		$123,098 51
Less.		
Foreign tax credit per Return		14.26
Tax per Re-Assessment Notice		$123,084.25
Undistributed income on hand of C Smythe Limited at December 28, 1961 per balance sheet at that date and detailed schedules		$728,652 00
32% (C Stafford Smythe share)		$233,168 64

CLARENCE H. DAY
CALCULATION OF INCOME TAX ASSESSED
ON JUNE 1, 1966 in respect of 1961

Taxable income declared		$ 25,862 65
Added by Re-Assessment		116,584.32
Revised taxable income per re-assessment		$142,446 97
	Taxable Income	
Tax per form	$125,000 00	$ 67,910 00
	17,446 97	12,212 88
	$142,446.97	$ 80,122.88

Less.		
Dividend tax credit—20% of $125,339.92		25,067 98
Dividends—per Return .....$ 8,755 60		
per re-assessment 116,584 32		
	125,339 92	
		55,054.90
Less.		
Foreign tax credit per Return		11 24
Tax per Re-Assessment Notice		55,043 66
Undistributed income on hand of C. Smythe Limited at December 28, 1961 per balance sheet at that date and detailed schedules		$728,652 00
16% (Clarence H Day share)		$116,584.32

One preliminary matter was argued by counsel, that is to say: counsel for the appellants submitted (and the Notices of Re-Assessment and the explanatory data accompanying the same on Department of National Revenue form T7W-C indicate) that the assessments were made on the basis of a deemed receipt of a dividend pursuant to section 81(1)[3] of the *Income Tax Act*; and that the respondent is not entitled as he did in his pleadings by way of reply to allege further facts and to plead other sections of the *Income Tax Act* to support these re-assessments.

Counsel for the respondent on the other hand, submitted that the respondent is not bound by the assumptions made by the assessor or the statement of reasons given in the Notice of Assessment or Re-Assessment for the assessment or re-assessment or by the section or sections of the *Income Tax Act* referred to, purporting to establish the basis for the assessment for tax, but is entitled to allege further facts and rely on other sections of the *Income Tax Act* in his

[3] 81. Undistributed income on hand.

(1) Where funds or property of a corporation have, at a time when the corporation had undistributed income on hand, been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of one or more of its shareholders on the winding-up, discontinuance or reorganization of its business, a dividend shall be deemed to have been received at that time by each shareholder equal to the lesser of

(*a*) the amount or value of the funds or property so distributed or appropriated to him, or

(*b*) his portion of the undistributed income then on hand.

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pleadings in proceedings in this Court contesting such assessment or re-assessment, but that in the case of the latter course of action by the respondent that the onus is on the respondent to prove the same; and that in exercise of this right further facts were alleged and other sections of the *Income Tax Act* were pleaded to support these re-assessments.

I am of opinion that the respondent is not bound by the assumptions made by the assessor or the reasons stated in the Notices of Assessment or Re-Assessment and is not restricted to relying on the reasons stated or the section or sections of the *Income Tax Act* referred to, purporting to be the basis for the assessment or re-assessment for income tax, but is entitled to allege in his pleadings in this Court other facts and to plead any other alternative or additional section or sections of the *Income Tax Act* as the basis for asking this Court to confirm or otherwise adjudicate upon any assessment or re-assessment for income tax; but in so far as the latter procedure is adopted by the respondent, the onus of proof is on him. (See *Roderick W. S. Johnston v. M.N.R.*[4]; *The Minister of National Revenue v. Pillsbury Holdings Limited*[5]; and *British Columbia Power Corporation Limited v. M.N.R.*[6]).

So much for the preliminary objection.

As to the main issues for decision in these cases, a more detailed statement of the facts is now given.

Prior to November 1959, the shareholders of C. Smythe Limited were aware of the incidence of income tax in respect to undistributed surplus income of the company if distributed, and of the then existing provisions of the *Income Tax Act* whereby special sections had been enacted to lighten the burden of so-called "double taxation" of income from a corporation upon which income tax had been paid at corporation rates, coming into the hands of an individual shareholder. They knew that certain statutory conditions had to be complied with before advantage could be taken of such provisions of the Act. I refer to section 95A of the 1948 *Income Tax Act* (now section 105 of the present *Income Tax Act*). On more than one occasion prior to that time, the shareholders of C. Smythe Limited availed

[4] [1948] S.C.R. 486 at 489.
[5] [1965] 1 Ex C.R. 676 at 686.
[6] 66 D.T.C. 5310 at 5311.

themselves of this statutory relief to obtain part of the undistributed surplus income of that company (see Exhibits R-63 and R-64).

Between November 3, 1959 and November 16, 1961 the shareholders of C. Smythe Limited were also advised by Mr. S. E. V. Smith of Price Waterhouse & Co. of various plans and arrangements whereby they might be paid the undistributed earned surplus and the capital gains of that company.

For example, by letter of November 3, 1959 (see Exhibit R-4), Mr. Smith wrote to Mr. Conn Smythe, the President of C. Smythe Limited, explaining to him the tax implications of invoking respectively the provisions of sections 105 and 105B of the *Income Tax Act*, and specifically in respect to the latter outlining a plan or arrangement in which the approximate cost for taxes and other charges Mr. Smith estimated to be $150,000. That letter reads as follows:

PRICE WATERHOUSE & CO.

55 Yonge Street
TORONTO 1
November 3, 1959.

CONFIDENTIAL

Conn Smythe, Esq., President,
C Smythe, Limited,
Postal Station "D", Box 8,
Toronto.

Dear Mr. Smythe:

With reference to your recent letter we have considered various methods whereby the shareholders of your company might be paid the balances of earned surplus and capital gain arising from sale of fully depleted gravel properties which together amounted to $1,326,508 at February 28, 1959.

Section 95A of the 1948 Income Tax Act is now Section 105 of the present Income Tax Act. This section is not too useful in your case where it is desired to distribute to shareholders a substantial amount of undistributed income and capital gains. This is so because to get out the capital gains tax free it is necessary to first dispose of all of the undistributed income. In order to do this under Section 105 it would be necessary to pay out 50% of earned surplus (viz. about $350,000) in cash dividends in, say, 1959 in order to make an election on an equal amount in 1960 on which tax of 15% would be paid This would give rise to very substantial personal income tax on the cash dividends in one year; if the procedure were spread out over a number of years it has the disadvantage that subsequent earnings also have to be paid out to the extent of 50%. This latter difficulty could be overcome by forming a new operating company and thus avoid annual increases in earned surplus of C. Smythe,

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Limited but we believe that, in view of the high personal rates of tax payable by you and your fellow shareholders, the alternative plan set out below might be more attractive

In outlining this plan we are assuming for simplicity that the amounts of earned surplus and capital gains from sale of depleted properties at the time you contemplate any action are the same as those carried on the company's books at February 28, 1959 You will also observe that under the plan a substantial tax payment is required and thus there would be no point in carrying it out unless fairly substantial sums of cash were made available from the sale to outsiders of marketable securities or Jane Street properties.

Since the proposal set out hereunder involves the interpretation of income tax legislation it should be reviewed by the company's solicitors. It might also be desirable to clear it in advance with income tax authorities but this is a matter which we could discuss later.

Section 105B, which is a fairly recent addition to the Income Act, contains provisions whereby:

(*a*) a non-resident corporation holding all of the stock of a Canadian company could get out the undistributed income by payment of a tax of 15% plus an additional withholding tax of 5%, except possibly in the case of distribution to a corporation resident in the United Kingdom which owned all the outstanding shares of the company, or

(*b*) a dealer in securities owning all of the stock of a Canadian company could get out the undistributed income by payment of a tax of 20%.

In a liquidation of the Canadian company the effective rate of these taxes would be somewhat reduced because the tax under Section 105B would be allowed as a deduction in computing the undistributed income subject to tax Accordingly it is possible that a non-resident corporation or a dealer in securities might be willing to purchase the shares of C. Smythe, Limited for an amount equal to the net assets of the company, less the estimated tax, and a profit for the work and risks involved in liquidating the company. The profit in such a transaction might run to from $10,000 to $35,000, depending on the time required, the risks involved and how good an arrangement you could negotiate. Thus in the case of your company the entire capital stock, premium on shares, capital gain from sale of depleted gravel properties and earned surplus might be made available tax free to the shareholders of C Smythe, Limited at an overall cost for taxes and other charges of about $150,000. The mechanics of carrying out the plan would be as follows:

1. A new operating company, say, Smythe Sand & Gravel Limited, would be incorporated by the shareholders of C. Smythe, Limited with the same percentage interest in the new company. Smythe Sand & Gravel Limited, would buy at book value all the assets of C. Smythe, Limited except the remaining Jane Street properties and marketable securities and would carry on the sand and gravel operations at Caledon.

2. The remaining Jane Street properties would be sold to Roseland Homes Limited at appraised values. This would give rise to a further capital gain from sale of depleted properties on the books of C. Smythe, Limited and any profit or loss on ultimate disposal of the properties would enter into the income tax

calculation of Roseland Homes Limited. (The appraised value should be as close as possible to estimated realizable value in order to avoid any undue taxable profit or loss in the hands of Roseland)

3. C Smythe, Limited would sell a portion of its marketable securities to outsiders for cash Any remaining marketable securities would be sold to the present shareholders of C. Smythe, Limited in the same ratio as their shareholdings, or to the new operating company, at fair market value on the date of sale. The sale of the securities would give rise to a capital profit which should not be subject to tax in the hands of C. Smythe, Limited or in the hands of its shareholders.

4. In the first instance the sale of assets to the new operating company and to Roseland Homes Limited would be carried on open account but immediately before the transaction referred to in 5 below the companies would obtain short term loans and pay off their indebtedness in cash. After all assets of C. Smythe, Limited have been sold to the new operating company, Roseland Homes Limited and outsiders, the new operating company would assume the liabilities of C. Smythe, Limited. The latter company would then be left with cash equal to the sum of the capital stock accounts, premium on shares, capital gains and earned surplus

5 At that stage the shareholders of C. Smythe, Limited would sell their shares of that company to a United Kingdom non-resident corporation or to a dealer in securities at an amount equal to the cash on hand less about $150,000 to cover income taxes payable and a profit for the buying corporation The net proceeds from the sale would be paid to the shareholders in cash by the purchaser who could then proceed to liquidate C. Smythe, Limited.

6. The cash received by the shareholders would be advanced to the new operating company and Roseland Homes Limited to the extent necessary to liquidate their short term borrowings and the balance of the proceeds would be held tax free by the shareholders. Presumably the advances would be evidenced by debentures or notes issued by Roseland Homes and the new operating company. As funds became available from the ultimate disposal of the remaining Jane Street properties held by Roseland Homes and from operations of the new operating company, the debentures or notes would be paid off and the cash would flow to the former shareholders of C. Smythe, Limited tax free

On the basis of current estimates which would be subject to revision in the light of conditions prevailing at the time the foregoing plan was carried out, we are setting out an example of how the proposed arrangement might work out:

Net book value of C Smythe Limited at February 28, 1959	$1,382,508
Excess of selling price of investments in common stocks of Canadian corporations over cost (Note 1), say	600,000
Proceeds from sale of fully depleted sand and gravel properties at Jane Street, say	375,000
Net book value of C Smythe Limited at date of sale	$2,357,508

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Less—Difference between net book value and amount received from the purchaser of shares of C. Smythe, Limited, say	150,000
Cash proceeds received by present shareholders of C. Smythe, Limited on sale of their shares (not subject to income tax)	$2,207,508
Less—Amount required to be advanced to the new operating company and to Roseland Homes Limited (Notes 1 and 2)	1,385,341
Net tax free proceeds available forthwith to the shareholders of C Smythe, Limited	$ 822,167

Notes:

1 It has been assumed that $750,000 has been received from outsiders for a portion of the investment in common shares and that the remainder have been sold to the shareholders of C. Smythe, Limited or to the new operating company at fair market value.

2 The amounts advanced to the new operating company and Roseland Homes Limited would be received free of tax when those companies pay off the advances to the present shareholders of C. Smythe, Limited.

We realize that the foregoing plan sounds complicated but in practice we believe that it could be carried out fairly simply, is within the framework of the Income Tax Act, and should enable a full release of the present net book value of C. Smythe, Limited. There are several further factors to be considered if any such arrangement were consummated but they are largely of a technical nature and we have not set them out herein We might mention, however, that the final sale of shares of C. Smythe, Limited would be carried out over a period of a day or two so that there should be little or no interest payable on the short term borrowings.

We feel that a discussion of the various factors involved would be helpful before any action is taken and when you have had an opportunity of reviewing this letter we shall be pleased to discuss it with you and your solicitors.

In case you may wish to pass this letter on to the other shareholders of the company we are enclosing additional copies.

Yours very truly,
(S. E. V. Smith)

Aside from the desire of shareholders of C. Smythe Limited to obtain cash for themselves from some or all of the undistributed earned surplus and capital gains of C. Smythe Limited, was the desire by the appellant Conn Smythe to implement an estate plan for himself. The reason for this was that approximately 50 per cent of his personal assets were represented by his shareholdings in C. Smythe Limited, and at that time, the liquid assets of C. Smythe Limited were relatively small in relation to the said total of undistributed earned surplus and capital

gains. As a consequence, as was pointed out to Mr. Conn Smythe by his personal solicitor, Mr. I. S. Johnston, Q.C., if he should at that time die, the incidence of income tax and estate tax would be most substantial if nothing were done in relation to C. Smythe Limited, whereas, if a proper and legal estate plan was implemented, the burden of these taxes would be lessened.

(As mentioned, the first thing that was done in fact was to sell off certain of the non-liquid assets of C. Smythe Limited, namely, the depleted gravel pits and the shares owned by it in Maple Leaf Gardens Limited and thereby there was put substantial amounts of cash in the hands of C. Smythe Limited to enable a corporate distribution to be made. But these appeals have nothing to do with the actions in putting the assets of C. Smythe Limited in such liquid form in 1961.

What these appeals have to do with, is in relation to what was done after that and specifically in December 1961 in connection with the undistributed earned surplus of $728,652 of C. Smythe Limited.)

Again on June 28, 1961, Mr. S. E. V. Smith sent a further proposal to Mr. Conn Smythe. This letter reads as follows and the proposal enclosed with it is also set out:

Copy for Mr. Ian S Johnston, Q.C.
PRICE WATERHOUSE & CO.

55 Yonge Street
TORONTO 1
June 28, 1961.

Personal

Conn Smythe, Esq.,
Maple Leaf Gardens Limited,
Church and Carlton Streets,
Toronto.

Dear Mr. Smythe:

As arranged, I am handing you three copies of a preliminary draft of a memorandum concerning a possible rearrangement of the affairs of C. Smythe, Limited and its associated companies, Roseland Homes Limited and Conn Smythe Contracting Company Limited.

There are two or three factors bearing on the rearrangement which are not included in the memorandum and which I would prefer to discuss with you at the meeting on Thursday morning. One of them might well be discussed with Mr. G. R. Gardiner.

I am also enclosing copy of a memorandum concerning the possible formation of a personal corporation to facilitate your own estate planning.

Yours sincerely,
S. E. V. Smith

Enc-Draft memorandum (3)

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Memorandum

c c to Mr. Ian S Johnston.

Memorandum for Mr. Conn Smythe.

PERSONAL ESTATE PLANNING

The income and estate tax problems concerning your horse racing and breeding stable operations and the desirability of reorganizing the corporate structure of C Smythe, Limited, Conn Smythe Contracting Company Limited and Roseland Homes Limited are both the subject of separate memoranda. The sole purpose of this memorandum is to recommend a course of action which we believe will simplify the ultimate administration of your affairs by your executors.

We recommend that you form a personal corporation, say, Conn Smythe Limited, under the Ontario Companies Act, which would hold your principal bank accounts, all of your stocks and bonds, all of your real estate and any life insurance payable to your estate; your horses would not be included in the holdings of the corporation. This company would have a nominal share capital of, say, 1,000 shares issued at $1 00 each, of which you would hold, say, 997 and your three executors would hold the remaining three shares. The balance of the consideration for the purchase of your various assets by the personal corporation would be carried in an open account payable to you; this is the most flexible method.

The by-laws of the company could place whatever restrictions you might wish on the transfer or use of any assets For example, there might be a complete restriction on the sale of Maple Leaf Gardens shares except for the benefit of your heirs, and a provision that they be included in a voting trust subject to voting by you or, in your inability to act, by your son, Stafford Smythe, or, failing his ability to act, by your nominee

There are no income or estate tax advantages in such a corporation since income on assets owned by the corporation has to be taken up in your personal income tax return annually. The advantage which we believe is sufficiently important to justify the incorporation expenses involved is that during any incapacity by you, or in the event of your death, the other directors could deal promptly with the assets. This is particularly important after death since transfer of assets is dependent on obtaining releases from the federal estates tax department and the Ontario succession duty department. Such releases might be held up for a year or more until all estate matters are settled and certainly there is considerable inconvenience and difficulty in obtaining releases for the sale of real properties and securities. In the meantime severe losses might be suffered in a time of falling market values Through a personal corporation only the shares of the personal corporation would be subject to restrictions on transfer and the other directors of the company, who would be your executors, would be able to deal promptly with any assets of the estate.

PRICE WATERHOUSE & CO
(S E. V. Smith)

TORONTO, June 26, 1961.

Preliminary draft for discussion purposes only

Memorandum for the Shareholders of C. Smythe, Limited.

This memorandum has been prepared for the shareholders of C. Smythe, Limited in order to outline a desirable method of reorganization which would also take into account Roseland Homes Limited and Conn Smythe Contracting Company Limited. (The latter companies are relatively unimportant as compared with C. Smythe, Limited) The necessity for such a reorganization, the benefits to be obtained, and the broad plan are set forth herein. Particulars of certain steps involved are set forth in Appendix B attached.

The basic problem of the three main shareholders of C. Smythe, Limited, and in particular of Conn Smythe and C. H. Day, is that a substantial portion of their personal estate is tied up in C. Smythe, Limited. If any of the shareholders died, the valuation of C. Smythe, Limited would be based on the value of the company without taking into account any income taxes payable on a total or partial distribution of assets necessary to provide for succession duties and the beneficiaries of the estate. Furthermore, the company has accumulated substantial capital gains from the sale of fully depleted gravel properties at Jane Street and from the sale of marketable securities, which cannot be put into the hands of the shareholders except by the payment of substantial dividends to individuals or until tax has been paid on the accumulated earned surplus, which amounted to $644,003 at February 28, 1961.

In this memorandum we are using amounts shown in the audited accounts of the companies as of February 28, 1961. When a reorganization is carried out, the accounts of the companies should be brought up to date. Although it would not be necessary to audit them, they should be reviewed by Price Waterhouse & Co. in order that all normal accruals and adjustments usually made only at fiscal year-ends are taken into account.

In our opinion it is most desirable to reorganize the companies in such a way that the assets of the shareholders may be more readily realized upon. If is also important that income taxes and other costs payable on distribution of accumulated earnings, which would probably aggregate a minimum of $150,000, be paid now in order that estate asset values of the shareholders may be reduced accordingly.

We have considered various methods by which a reorganization might be carried out and, to the best of our ability, have taken into account the various interests of the three main shareholders. It should be recognized that modifications may be necessary if further information is brought out as a result of discussions between the shareholders and us.

In our opinion, the plan set forth herein should be the most economical from the standpoint of income taxes, legal and accounting fees and, as far as we know, falls within the framework of present income tax legislation. It should not be carried out until the final 1961 federal budget legislation is adopted since technical amendments to the Income Tax Act are sometimes introduced at a late date, but it should be carried out as soon as possible after that time.

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The proposed plan of reorganization is set out hereunder:

1. The four shareholders of C. Smythe, Limited would cause the shareholdings of Roseland Homes Limited and Conn Smythe Contracting Company Limited to be rearranged in such a way that the shares of all three companies would be owned in the following ratios:

   Conn Smythe 52%
   C. S. Smythe 30 8%
   C. H. Day 16%
   A M. Boyd 1.2%

   (Details of the steps required are set out in Appendix B(1))

2. C. Smythe, Limited, Roseland Homes Limited and Conn Smythe Contracting Company Limited would merge under the amalgamation provisions of Section 96 of the Ontario Corporations Act into a new company, say, C. Smythe (1961) Limited.

3. C. Smythe (1961) Limited would sell all of its operating assets, including cattle and Caledon sand and gravel properties, to a new operating company, Smythe Sand & Gravel Limited The assets would be sold at fair market value except for Caledon sand and gravel properties and other depreciable assets which would be sold at values established for tax purposes. The new company would pay for the assets purchased by the issue of 10,000 common shares at 10¢ each ($1,000) and 5% income debentures for the balance ($683,296). The new operating company would provide for working capital through bank loans or loans from shareholders. (A pro forma balance sheet setting out the position of the new company is attached as Appendix A.)

4. The shareholders of C. Smythe (1961) Limited would purchase their share of all remaining assets of the company (viz. investments in bonds and stocks, mortgage due on Jane Street property, the remaining Jane Street property, and the common shares and 5% income debentures of Smythe Sand & Gravel Limited) at fair market value. It may appear that the use of market values for the investments, particularly the shares of Maple Leaf Gardens Limited might be undesirable, but it has no real effect on the shareholders of C. Smythe, Limited since they are simply transferring their portion of the assets held by the company to their personal possession.

   As a practical matter the mortgage on the Jane Street property and the remaining Jane Street property should probably be sold to a liquidating trust which would collect interest and payments on capital from the mortgage and sale of land and distribute them to the shareholders as collected.

   Also, it is contemplated that all shares of Maple Leaf Gardens Limited would be put under the control of a voting trust whereby dividends therefrom would flow directly to the individual shareholders concerned but voting of the shares would be done by Conn Smythe, or failing him, C. S. Smythe, or failing them, their nominee.

5. The shareholders would pay cash for the assets referred to in Item 4 above. Immediately thereafter they would sell all of

their shares in C. Smythe (1961) Limited to a non-resident United Kingdom corporation for cash at a price which would be equivalent to the shareholders' equity in C. Smythe (1961) Limited, after taking into account capital gains on all dispositions of Jane Street property and investments in common stocks, less income taxes and other costs arising from reorganization and effective distribution of the assets of C. Smythe, Limited, Roseland Homes Limited and Conn Smythe Contracting Company Limited. (This transaction could be carried out through a dealer in securities but the tax on undistributed income would be 5% higher.)

The net results of the foregoing plan may be summarized as follows (values at February 28, 1961 are used in all cases and the sale price of the remaining Jane Street property has been taken to be $250,000):

Net book value of C. Smythe, Limited	$1,590,244	
Add:		
Excess of market value of investments in common stocks of Canadian corporations over cost	432,820	
Market value of remaining fully depleted sand and gravel property at Jane Street	250,000	
Adjusted net book value of C. Smythe, Limited		$ 2,273,064
Net book value of Roseland Homes Limited	$ 23,880	
Add—Excess of market value of investments in marketable securities over cost	10,866	
Adjusted net book value of Roseland Homes Limited		34,746
Net book value of Conn Smythe Contracting Company Limited		27,114
Adjusted net book value of the merged corporation, C. Smythe (1961) Limited		$ 2,334,924
Less—Cost of income taxes payable on undistributed income of merged corporation and other items, (estimated $125,000 to $150,000) say		150,000
		$ 2,184,924
Less—Amount invested in the new operating company, Smythe Sand & Gravel Limited (See pro forma balance sheet—Appendix A)		684,296
Balance of assets available for pro rata distribution *tax free* to shareholders		$ 1,500,628

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These assets would comprise:

Cash			$ 25,134
Government of Canada bonds			100,800
Marketable securities at market value—			
	Shares	*Market value*	
Maple Leaf Gardens Limited ..	29,728	$ 836,100	
Milton Brick Co. Ltd.	34,865	78,446	
The Jockey Club Limited	10,000	29,000	
Canadian Collieries Resources Limited—			
Common	3,275	20,878	
5% Preferred	10,000	7,600	
The International Nickel Company of Canada, Limited	260	16,900	
Noranda Mines Limited	100	4,200	
Standard Paving & Materials Ltd. ..	100	1,650	
			994,774
Mortgage receivable on Jane Street property			129,920
Jane Street property, at market value			250,000
			$ 1,500,628

The basic benefits of the foregoing rearrangement for the shareholders of C. Smythe, Limited may be summarized as follows:

1. Cash, marketable securities and other assets resulting from capital gains in C. Smythe, Limited and Roseland Homes Limited are put into the hands of the individual shareholders at a minimum income tax cost.

2. The combined potential estate value of the shareholders is reduced by $150,000.

3. Through holding separate marketable securities, etc. the shareholders can carry out their own estate planning on a more flexible basis.

4. The income debentures of the new company, Smythe Sand & Gravel Limited, owned by a shareholder, could, in the event of his death and by an agreement between the shareholders, be paid to his estate through raising a mortgage on Caledon sand and gravel properties or by other means.

5. If desired, the shareholders' interests could be rearranged. For example, C. H. Day could sell his common shares in the new operating company, Smythe Sand & Gravel Limited, to C. S. Smythe at fair market value and take 5% income debentures owned by Smythe in payment thereof.

Similarly Conn Smythe could sell all or most of his interest in the new company to C. S. Smythe and take income debentures of the new company and other obligations of C. S. Smythe. Under this method Conn Smythe could still retain voting control through having a majority of the common shares of Smythe Sand & Gravel Limited, subject to an irrevocable proxy to be voted by him during his lifetime. A benefit from this course would be to establish estate values for Conn Smythe's interest in the Caledon properties now and to freeze them at this figure with any growth going to C. S. Smythe.

Alternatively, arrangements could be worked out so that the beneficiaries of Conn Smythe's will might hold his common shares in Smythe Sand & Gravel Limited subject to Conn Smythe's voting control during his lifetime.

All such alternatives and details could only be dealt with in the light of the wishes of the interested parties and after thorough and complete discussion and consideration.

The important step now is to carry out the basic essentials of the plan which is to pay income tax on the undistributed income of the various companies so as to reduce the individual shareholders' inheritance tax, to get assets in their hands which may be more readily liquidated, and put their personal affairs in a more flexible condition if any one of them should die.

PRICE WATERHOUSE & CO.
(S. E. V. Smith)

TORONTO, June 26, 1961.

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Appendix A

SMYTHE SAND & GRAVEL LIMITED
(a new company)

PRO FORMA BALANCE SHEET AS AT FEBRUARY 28, 1961

After giving effect to the following transactions:

1. The purchase of all Caledon sand and gravel operating assets, including cattle and trucks, by Smythe Sand & Gravel Limited, a new company.
2. The settlement of the purchase price by—
   (a) the issue of 10,000 common shares for 10¢ each
   (b) the issue of 5% income debentures in the amount of $683,296.

ASSETS

Current Assets:			
Trade accounts receivable less allowance for doubtful accounts of $10,000			$ 123,965
Other receivables			3,243
Inventory of feeder cattle, at cost			62,670
			$ 189,878
Fixed Assets, at cost:			
Sand and gravel properties, including buildings	$ 622,267		
Less—Accumulated depletion and depreciation	206,461		
		$ 415,806	
Plants and equipment	$ 959,318		
Furniture and fixtures	20,574		
Trucks and automobiles	105,136		
	$ 1,085,028		
Less—Accumulated depreciation	861,930		
		223,098	
			638,904
			$ 828,782

LIABILITIES

Current Liabilities:	
Accounts payable and accrued liabilities	$ 66,486
Mortgage payments due within one year	24,000
	$ 90,486
Mortgages Payable (exclusive of amounts due within one year)	54,000
5% Income Debentures	683,296
	$ 827,782
Capital Stock Issued:	
10,000 no par value common shares for 10¢ each	1,000
	$ 828,782

Appendix B

1. In order to carry out a satisfactory merger of C. Smythe, Limited, Roseland Homes Limited and Conn Smythe Contracting Company Limited it is necessary that the shareholdings of Conn Smythe, C. S. Smythe, C. H. Day and Arthur M. Boyd be in the same ratio for the three corporations. (Any outstanding preference shares of C. Smythe, Limited should be redeemed before the merger.) The ratio of present shareholdings in C. Smythe, Limited is as follows:

Conn Smythe	52%
C. S. Smythe	30.8%
C. H. Day	16%
A. M. Boyd	1.2%

To bring the common share ownership of the other companies into the same relationship the following transactions would need to be carried out:

(a) Roseland Homes Limited—
I. E. Smythe should sell 100 shares to C. S. Smythe.
M. Holt should sell 100 shares to C. S. Smythe.
H. Smythe should sell 100 shares to C. S. Smythe.
C. H. Day should sell 70 shares to C. S. Smythe and 30 shares to A. M. Boyd.

(b) Conn Smythe Contracting Company Limited—
Conn Smythe should sell 40 shares to C. S. Smythe.
C. H. Day should sell 6 shares to Arthur M. Boyd and 14 shares to C. S. Smythe.

For practical purposes the sale price of these shares could be fixed at their book value adjusted upwards in the case of Roseland Homes for the excess of market value of common stocks over cost and, in each case, reduced by 20% of undistributed income on hand. On this basis the value per share of Roseland Homes Limited and Conn Smythe Contracting Company Limited at February 28, 1961 would be $12.01* and $43.53 respectively.

*This price is price as based on capital stock issued for a consideration of $1 00 of which only 10 cents has been paid up. Before any merger it would probably be advisable to have the additional 90 cents per share paid up on the stock of Roseland Homes Limited. Such payments would be recovered by the shareholders on liquidation.

2. The merger of the corporations would present no particular problems, except to carry out the necessary legal requirements, and the shareholders of the merged corporation would have the same percentage ownership as they now have in C. Smythe, Limited.

3. The merged corporation would sell all of its operating assets, including Caledon sand and gravel properties, cattle and trucks now owned by Conn Smythe Contracting Company Limited to the new operating company, Smythe Sand & Gravel Limited. Except for depreciable assets and cattle, we would expect that fair market value would be equivalent to book value. In the case of cattle, which are carried at cost on the books, fair market value would likely be somewhat higher; such values based on the best estimates of company officials should be used. Depreciable assets should be transferred,

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including Caledon sand and gravel properties, to the new operating company at tax values in order that there may be no recapture of depreciation for tax purposes.

The new operating company should be able to take the same depreciation rate, viz. 6¢ per ton, now allowed to C. Smythe, Limited. Obviously, we cannot guarantee that this would be accepted by income tax authorities but, in speaking to a senior member of the Toronto District Office, he indicated that there was no reason, in a non-arm's length transaction such as this, why the Department would require a new engineering estimate of the property. He stated that the rate had been determined once in accordance with the Department's regulations and that, in his opinion, the rate of 6¢ could be used by the new company. Although no names were mentioned, it is probable that he had C. Smythe, Limited in mind.

4. In selling the assets of the merged corporation, C. Smythe (1961) Limited, to its shareholders, fair market value should be used. For this purpose quoted market prices would be used for marketable securities, book value for mortgages, and an appraised value for the Jane Street property. It would be preferable if the Jane Street property were sold and the mortgage or other proceeds were available for distribution to the shareholders, but there is some chance that if it were sold to a trust for liquidation, any subsequent excess over the transfer price could be treated as a capital gain for tax purposes.

Under this proposal of Mr. Smith, as noted, the estimated income tax cost if it had been implemented would have been between $125,000 and $150,000; and under it, a new operating company would have been incorporated which would buy and pay for the assets of C. Smythe Limited by issuing 10,000 common shares at 10c per share and 5 per cent income debentures for the balance of the purchase price.

Then on July 5, 1961, at a meeting of the shareholders of C. Smythe Limited at which Mr. C. H. Day was not present, Mr. Smith advised that there were "two methods talked about in current tax literature whereby undistributed earnings of a company could be distributed tax free" and that he "was very reluctant to recommend such methods since he felt that they might be successfully attacked by income tax authorities".

As a result of that meeting, Mr. Conn Smythe expressed the opinion that the *status quo* of C. Smythe Limited was satisfactory and Mr. C. Stafford Smythe expressed the opinion that the cost of $150,000 for income tax and other items was too great for the benefits to be achieved.

On the same day July 5, 1961, Mr. Smith wrote Mr. C. H. Day informing him of these proposals and of these

opinions expressed by Messrs. Conn Smythe and C. Stafford Smythe (see Exhibit A-3) and that letter reads as follows:

Copy for Mr. Ian S. Johnston, Q.C.
PRICE WATERHOUSE & CO.

55 Yonge Street
TORONTO 1
July 5, 1961.

Personal

C. H. Day, Esq.,
Elgin Handles Ltd.,
21 Kains Street,
St. Thomas, Ontario.

Dear Mr. Day:

With reference to our telephone conversation on Friday last I am enclosing a copy of the preliminary draft of a memorandum for the shareholders of C. Smythe, Limited setting out possible means of reorganization which we believed might be useful for the three main shareholders of C. Smythe, Limited. This memorandum was discussed at some length in a meeting with Messrs. Conn and Stafford Smythe; Mr. Ian Johnston, Q.C., also attended throughout the meeting.

At present the Smythes do not wish to take any steps to implement such a reorganization. Mr. Conn Smythe feels that the present arrangement is satisfactory and Mr. Stafford Smythe believes that the cost of $150,000 for income taxes and other items is too great for the benefits to be achieved This, of course, is a matter of opinion and since the shareholders are the ones who bear the cost, naturally we accept their views on the matter.

During the meeting with the Smythes I mentioned that there were two methods talked about in current tax literature whereby undistributed earnings of a company could be distributed tax free but that I was very reluctant to recommend such methods since I felt that they might be successfully attacked by income tax authorities, in which case the ultimate cost to individual shareholders would be considerably greater.

In the discussions I also pointed out that the question of undistributed income and designated surplus of corporations had been mentioned in the 1961 budget address of the Minister of Finance but he indicated that the whole matter was still under consideration and that the Government had come to no conclusions on how this rather difficult problem, particularly with respect to successful private companies, was to be dealt with. I had heard rumours before the budget address that some basis of withdrawing undistributed income from private corporations might be included in 1961, perhaps a flat rate of 15%. I also heard unsupported rumours that tax might be eliminated on such distributions. Certainly any step which would simplify the distribution, even at a 15% rate, would be cheaper for the shareholders than the methods outlined in the enclosed memorandum. On the other hand, taxes on the distribution of accumulated earnings might be increased. In view of the uncertainty it is difficult

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for us to advise a specific course of action too strongly but we feel that the possibilities should be considered periodically by the individual shareholders in the light of their personal circumstances.

Naturally Mr. Conn Smythe is concerned about his own personal estate planning and during our recent meeting he stated that the following arrangements had been made orally between the three major shareholders of C. Smythe, Limited, viz.:

1. In the event that Mr. Conn Smythe died, C. Smythe, Limited would arrange to purchase all shares of Maple Leaf Gardens Limited owned by him personally at fair market value at date of death in order to put Mr. Smythe's estate in funds to pay estate tax and succession duties. To do this C. Smythe, Limited would probably have to raise a loan with the shares as security or place a mortgage on the Caledon property. It is likely that interest on money borrowed specifically to buy shares of Maple Leaf Gardens would not be allowed for income tax purposes; on the other hand, an arrangement might be worked out in such a way that the interest would be allowed.

   At the meeting the possibility of paying more than the quoted market value was suggested since, by acquisition of all the shares, C. Smythe, Limited would have effective control of Maple Leaf Gardens Limited and the shares might properly be worth more than quoted market. I believe that this might be undesirable from an income tax standpoint since the excess between such a price and quoted market value might be deemed to be a benefit to a shareholder, viz. Mr. Smythe's estate.

2. In the event of your death, Mr. Smythe stated that either he or Stafford would arrange to purchase the shares of C. Smythe, Limited now owned by you from your estate at fair value. The suggestion was made that fair value might be that determined for estate tax and succession duty purposes but, on further reflection, I am inclined to think that such a fair value should probably be determined along the following lines:

   Net book value of C. Smythe, Limited plus excess of market value of marketable securities over book value plus excess of appraised value of Caledon land over book value.

   This matter should be considered further before any final arrangements are made.

3. In the event that Stafford Smythe died, Conn Smythe would buy the shares of C. Smythe, Limited now owned by Stafford Smythe from his estate at fair value.

During our discussions on Thursday I told the Smythes that any such arrangement should be in the form of a written agreement between the three main shareholders in order that their heirs would be adequately protected. This is most important both for the heirs and for the remaining shareholders since the remaining shareholders will be dealing with executors rather than with the individuals who discussed and agreed upon the original arrangements.

As arranged in our telephone conversation, you are to review the memorandum and the other matters outlined in this letter and consider them with your own financial adviser. I would hope that by the end of September final legislation in respect of the 1961 budget resolutions will have been enacted and at that time perhaps we could discuss the matter further when you are in Toronto.

As you know, I expect to be out of the country for several weeks but if you should have any immediate questions in connection with the matters referred to in this letter you could reach me by telephone on July 6.

Yours sincerely,
S. E. V. Smith

Enc.-Draft memorandum

On November 3, 1961, Mr. I. S. Johnston, Q.C., solicitor for Mr. Conn Smythe, in connection with drawing his will and implementing an estate plan for him, wrote him and in that letter advised that for liquidity of his estate, the reorganization of C. Smythe Limited was a major problem for future discussions (see Exhibit A-4). That letter in relevant part reads as follows:

3rd November, 1961.

PERSONAL:

Conn Smythe, Esq.,
President,
Maple Leaf Gardens Limited,
Carlton and Church Streets,
TORONTO 2, Ontario.

Dear Conn,

I enclose an outline of a Will in accordance with the instructions you gave me the other day.

. . .

This new Will will certainly simplify administration on the distribution of capital. However, it will not simplify the question of raising money for tax. The problem is that there is insufficient money in the free estate to pay the tax. I enclose a new Estimate of Estate Tax. This estimate presumes that the gift of 4,000 shares of Maple Leaf Gardens will be complete, the Lake Simcoe house is taken out of specifics, $16,000 added to free assets and Income Tax on the horses will be allowed as a deduction for Estate Tax.

The old problems are still there. Insufficient free assets for tax purposes. C. Smythe Limited will have to distribute $25 to get $13 for your estate. To get money out of C. Smythe Limited, Income Tax will have to be paid on the undistributed income on hand and the amount of Income Tax will be included in your estate for Inheritance Tax purposes.

A reorganization of C. Smythe Limited is a major problem for future discussion.

. . .

I have spoken to Mr. Smith and we would like some further discussion with you.

ISJ·MC
Encls.
cc: Mr. S. E. V. Smith.

Yours sincerely,
(I. S. Johnston)

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Then between November 17, 1961 and December 14, 1961, certain action was taken by the directors and shareholders of C. Smythe Limited in reference to obtaining for the shareholders a distribution to them of some of the said undistributed earned surplus of $728,652.

On November 17, 1961, (as mentioned earlier in these Reasons) at a meeting of the directors of C. Smythe Limited, it was "moved by Mr. C. Stafford Smythe, seconded by Mr. Day and unanimously carried, that the President be empowered to instruct the Managing Director, in consultation with Price Waterhouse & Co. to proceed immediately to arrange for the distribution of $375,000 to the shareholders of C. Smythe, Limited".

(This was made possible as mentioned above, because C. Smythe Limited had put in liquid form some of its assets and took further steps in this connection, *viz*; at this meeting, the directors authorized the sale of stock in Maple Leaf Gardens Limited to C. Stafford Smythe for $800,000 and prior to that they had authorized the sale of certain of the depleted gravel pits C. Smythe Limited owned.)

This direction of the directors in relation to part of the said undistributed earned surplus of C. Smythe Limited was in essence to implement the essential part of the plan of Mr. S. E. V. Smith of Price Waterhouse & Co. suggested on June 28, 1961, which as above noted involved the following matters:

(a) that a new company be incorporated;

(b) that the assets of the old company be sold to a new company;

(c) that the shareholders of the old company sell their shares to a dealer in securities;

(d) that the financing to enable the shares of the old company to be sold, be effected by obtaining "daylight" accommodation from the Bank (Mr. Smith said it could be as short as one minute);

(e) that there be a simultaneous exchange of cheques or drafts between the purchaser of the shares of the old company from its shareholders;

(f) that the security dealer's gross profit be the difference in price between the monies he obtained in C. Smythe Limited, the old company, and the amount

he paid for the shares of the old company, less the taxes he would be required to pay under the provisions of section 105B of the *Income Tax Act*;

(g) that the shareholders of the old company reinvest the monies they obtained from the sale of their shares in the old company, in common shares and preference shares and debentures or other forms of loans in the new company; and

(h) that the business without interruption be carried on by the new company.

On the direction of Mr. Conn Smythe the security dealer chosen with whom it was proposed to deal was Greenshields Inc., with head office in Montreal, Quebec. This choice was made by Mr. Conn Smythe because of some World War II association he had with one of the latter's partners, a Mr. Tafts.

(Under this plan, it should be again noted, it was proposed that C. Smythe Limited pay the income tax required pursuant to the provisions of section 105B.

However, as also noted, this was not done, and the plan was slightly changed and Mr. Smith later advised the transaction that was entered into with the two Vancouver-based companies, F. H. Cameron Limited and Dabne Enterprises Limited, and no income tax was paid by C. Smythe Limited pursuant to section 105B of the *Income Tax Act,* or personally by any of the appellants or A. M. Boyd.)

On November 29, 1961, Mr. Smith, in carrying out the request of the directors pursuant to their said resolution of November 17, 1961, discussed with the shareholders of C. Smythe Limited the methods of getting out $375,000 to them; and on the same date, Mr. I. S. Johnston, Q.C., was instructed that he would be retained as solicitor in the reorganization of C. Smythe Limited necessary for this purpose.

On December 7, 1961, Mr. Smith advised Mr. Conn Smythe, President of C. Smythe Limited by letter (see Exhibit A-6) that the income tax cost of distributing the $375,000 would be $102,000 but that the shareholders would still be unable to withdraw "the realized and unrealized capital gains of about $1,800,000 . . . without paying tax

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on the balance of the accumulated earnings" (i.e. the balance after subtracting $375,000 from $728,652) of the company.

He said "since the remaining accumulated earnings amount to about $300,000, it would probably cost another $100,000 to free the capital gains in the next year or two . . . ".

(It should be noted that in doing what was eventually done here—eliminated a tax cost to the company estimated by Mr. Smith of over $202,000.)

Mr. Smith then recommended the sale of assets to the new company, and the subsequent sale of shares of the old company to a broker at a cost to the company of approximately $150,000 (being approximately $48,000 of other costs, *viz.*, of accountants, solicitors, incorporations, etc., which added to the income tax cost of $102,000 payable under section 105B of the *Income Tax Act* brought the total estimated costs to about $150,000); and Mr. Smith stated that under this plan the shareholders of C. Smythe Limited would receive $2,117,580 in non-interest-bearing debentures, 10,000 shares in the new company and cash in the sum of $275,000, and in respect to the receipt of these three things the said shareholders would pay no personal income tax.

The said letter of Mr. Smith of December 7, 1961 to Mr. Conn Smythe reads as follows:

PRICE WATERHOUSE & CO.

55 Yonge Street
TORONTO 1

December 7, 1961.

Confidential

Mr. Conn Smythe, President,
C. Smythe, Limited,
899 Jane Street,
Toronto 9, Ontario.

Dear Mr. Smythe:

In accordance with the directors' resolution of November 16, 1961 you have asked our advice on the best method of making a cash distribution of $375,000 to the shareholders.

Among the ordinary methods of distribution a combination of cash dividends and a Section 105 election is the most economical in the circumstances. However, even if this method is used a distribution of $375,000 by March 1962 would involve a tax cost of about $100,000

(see Schedule A). Despite this substantial outlay in tax, the realized and unrealized capital gains of the company of about $1,800,000 could still not be withdrawn without paying tax on the balance of the accumulated earnings. Since the remaining accumulated earnings amount to about $300,000, it would probably cost another $100,000 to free the capital gains in the next year or two and the tax cost would gradually increase as profitable operations added to the accumulated earnings.

Under these circumstances we strongly recommend that you adopt a different course of action which, for the expenditure of about $150,000, will make all the accumulated earnings and capital gains of the company to date available to the shareholders without payment of further tax. Under the proposed plan, the assets of the present company would be sold to a new operating company owned by the shareholders of C. Smythe, Limited and the shareholders would then sell their shares of C. Smythe, Limited to a dealer in securities for a price which, in the aggregate, would be $150,000 less than their equity. A dealer in securities would be able to pay this price for the shares since, under Section 105B of the Income Tax Act he could have the company's assets distributed at a tax cost equal to 16⅔% of the accumulated earnings. The principal result of the reorganization would be that the shareholders would replace their common shares of C. Smythe, Limited with debentures (and shares) of a new operating company; such debentures could be redeemed free of tax when funds were available and not needed for the new company's operations.

A detailed outline of the proposed plan is set out on Schedule B attached, along with a pro forma balance sheet showing the position after the reorganization. In this outline we have assumed that the Jane Street properties would be sold to the new company at fair market value, which has been taken as $250,000. On the basis of our conversations with you we understand that the shareholders are to receive the same amount as if a cash distribution of $375,000 had been made by the company, viz. $275,000 after taxes. Under the proposed plan this distribution would be accomplished since the shareholders of C. Smythe, Limited would hold the following assets instead of their present holdings in C. Smythe, Limited:

		Securities of a new operating company	
	Cash	Non-interest bearing debentures	Common stock
Conn Smythe	$ 143,000	1,101,141	5,200
C. Stafford Smythe	84,700	652,215	3,080
C. H. Day	44,000	338,813	1,600
A. M. Boyd	3,300	25,411	120
	$ 275,000	2,117,580*	10,000

*Based on unaudited financial statements at October 31, 1961 and adjustments referred to on Schedule B.

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You will note from the pro forma balance sheet in Schedule B that the new operating company would have cash and liquid assets of $1,197,880 in addition to other working current assets which exceed its liabilities. If it were decided to distribute some of these funds or some of the funds produced by future operations of the new company, non-interest bearing debentures could be redeemed pro rata and the proceeds received tax free by individual shareholders.

In order to provide funds for the estate of a deceased shareholder an agreement could be entered into among the shareholders whereby in the event of any shareholder's death, debentures held by his estate would be redeemed in the following annual amounts:

Conn Smythe	$ 26,000
C. Stafford Smythe	15,400
C. H. Day	8,000
A. M. Boyd	600

This would be in addition to any pro rata distribution of cash earnings; presumably the agreement would also provide that no distributions would be made which would jeopardize the company's ability to make the specified annual redemptions of debentures held by a deceased shareholder's estate.

We believe that the arrangement outlined in general above and in somewhat more detail in Schedule B would be in the best interests of all the shareholders and we strongly recommend that it be adopted. If the shareholders do decide to go ahead with the plan we believe that it should be completed before February 28, 1962. The specific actions to be taken are numerous (see Schedule C), and accordingly a decision should be made as soon as possible.

Undoubtedly you will wish to have the company's solicitor consider the plan and its ramifications and the necessary documents required to implement the proposed reorganization.

If you or any other shareholder would like to discuss this plan further with us we shall be pleased to do so.

Yours very truly,
(S. E. V. Smith)

Enc.-Schedules

Schedule A

C. SMYTHE, LIMITED

CALCULATION OF INCOME TAXES AND NET PROCEEDS TO SHAREHOLDERS FROM A $375,000 DISTRIBUTION BY THE COMPANY

	Gross distribution	Less income taxes	Net to shareholders
Cash dividends:			
Before December 31, 1961	$ 93,750	37,012	56,738
After December 31, 1961 and before February 28, 1962	93,750	37,012	56,738
	$ 187,500	74,024	113,476
Section 105 distribution:			
After February 28, 1962	187,500	28,125	159,375
	$ 375,000	102,149	272,851
		Taken as	$ 275,000

Net proceeds to shareholders after all income taxes (see Note):

Conn Smythe	$ 136,200	
C. S. Smythe	88,400	
C. H. Day	46,700	
A. M. Boyd	3,700	
		$ 275,000

NOTE: The above calculations are based on estimates of the shareholders' taxable incomes.

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Schedule B

C SMYTHE, LIMITED

PROPOSED REORGANIZATION OF COMPANY'S OPERATIONS

1. Form a new operating company, C. Smythe For Sand Limited, with an Ontario charter and a capitalization of, say, 40,000 common shares at $1 00 per share.

   Present shareholders of C. Smythe, Limited would subscribe for shares in the new company for cash in exactly the same ratio as their present holdings in C. Smythe, Limited, viz :

Conn Smythe	5,200
C. Stafford Smythe	3,080
C H Day	1,600
A. M. Boyd	120
	10,000

2. C. Smythe, Limited would sell the following assets to C. Smythe For Sand Limited:
   (a) All cash except $435,000 required for cost of reorganization and cash requirements of shareholders
   (b) All Caledon sand and gravel mines, buildings and other fixed assets at book value which is equivalent to undepreciated capital cost.
   (c) All other Caledon operating assets, including cattle, accounts receivable, etc., at fair market value.
   (d) 10,000 shares of Maple Leaf Gardens Limited at $300,000 (the option price, which equals fair market value).
   (e) Other marketable securities at fair market value which approximates book value.
   (f) The mortgage receivable on Jane Street property at book value, which is fair market value.
   (g) The fully depleted sand and gravel properties at Jane Street at fair market value (taken as $250,000 in present calculation).
3. C. Smythe For Sand Limited will assume all liabilities of C. Smythe, Limited.
4. C. Smythe For Sand Limited will issue non-interest bearing debentures for the net assets taken over from C. Smythe, Limited.
5. The shareholders of C. Smythe, Limited would sell their shares to a dealer in securities at a price which would be equivalent to the shareholders' equity in C. Smythe, Limited (after taking into account capital gains on all dispositions of Jane Street property and investments in common stocks) *less* income taxes and other costs arising from the reorganization, which are estimated to be $150,000.

A pro forma balance sheet of the new operating company based on unaudited figures as of October 31, 1961 as supplied by the company's

accountant, taking into account the above transactions and the sale to outsiders of 20,000 shares of Maple Leaf Gardens Limited at 40¢ per share for cash, is set out below:

C. SMYTHE FOR SAND LIMITED

(a new company)

ASSETS

Cash and Other Liquid Assets:		
Cash	$ 585,600	
10,000 shares of Maple Leaf Gardens Limited at $30 each	300,000	
Investment in stocks and bonds at market value	171,080	
Mortgage due on Jane Street property	131,200	
Subscriptions on capital stock due from shareholders	10,000	$ 1,197,880
Other Current Assets:		
Trade and other receivables	$ 173,700	
Due from Conn Smythe Contracting Company Limited	31,200	
Cattle inventory	35,300	240,200
		$ 1,438,080
Mortgage Receivable		24,000
Jane Street Properties, at estimated realizable value		250,000
Fixed Assets:		
Caledon and other operating assets, at cost less depreciation		541,700
		$ 2,253,780

LIABILITIES

Current Liabilities:		
Accounts payable and accruals	$ 67,100	
Provision for income taxes	5,100	$ 72,200
Mortgages Payable		54,000
Non-interest Bearing Debentures		2,117,580
Capital Stock:		
10,000 common shares of $1 each		10,000
		$ 2,253,780

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A pro forma balance sheet of C. Smythe, Limited shortly before completion of its sale to an outsider is set out hereunder:

ASSETS

Cash for distribution of shareholders		
To be retained		$ 275,000
To be reinvested by shareholders in common stock of C. Smythe For Sand Limited, a new operating company		10,000
Cash for income taxes and other costs of reorganization		150,000
		$ 435,000
Non-interest bearing debentures of C. Smythe For Sand Limited		2,117,580
		$ 2,552,580

SHAREHOLDERS' EQUITY

Common shares		$ 25,000
Premium on common shares		6,000
Capital gains (Note 1)		1,840,380
Accumulated earnings:		
Balance at February 28, 1961	$ 644,003	
Earnings for eight months ended October 31, 1961 (Note 2)	37,197	681,200
		$ 2,552,580

NOTES:

1. Capital gains are made up of the following items:

Sale of fully depleted gravel properties	$ 789,200		
Sale of investments in common stocks	104,300		
Sale of 20,000 shares of Maple Leaf Gardens Limited at $40 per share	531,253		
		$ 1,424,753	(Realized)
Sale to C. Smythe For Sand Limited of—			
(a) 10,000 shares of Maple Leaf Gardens Limited at $30 per share	$ 165,627		
(b) Jane Street properties at	250,000		
		$ 415,627	(Unrealized)
		$1,840,380	

2. The above amounts are based on unaudited figures at October 31, 1961.

Immediately before the sale of C. Smythe, Limited to an outsider, the shareholders would buy for cash the non-interest bearing debentures of $2,117,580 from the company. The selling price of the shares of C. Smythe, Limited to the outsider would then be $2,402,580 cash, and the shareholders would net $285,000 in cash, viz. $275,000 distribution and $10,000 to be reinvested in the new company.

Schedule C

C. SMYTHE, LIMITED
ACTIONS TO BE TAKEN AND TENTATIVE TIMETABLE FOR PROPOSED REORGANIZATION

To do	*To be done by*	*Date to be completed*
1. Call special meeting of shareholders to approve reorganization	President	December 8
2. Incorporate new company	Company solicitor	Incorporation date December 12
3. Close books of C. Smythe, Limited and open books of new company as of incorporation date	Company accountant	December 12
4. Subscription for shares of new company	C. Smythe .... 5,200 C. S. Smythe .. 3,080 C. H. Day ..... 1,600 A. M. Boyd 120	December 15
5. Calculation of undistributed income of C. Smythe, Limited as at February 28, 1961	P. W.	December 15
6. Appraisal of Jane Street property	Company officials and appraisor	December 15
7. Draw up agreement for sale of assets of C. Smythe, Limited to new company as of date of incorporation of latter company	Company solicitor in collaboration with P.W.	December 15
8. Negotiation with a dealer in securities to settle fee and other details re sale of shares of C. Smythe, Limited	P.W. subject to final confirmation by company officials	December 4 on
9. Approval of sale of assets of C. Smythe, Limited at special shareholders' meeting	Shareholders	December 22
10. (a) Audit of C. Smythe, Limited as of date of sale of assets	P.W.	January 26
(b) Preparation of final tax returns and completion of undistributed income for C. Smythe, Limited	P.W.	January 31

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	To do	*To be done by*	*Date to be completed*
11.	Completion of sale of assets of C. Smythe, Limited to new company, in return for debentures	Company officials and company solicitor in collaboration with P.W.	January 31
12.	(a) Shareholders of C. Smythe, Limited purchase debentures of new company for cash	Shareholders and company solicitor in collaboration with P.W.	February 6
	(b) Audited balance sheet of C. Smythe, Limited, showing cash and shareholders' equity	P.W.	February 6
	(c) Sale of all shares of C. Smythe, Limited to dealer in securities	Shareholders and company solicitor in collaboration with P.W.	February 7
13.	(a) File final tax returns and calculation of undistributed income of C. Smythe, Limited, reporting regular income for incomplete fiscal year 1961/2 and tax under Section 105B	Dealer in securities	February 8
	(b) Distribution of remaining cash of C. Smythe, Limited to dealer in securities on winding up	Dealer in securities	February 8
14.	After tax clearance has been obtained, wind up C. Smythe, Limited	Dealer in securities, solicitors and auditors	After February 8

On December 8, 1961, Mr. Smith got in touch with the said Mr. Tafts (the partner of Greenshields Inc., Mr. Conn Smythe had known) to find out whether that company would be interested in acting as such a dealer in securities under the proposals. Mr. Tafts told Mr. Smith that he was unfamiliar with this type of transaction and that he would take it up with his Montreal associates who had experience with these matters and advise.

Then on December 12, 1961, Mr. Campbell Leitch, a Montreal partner of MacDonald Currie and Co., the auditors for Greenshields Inc., called Mr. Smith and made a proposal that Greenshields Inc. buy the shares of C. Smythe Limited at book value less 5 per cent of undistrib-

uted income for resale to some other party or parties. Mr. Smith recommended this transaction to Mr. Conn Smythe.

But by December 14, 1961, it seemed apparent that no sale of the shares in C. Smythe Limited would be made to Greenshields Inc. because the latter had amended their proposals. Greenshields Inc., according to the evidence, wanted the vendor shareholders of C. Smythe Limited, prior to the sale of shares of it, to arrange for a stock split of its shares and also they wanted the closing of such sale by the end of the year (i.e. 1961). Mr. Smith advised against this sale because it was thought by him and Mr. Johnston that there was no "good business reason" for splitting the shares of C. Smythe Limited and if the present shareholders of it caused such to be done, such action might be considered by the income tax authorities to be part of a "winding-up, discontinuance or reorganization of its business", so that the then present shareholders (the appellants and Mr. A. M. Boyd) of C. Smythe Limited, pursuant to the provisions of section 81(1) of the *Income Tax Act* might be deemed to have received a dividend to the extent of their respective "portion of the undistributed income then on hand" of C. Smythe Limited. (see section 81(1)(*b*) of the Act.)

Mr. Smith put it this way in his evidence:

> MR. SMITH: Well, it would appear to me that they were asking us to countenance some type of transaction by the present shareholders, at least by the Smythe group then shareholders of C. Smythe Limited that might lead to the evasion of taxes eventually and we did not wish to have any part of it. It did not seem to us that there was any good business reason why we should split the shares of C. Smythe Limited to say one to ten, one to nine—I think it eventually got up to one to one hundred. And both Mr. Johnston and I advised that we could see no reason to carry this type of transaction out.

Then between December 15, 1961 and December 27, 1961, the following things took place:

On December 15, 1961 (Friday), a meeting of the Board of Directors of C. Smythe Limited authorized the sale to C. Smythe For Sand Limited of the former's assets pursuant to the terms of a Draft Agreement attached to the Minutes.

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On the same day, there was a purported meeting of the Board of Directors of C. Smythe for Sand Limited (an application for a charter for which had just been made that day to the Provincial Secretary of the Province of Ontario but which company was therefore still unincorporated) at which the Directors (1) authorized the allotment of 9,996 common shares of the company to the appellants for $9,996; (2) authorized the creation of non-interest-bearing debentures not exceeding $2,750,000 to mature December 15, 1981; and (3) approved the purchase of assets and undertaking of C. Smythe Limited as per Draft Agreement.

This Agreement between C. Smythe Limited and C. Smythe For Sand Limited was finally executed in the form as set out in Exhibit A-26 as follows:

> MEMORANDUM OF AGREEMENT made as of the 15th day of December, 1961,
>
> BETWEEN:
>
> C. Smythe, Limited, hereinafter called "the Vendor",
>
> OF THE FIRST PART
>
> and
>
> C. Smythe for Sand Limited, hereinafter called "the Purchaser"
>
> OF THE SECOND PART
>
> IN CONSIDERATION of the mutual agreements hereinafter contained it is agreed by and between the parties hereto as follows:
>
> 1. The Vendor agrees to sell and the Purchaser agrees to purchase all the undertaking, property and assets as a going concern of the Vendor as at the close of business on the 15th day of December, 1961, including the following:
>
> (a) the goodwill of the said business with the exclusive right to represent the Purchaser as carrying on the same in continuation of and in succession to the Vendor and the right to use any words indicating that the business is so carried on;
>
> (b) all trade marks, trade names, copyrights, trade designs, inventions and patents and licenses connected with the business of or belonging to the Vendor;
>
> (c) all of the property of the Vendor moveable or immoveable, real and personal of every kind and wheresoever situate including freehold and leasehold property, leases and licenses owned or held by the Vendor;
>
> (d) all the sand and gravel mines, buildings, improvements, plant, machinery, equipment, trucks, motors, waggons and horses, tools, utensils, inventory, stock-in-trade, supplies of every kind and nature owned by the Vendor;
>
> (e) all of the book and other debts due or accruing due to the Vendor and the full benefit of all securities for such debts;

(f) the full benefit of all existing contracts and engagements to which the Vendor may be entitled;

(g) all cash on hand and in bank and all Bills and Notes owned by the Vendor;

(h) all shares, bonds and securities owned by the Vendor, including 10,000 shares of Maple Leaf Gardens Limited which are subject to an Option Agreement;

(i) all other property, assets and rights to which the Vendor is entitled in connection with its business or otherwise.

2. The Vendor shall take all proper steps, actions and corporate proceedings on its part to enable it to vest a good and marketable title in the Purchaser to the said business, property, assets and undertaking, and at the time of closing shall deliver to the Purchaser such deeds, conveyances, assurances, transfers, assignments and consents as Counsel for the Purchaser may require. And the Vendor will from time to time on reasonable request and at the expense of the Purchaser execute such further documents and assurances as may be necessary to assure the property and assets in the Purchaser. The Purchaser agrees to accept the title of the Vendor in all property and assets as such title will, stand at the date of closing.

3. The consideration payable by the Purchaser under this Agreement shall be the sum of $2,611,769.00 which is the difference between the aggregrate value of the assets set out in Schedule "A" hereto and the aggregrate value of the liabilities set out in Schedule "B" hereto.

4. The Purchaser covenants to pay, satisfy, discharge, perform and fulfil all debts, liabilities, contracts and engagements of the Vendor incurred and/or arising on or before the date of closing the purchase and sale and to indemnify and save harmless the Vendor, its successors and assigns against all actions, proceedings, claims and demands in respect thereof including, without limiting the generality of the foregoing, all debts and liabilities of the Vendor not recorded on its books incurred and/or arising on or before the date of closing the purchase and sale.

5. The Vendor covenants with the Purchaser that the Vendor will cause to be prepared such Returns as may be required by The Income Tax Act of Canada and The Corporations Tax Act of Ontario for the fiscal period ending the 28th day of February, 1962, in such form and with such content in respect of operations for the periods ending on or before the 15th December, 1961 as may be acceptable to Messrs. Price Waterhouse & Co. The Parties agree that if the Minister of National Revenue or the Treasurer of Ontario shall assess a larger amount of tax than that shown on the original or amended Tax Returns of the Vendor in respect of the periods ending on or before the 15th day of December, 1961, then the Purchaser shall have the right to object and appeal any such assessment in the name of the Vendor.

6. The sale and purchase shall be closed in Toronto on the 28th day of December, 1961, or on such earlier or later date as shall be mutually agreed.

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7. The sale and purchase shall take effect as at the closing of business on the 15th day of December, 1961, from which time until the closing of the sale and purchase the Vendor shall be deemed to have carried on its undertaking and business for and on behalf of the Purchaser, and the Purchaser shall be entitled to all income and profits in connection therewith during the said period. And the Vendor warrants and agrees that until the closing of the sale the Vendor's business shall continue to be carried on in its usual and ordinary course, and that the Vendor shall not declare or pay any dividends or make any payments except such as are necessary for the ordinary conduct of its business, including wages and salaries to employees and officers at the rates heretofore prevailing.

8. All books of account of the Vendor, all books of reference to customers, and all documents and data of the Vendor or in its possession or control relating to the business of the Vendor shall, on closing, be delivered to the Purchaser which shall henceforth be entitled to the custody thereof. The Purchaser covenants to retain such books and documents as required by the Income Tax Act and will make them available to the Vendor upon reasonable request. The Vendor shall retain possession of the Corporate Seal, Stock Ledger and Transfer Book, and the Company's Minute Books. It is agreed that after the date of closing the Purchaser or its agent shall have access to the Company's Minute Books covering the period prior to the date of closing and shall be entitled to make copies or excerpts therefrom.

9. The Vendor shall forthwith after the closing of the sale and purchase cease to carry on the business of producing sand and gravel and dealing in and using construction materials in the Province of Ontario.

10. The Vendor hereby undertakes to make application to the Provincial Secretary of Ontario for permission to change its name to any name acceptable to the Lieutenant-Governor of Ontario which does not include the name "Smythe", such application to be made within thirty days of the closing of the transaction, or in the alternative, to distribute its assets and make application to the Provincial Secretary of Ontario for surrender of its Charter, such application to be made within sixty days of the closing of the transaction.

IN WITNESS WHEREOF the parties hereto have executed this Agreement under the hands of their duly authorized officers in that behalf this 28th day of December, 1961.

C. SMYTHE, LIMITED
per: Conn Smythe
per: A. M. Boyd

C. SMYTHE FOR SAND LIMITED
per: Conn Smythe
per: A. M. Boyd

SCHEDULE "A"

SUMMARY OF ASSETS SOLD BY C SMYTHE, LIMITED TO C. SMYTHE FOR SAND LIMITED AS OF DECEMBER 15, 1961

Description	*Amount*
Cash on hand	$ 7,031
Bank balances and accrued interest	188,126
Time deposit due January 2, 1962 at guaranteed principal amount and accrued interest	800,945
Marketable securities (including 10,152 shares of common stock of Maple Leaf Gardens Limited) at fair market value	475,279
Trade accounts receivable at book value, less allowance of $10,000 for doubtful accounts	181,694
Amount receivable from Conn Smythe Contracting Company Limited at book value	29,773
Amounts receivable from employees and others	1,215
Income tax refund receivable from the Department of National Revenue	2,500
Inventory of feeder cattle at fair market value	108,661
Prepaid insurance and realty taxes	2,896
Mortgage receivable from Vodan Investments Ltd. at principal amount and accrued interest	128,320
Caledon sand and gravel mine at book value	339,528
Caledon plant parking area construction at net book value	1,000
Caledon cement silo at net book value	2,362
Caledon frame buildings and fences at net book value	12,668
Caledon equipment and other tangible capital assets not otherwise specified at net book value	5,626
Caledon buildings and mining machinery and equipment acquired for the purpose of gaining or producing income from a mine, contractor's movable equipment, movable farm equipment, wagons, trailers, automotive equipment, etc. at net book value	223,764
Jane Street, Toronto, sand and gravel mine at fair market value	250,000
Jane Street, Toronto, building acquired for the purpose of gain or producing income from a mine	1
Goodwill	1
	$ 2,761,390

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SCHEDULE "B"

SUMMARY OF RECORDED LIABILITIES OF C. SMYTHE, LIMITED ASSUMED BY C. SMYTHE FOR SAND LIMITED, AS OF DECEMBER 15, 1961

Trade accounts payable	$	52,246
Accrued liabilities		40,856
Amount payable to Roseland Homes Limited		2,519
Mortgages payable—principal amount		
John L. Kestle		10,000
Melvin Lundy		4,000
Mrs. I. M. Krouse		10,000
F. N. Braiden		30,000
	$	149,621

After this meeting on December 15, 1961, Mr. Conn Smythe asked Mr. Smith to contact Greenshields Inc. again to ascertain "whether or not it would act as a dealer in securities under the original proposal" and Mr. Smith did; but Greenshields Inc. declined to enter into a contract in this fashion. Mr. Smith communicated this information to the shareholders of C. Smythe Limited on Friday, December 15, 1961 "with the suggestion that I would reconsider the possibility of adopting other methods of dealing with the problem although I had previously told 'A' (Mr. Conn Smythe) that I did not recommend devious methods." (See Exhibit A-41.)

Then on Monday, December 18, 1961, Mr. Smith sought legal advice for his firm, Price Waterhouse & Co. in this matter and consulted Mr. Stuart Thom, Q.C., of Toronto. One of Mr. Smith's stated reasons for so doing, was "the possibility that I should consider on my client's behalf devious methods suggested in current tax literature for dealing with private companies with undistributed income on hand . . ." (see Exhibit A-41).

At this consultation, Mr. Smith asked the following questions and received the answers following, according to a memorandum which was, according to Mr. Smith "prepared on January 2, 1962 in case I ever needed to refresh my memory on the matter at some later date".

(See Memorandum, Exhibit A-41.) The relevant part of this memorandum reads as follows:

1. In his opinion would there be anything improper, having reference to section 138 of the Income Tax Act, in having "X"'s shares sold to a dealer in securities, the dealer paying the 20% tax on undistributed income and then winding up the company?
   Thom indicated that in his opinion this action was provided for in the Income Tax Act and that it was perfectly straightforward and acceptable to the income tax authorities.

2. I then asked Thom if the proposal from Greenshields whereby the shareholders of "X" would sell their shares for a fixed price determined at net book value of the company less 5% of undistributed income could, in his opinion, involve the shareholders of my client in any action or publicity under Section 138 or other sections of the Income Tax Act.
   Thom informed me that there was no section of the Income Tax Act which provided for a tax on undistributed income of a company or on its shareholders until such time as they decided to distribute such income. Obviously the shareholders of "X" could defer paying tax indefinitely and under the Greenshields' proposal presumably the purchaser was either arranging for an indefinite deferment of tax or no tax. In view of all the circumstances, Thom was of the opinion that the shareholders of "X" could not be successfully attacked on any grounds for selling their shares at the best possible price they could get.

3. I then asked Thom if the shareholders arranged to have "X"'s shares split, say in a ratio of nine non-voting to one voting, in order that they might sell their shares, whether he would consider that there was anything improper in the transaction.
   Thom informed me that although this was not quite as clear as 2 above, after all common shares are frequently split and if this was a condition of the purchaser before he would acquire the shares, then presumably it was reasonable for the shareholders of "X" to do so in order to get the best price for their shares and he doubted if anyone could successfully attack the transaction.

4. In view of the fact that many suggestions for withdrawing undistributed income or "dividend stripping" are mentioned in tax literature, I asked Thom what would be the position of "X"'s shareholders, or my position, if they, or I on their behalf, went out and solicited several brokers in order to find two or more who would each buy less than 50% of the shares of "X" and thus be able to take out dividends without paying the tax required under Section 105B.
   Thom informed me that this might well be considered an endeavour to evade tax that might otherwise be payable under the Income Tax Act and thus might fall under Section 138. He also called my attention to Section 132 which says, in part—"Every person who has.....wilfully, in any manner, evaded or attempted to evade, compliance with this Act or payment of taxes imposed by this Act,.....is guilty of an offence" and, in brief, may be subject to a fine not exceeding $10,000 and a term of imprisonment not exceeding two years.

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> In addition to the possibility that my clients, the brokers or I might be considered as conspiring to evade taxes, the brokers might well be considered to be not acting at arm's length, in which case control of "X" would be acquired by a group and the undistributed income at the beginning of the year deemed to be designated surplus taxable on distribution at ordinary corporate rates.
>
> In view of the foregoing advice I discarded any thought of promoting any devious methods of dealing with undistributed income or "dividend stripping".

At this discussion also, Mr. Smith said he considered with Mr. Thom a letter of proposal to a Mr. Joseph Tenanbaum, President of Runnymede Steel Construction Company, Toronto, dated December 5, 1961, which company was a mutual client of Mr. Thom's firm and Price Waterhouse & Co. This letter concerned the possibility of selling shares of a private company at book value less 5 per cent of undistributed income. A copy of this letter to Mr. Tenanbaum is Exhibit A-42 and reads as follows:

December 5, 1961.

Mr. Joseph Tenanbaum,
Runnymede Steel Construction Company Limited,
3471 Dundas Street,
Toronto, Ontario.

Dear Sir:

Because we are solicitors for one of a group of investors we have been asked to write to you. These investors are interested in the purchase of all of the shares of your Company. They understand that your Company has sold all its assets to Dominion Bridge Company Limited retaining only cash and some property. They are prepared to pay cash for the shares.

Our clients understand that the surplus of your Company exceeds $1,000,000.00 and they will purchase on the basis of dollar for dollar on capital and 95 cents on the dollar for surplus (undistributed income).

Our clients believe that you may intend to retain the shares of Runnymede Steel Construction Company Limited and ask you to consider the advantages which would accrue to you in the elimination of its corporate surplus. They can suggest a pattern whereby this elimination might be carried out by you in a practical manner.

Our clients propose that you form a new Company known as Runnymede Steel Construction 1961 Limited or any name you prefer and that you change the name of the present Company to R.S.C. Enterprises Ltd. Then you can cause the old Company, R S C. Enterprises Ltd. to sell all of its business and assets to the newly incorporated company for a note or a note and preference shares.

At this point the balance sheet of the new company would show assets being all of those assets transferred from the old Company with liabilities being a note payable to the old Company, capital

as you may wish to establish it and all surplus. The old Company's balance sheet would show assets being a note or a note and preference shares with liabilities being only capital and surplus.

You will wish to discuss with your advisors the advantages which can accrue in the establishment of such a new Company. They will quite likely wish to organize it in a way which will bring to you advantages in estate planning and particularly the minimisation of taxation.

Having re-organized you would cause the new Company to borrow sufficient monies to pay off its note to redeem its preference shares if any from the old Company and this would transfer the indebtedness of the new Company from the old Company to the bank. It would place the old Company in a fully liquid position with all of its assets being cash. With the old Company in this position my clients would pay you cash for all of the shares of the old Company.

Actually your borrowings from the bank in the new Company need only last for a half-hour to a one-hour period because the sale of shares of the old Company would place cash in the vendor shareholders' hands which they would in turn immediately advance to the new Company. The new Company would then be in a position to retire its bank loan.

Notice that you would then be in a position to withdraw any sum of money you wished from your new Company because of its liquid position. You would be able to make withdrawals free of personal income tax to the full amount of the shareholders' loan and the capital of your new Company.

Our investor clients would use the Company which they purchased for investment purpose. They do not in a short time liquidate such Companies but maintain them over a period of years making use of investment powers.

Our clients would be pleased to have this matter discussed at greater length with your solicitors or your chartered accountants. They regret that time within this year is short but suggest that the feasibility of this transaction should be established as early as possible. It would be desirable, if you are interested, to complete such a transaction prior to December 31st of this year.

Yours truly,

DOUGLAS, SYMES & BRISSENDEN,
Per

WJT/mm

Mr. Smith had previously heard of this proposal and on Tuesday, December 19, 1961, made further inquiries from Mr. J. H. M. Woods, a partner of his, of Price Waterhouse & Co. who was dealing with the matter of Mr. Tenanbaum and Runnymede Steel Construction Company Limited.

Apparently the day previous Mr. Wood had spoken with Mr. A. D. Russell, a Vancouver partner of Price Waterhouse & Co., and a reputed tax specialist, in a conference call with the representative of the prospective purchaser

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and his solicitor, but Mr. Tenanbaum was not interested in this proposal. Mr. Wood had sent to Mr. Russell a copy of this Tenanbaum letter.

In the afternoon of December 19, 1961, Mr. Smith telephoned Mr. Russell in Vancouver and asked him to make inquiries as to the reputation of the solicitors who wrote this so-called said "Tenanbaum letter" namely, Douglas, Symes & Brissenden, and also of Mr. F. H. Cameron who was the representative of the purchaser.

(In this connection, as appears from the evidence of Mr. Russell taken on commission in Vancouver, B.C., which questions and answers were put to Mr. Russell at this trial when he was called as a witness, Mr. Russell knew that Mr. Cameron was what colloquially was referred to at the time as a "dividend stripper". The questions and answers were as follows:

Q. Did you know that Cameron purchased a great many of the companies for the sake of obtaining the surplus out of the company?

A. I knew he was in the business but I didn't know how extensive it was.

Q. But you knew he was in that business?

A. Oh yes, it was common knowledge.

Q. As far as you know, have Price, Waterhouse in Vancouver had any other similar dealings to this?

A. Not to my knowledge. I was the only tax partner at that time and I have had no part of any such transactions . . .

Q. The Commissioner: To the best of our knowledge Price, Waterhouse has not been in any other than this one.

A. That is my understanding too, and I personally wasn't too happy about this. We certainly did not go out and advocate this type of transaction or promote it with our clients at all.)

Mr. Russell reported to Mr. Smith what he had ascertained as a result of the inquiries he made following this request, whereupon Mr. Smith asked Mr. Russell to find out if Mr. Cameron would be interested in making a proposal similar to that made to Tenanbaum (as contained in the above mentioned letter).

Mr. Russell called Mr. Cameron and later that day Mr. Cameron telephoned Mr. Smith to tell him that he was interested. Mr. Cameron told Mr. Smith also that he would wish such a transaction closed before December 29, 1961. Mr. Smith then inquired as to how soon Mr. Cameron would have to know the precise final amount payable for completing the transaction, and also two other matters which are important.

The two other matters discussed in my view in this telephone conversation between Mr. Smith and Mr. Cameron were as follows; and about them there was a reluctance on the part of Mr. Smith to admit in the witness box; and in respect to them in the argument on summing up there were different views submitted by opposing counsel.

Mr. Smith made notes at the time of this telephone conversation with Mr. Cameron (See Exhibit R-52; and such should be compared with the Tenanbaum letter (Exhibit A-42) especially the first and last paragraphs of it as to which specifically Mr. Smith made these notes in his memorandum reading:

"first paragraph" and "second last paragraph".)

The first paragraph of the Tenanbaum letter (Exhibit A-42) states that the solicitors represent and act for a group of "investors" who are interested in the purchase of all of the shares of Mr. Tenanbaum's company.

The second last paragraph of this letter says that these client "investors" "do not in a short time liquidate such companies but maintain them over a period of years making use of investment powers".

Following this, Mr. Smith again called Mr. Thom on the telephone and asked him for his opinion on the sale of the shares in C. Smythe Limited to a group of investors in Vancouver. Mr. Thom said he would consider the matter and let Mr. Smith know by noon December 20, 1961.

Later on that evening Mr. Cameron again spoke on the telephone to Mr. Smith and again assured Mr. Smith that his group never liquidated companies. Mr. Smith asked "for confirmation of Cameron's proposal by night letter". Mr. Cameron agreed to this and said he would also have his solicitors confirm this information. (Reference to this telephone conversation and what was requested is contained in Mr. Smith's further notes—Exhibit R-52.)

On the next day, December 20, 1961, Mr. Smith received a night letter from Mr. Cameron advising Mr. Smith that they represented "a group of investors" who would purchase all the issued shares on the basis of "dollar for dollar on capital and nine-five per cent on undistributed income" (see Exhibit A-17).

Mr. Smith also received a night letter from the solicitors for Mr. Cameron's group, namely, Mr. Thompson of the

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legal firm of Douglas, Symes & Brissenden. Mr. Thompson confirmed that Mr. Cameron's group did not wind-up companies (see Exhibit A-18), but kept them in good standing and used "their investment powers".

These two night letters read as follows:

A CANADIAN PACIFIC

TELEGRAM

1961 DEC 20 AM 1 13

FD VANCOUVER BC 19

MR S E V SMITH

PRICE WATERHOUSE AND CO 55 YONGE ST TORONTO ONT

WE UNDERSTAND THAT YOU HAVE AN UNDISCLOSED CLIENT WHO OWNS A COMPANY WITH ASSETS BEING CASH NOT EXCEEDING THREE MILLION DOLLARS AND WITH ITS ONLY LIABILITIES BEING CAPITAL, SURPLUS PREMIUM ON SHARES AND WITH UNDISTRIBUTED INCOME OF NOT LESS THAN FIVE HUNDRED THOUSAND DOLLARS STOP WE REPRESENT A GROUP OF INVESTORS WHO ARE PREPARED TO PURCHASE ALL OF THE ISSUED SHARES OF THIS COMPANY FOR CASH AT DOLLAR FOR DOLLAR ON CAPITAL AND NINETY FIVE PER CENT ON UNDISTRIBUTED INCOME STOP WE DO NOT LIQUIDATE SUCH COMPANIES AND THIS COMPANY WILL BE MAINTAINED IN EXISTENCE AS A MEANS OF INVESTMENT AND WILL FILE ANNUAL TAX RETURNS AND PROVINCIAL REPORTS STOP WE UNDERSTAND THAT THE COMPANIES NAME WILL BE CHANGED PRIOR TO OUR PURCHASE OR WILL BE IN THE PROCESS OF BEING CHANGED AT THAT TIME F H CAMERON LTD

CN TELECOMMUNICATIONS

VANCOUVER B C 1961 DEC 20 AM 12 08

S E V SMITH, PRICE WATERHOUSE AND CO

55 YONGE ST TOR

RE: NIGHT LETTER FROM CLIENT FH CAMERON WHO REPRESENTS INVESTORS WHO PURCHASE SHARES OF COMPANIES WITH SURPLUSES. HIS OFFER WITH CONDITION THAT INVESTORS BE FULLY PROTECTED AS OUTLINED IS BONA FIDE. THE COMPANY WHOSE SHARES ARE TO BE PURCHASED WILL NOT BE LIQUIDATED FOR MANY YEARS. NO COMPANIES WITH SURPLUSES WHOSE SHARES HE HAS CAUSED TO BE PURCHASED AND WITH RESPECT TO WHICH WE HAVE ACTED FROM 1956 TO DATE HAVE BEEN LIQUIDATED. THEY ARE KEPT IN GOOD STANDING THEIR INVESTMENT POWERS ARE USED AND ANNUAL TAX RETURNS AND COMPANY REPORTS ARE FILED

DOUGLAS, SYMES AND BRISSENDEN

(In this connection, it should be mentioned that the Tenanbaum letter (Exhibit A-42) was not produced in the usual way in pre-trial proceedings. The respondent found it among some seized documents in another matter. The solicitors for the respondent showed it to the solicitors for the appellants. The appellants' solicitors showed it to Mr. Smith. Mr. Smith asked these solicitors—did they have to disclose it. The appellants' solicitors informed Mr. Smith that they did, and it was then disclosed.)

This so-called Tenanbaum letter and Mr. Smith's notes on his memorandum (Exhibit R-52) remove any suggestion of spontaneity or lack of specific solicitation that might otherwise be inferred from the contents of these said night letters.

Then, Mr. Cameron telephoned Mr. Smith at which time (predicated on a deal being subsequently made), the following were discussed or settled:

(a) that Price Waterhouse & Co. would resign as auditors after closing;

(b) there was a discussion as to the provisions of books of account other than the C. Smythe Limited minute book;

(c) there was a discussion as to how parties could arrive at final figures having regard to the four year reassessment limitation in the *Income Tax Act*;

(d) there was a discussion as to how soon Price Waterhouse & Co. had to ascertain the final figures for the transaction and it was decided that it would be settled at December 22, 1961.

The above is all recorded in the further notes made by Mr. Smith of his conversation (see Exhibit R-54).

On this same day (December 20, 1961), Mr. Peter Osler, Q.C., solicitor for Greenshields Inc. telephoned Mr. I. S. Johnston, Q.C., solicitor for C. Smythe Limited etc., saying he had been instructed to act in a transaction wherein the shares of C. Smythe Limited would be split, but Mr. Johnston told Mr. Osler that he lacked authority to proceed in

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this manner but would discuss the matter with his clients whereupon, Mr. Johnston, after consultation with Mr. Smith, advised Mr. Conn Smythe and Mr. C. Stafford Smythe that Mr. Smith thought the Greenshields Inc. scheme too devious, and at that time received instructions from them not to proceed with the proposed deal with Greenshields Inc. but rather to proceed with the Cameron transaction.

In other words, it was at this time a decision was made by the appellants *qua* shareholders in C. Smythe Limited not to proceed with a sale of the shares of C. Smythe Limited to a "dealer in securities" (Greenshields Inc.) but instead to proceed with a sale of such shares to the Cameron group at a price equivalent to a "dollar for dollar on capital and ninety-five per cent on undistributed income" (see Exhibit A-13); and the purported reason for the decision not to proceed with the proposed sale to this specific dealer in securities Greenshields Inc. was that their proposal was considered "too devious" and therefore might render the appellant shareholders liable for income tax because Greenshields Inc. required under its proposal that the shares of C. Smythe Limited be split before they would purchase them.

A fortiori, (it is hardly necessary to say) it was then decided that the transaction to be entered into with the Cameron group was not "too devious".

The matter of deviousness or not may perhaps be best adjudged by a more detailed narrative of what happened than would otherwise be made. There follows such a narrative.

That same day at about 11:30 a.m., Mr. Thom telephoned Mr. Smith and stated he had considered the matter requested by Mr. Smith the day before and discussed it with his partner, Mr. Wotherspoon; and that they both felt it would be quite in order for the shareholders to sell their shares to the Vancouver group and that Mr. Thom would recommend this course if it was his client. Mr. Smith then read the copies of the night letters, which he had received

from Mr. Cameron and his solicitors, to Mr. Thom who said that Mr. Smith "had made inquiries beyond those which he would have considered necessary in the circumstances and that he would have no hesitation whatsoever in recommending the proposed sale". (See Exhibit A-41.)

(It perhaps should be noted in connection with Mr. Smith's telephone discussions with Mr. Thom, that what is significant is what was not told Mr. Thom of these proposed transactions and also what questions were not asked.)

On that same day, Mr. Smith discussed the transaction with Mr. Conn Smythe and told him he was checking the "bank credit" with the Bank of Montreal, Cameron's banker. It was at this time that Mr. Conn Smythe agreed that in computing the sale price of the shares there should be no adjustment to undistributed income more or less than a $5,000 variance from the original figures calculated. Mr. Conn Smythe also authorized Mr. Smith at that time to disclose the identity of C. Smythe Limited to Mr. Cameron. (See Mr. Smith's further notes, Exhibit R-55.)

Thereupon, Mr. Smith wired Mr. Cameron that the shareholders of C. Smythe Limited were interested in the night letter proposals, (see Exhibit A-19).

Then Mr. Cameron made an informal request of Mr. Peel, Bank of Montreal Manager, Hastings and Burrard Streets Branch, Vancouver, B.C., according to the evidence of Mr. Peel, for an accommodation for a short time to enable F. H. Cameron Limited and Dabne Enterprises Limited to purchase the shares of C. Smythe Limited.

Mr. Peel sought permission by way of telegram from the Bank of Montreal, Head Office Montreal, to make the temporary loan to F. H. Cameron Limited and Dabne Enterprises Limited for this purpose and obtained it (see Exhibits R-68 and A-20). (This loan was for $2,570,336.)

Mr. Smith telephoned Mr. Russell and requested him to check Mr. Cameron's bank credit. Mr. Smith at this time knew that it was only temporary financing that Mr.

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Cameron's group needed—that it was to be as it was put in the evidence—a "daylight loan". (In this connection, the evidence is that the Bank of Montreal knew the loan was for the purpose of what was colloquially called a so-called "dividend strip", and the bank charged a special fee for such a loan. The bank also knew they were going to be repaid this loan out of the cash assets of the company, C. Smythe Limited, the shares of which the Cameron group were purchasing and not from any assets of the Cameron group; and to be sure of this, the bank took the so-called "safety cheques" from the Cameron group as purported officers of C. Smythe Limited before these Cameron people had purchased the shares of that company, and did the other things hereinafter referred to.)

Mr. Russell then made inquiries of Mr. Peel as "to the ability of Cameron to carry through the transaction" with the assistance of the Bank of Montreal, Vancouver, B.C. Mr. Russell was informed by Mr. Peel that the assistance of the Bank of Montreal for this particular purpose would be forthcoming. (This assistance, as mentioned, was for a so-called "dividend strip".)

On the same day Mr. Cameron and Mr. Thompson attended Mr. Russell's office at Price Waterhouse & Co., Vancouver, and discussed arrangements for closing.

On December 21, 1961 Mr. Smith telephoned Mr. Cameron and they agreed that (a) closing would be either in Toronto or Vancouver, or in both cities at once, using conference telephones; and (b) a duplicate seal for C. Smythe Limited would be prepared and sent to Vancouver in order to pass the necessary banking by-law on the closing date.

On Friday December 22, 1961 Mr. Cameron had a telephone conversation with Mr. Smith and agreed (a) that prior to closing, the existing directors of C. Smythe Limited would resign and Cameron's nominees would be elected as directors "so that they could function" at closing; (b) that Mr. Russell would attend at closing in Vancouver and bring the duplicate seal of C. Smythe Limited;

(c) that the probable closing time would be December 28, 1961 at 1:30 p.m. Toronto time and (d) that at that time because final figures were still unknown Mr. Smith would call Mr. Cameron later and give him a "ceiling on gross amount". (See Exhibit R-59 and Exhibit R-88.)

Mr. Smith then telephoned Mr. Cameron that the ceiling on gross amount would be $2,650,000. (See Exhibit R-59.)

Mr. Smith then telephoned Mr. Conn Smythe and cleared the arrangements (See Exhibit R-59).

(On the following days, no action was taken for obvious reasons:

December 23, 1961—Saturday.

December 24, 1961—Sunday.

December 25, 1961—Christmas.

December 26, 1961—Boxing Day.)

On December 27, 1961 (Wednesday), Mr. Smith then prepared a memorandum of the proposal for "the use of two escrow agents". (See Exhibit R-62).

On this day also, C. Smythe Limited requested the International Division Branch of the Toronto-Dominion Bank to transfer title of the $800,000 fixed deposit to C. Smythe For Sand Limited for security to the bank in respect to the loan that was subsequently made by this bank to this latter company for the payment of this transaction.

Mr. Smith also telephoned Mr. Cameron and gave the final figures for closing, namely:

Total assets of old company (C. Smythe Limited)	$ 2,611,769
Undistributed income	$ 728,652
Discount of 5% of undistributed income	$ 36,433
Add all-round amount	5,000
	$ 41,433
Purchase price of shares	**$ 2,570,336**

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(In this connection, it should be noted that Mr. Cameron and his associate through F. H. Cameron Limited and Dabne Enterprises Limited were to (and did) receive this said sum of $41,433 for their part in implementing this transaction.)

Mr. Smith then prepared a balance sheet for C. Smythe Limited as at 12 noon E.S.T., December 28, 1961.

This balance sheet showed the sole asset of C. Smythe Limited to be $2,611,769. (See Exhibits R-61, A-28, A-29, A-30 and A-31.)

The plan to use escrow agents for closing was abandoned and arrangements were made with the Toronto-Dominion Bank for (a) the simultaneous exchange of its draft of $2,611,769 for the Bank of Montreal drafts totalling $2,570,336; and (b) for a temporary bank loan of $316,769 to cover the deficiency in the above drafts of $41,433 (this is the amount Mr. Cameron and his associates were to and did get) plus the amount of cash to be distributed to the shareholders of C. Smythe Limited, *viz.*, $275,336; and (c) to secure this temporary loan of $316,769 with the said fixed term deposit of $800,000, (this represented the sum obtained from the said sale by C. Smythe Limited of its shares in Maple Leaf Gardens Limited, which at the time were invested in U.S. (funds) and (d) for repayment of the temporary loan on January 2, 1962.

These arrangements were made pursuant to the recommendations of Price Waterhouse & Co. (S. E. V. Smith) to Mr. Conn Smythe (See Exhibit R-73).

Mr. Smith then prepared for the shareholders of C. Smythe Limited, a Pro Forma Balance Sheet as at December 15, 1961 after giving effect to the banking transactions on closing. This showed a bank overdraft of $316,769 and paid up capital of $10,000 and non-interest-bearing debentures $2,285,000 totalling in all $2,611,769. Attached to the Pro Forma Balance Sheet was a schedule showing the shareholders' ownership of these shares and debentures and the amounts of cash payable to each of them ($275,336). (See Exhibits A-32 and A-31.)

Then between December 28, 1961 and January 4, 1962, the following took place:

On December 28, 1961 (Thursday) the Bank of Montreal in Vancouver: (a) opened a bank account in the name of

C. Smythe Limited; and had prepared a draft banking resolution of C. Smythe Limited, appointing the Bank of Montreal as one of its banking agents and authorizing Mr. Cameron and Mr. Bone as signing officers; (b) drew "safety cheques" on the account of C. Smythe Limited and had them signed by Messrs. Cameron and Bone; and (c) issued instructions that the ledger card for C. Smythe Limited was to be kept separate and that no cheques were to be honoured on this account without the specific instruction from the manager who would then negotiate the safety cheques.

The Bank of Montreal also on December 28, 1961 obtained from F. H. Cameron Limited a promissory note for $1,285,000 and a promissory note from Dabne Enterprises Limited for $1,280,000.

Sums in these amounts were credited to the respective accounts of F. H. Cameron Limited and Dabne Enterprises Limited; and simultaneously there was drawn on these accounts, banker's drafts for $1,285,168 (Dabne) and $1,285,168 (Cameron) payable to the Toronto-Dominion Bank, Vancouver, which were held in escrow by Mr. Peel, the Bank of Montreal, Vancouver, Manager.

Then at 10.00 a.m. a directors' meeting of C. Smythe Limited was held wherein the by-laws were amended: (a) to permit shareholders meetings in Vancouver; and (b) to remove the chairman's casting vote.

Between 10:30 a.m. to 2:30 p.m., a shareholders' meeting of C. Smythe Limited was held wherein: (a) the sale of the assets was confirmed; (b) the resignations were accepted from Conn Smythe, C. Stafford Smythe, C. H. Day and A. M. Boyd as officers and directors; and (c) transfers of shares were made from Conn Smythe to F. H. Cameron, D. A. Bone, W. J. Thompson, W. G. Lane, W. H. Bouck, J. R. Hetherington, Ian Douglas and Ester Fortney.

At 2:30 EST, 11:30 PST, simultaneous meetings were held at: (a) Head Office, Toronto-Dominion Bank, Toronto; and (b) Main Branch, Toronto-Dominion Bank, Vancouver, at which the following transpired:

(i) the corporate seal and corporate records of C. Smythe Limited were handed over to the Cameron group;

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(ii) the banking resolution of C. Smythe Limited appointing the Bank of Montreal as its banking agent and authorizing Mr. Cameron and Mr. Bone as signing officers was executed by affixing the corporate seal of C. Smythe Limited;

(iii) shares of C. Smythe Limited were handed over to the Cameron group;

(iv) the bank drafts were exchanged between Bank of Montreal and Toronto-Dominion Bank.

The Toronto-Dominion draft of $2,611,769 was credited to the C. Smythe Limited account in Bank of Montreal, Vancouver.

The bank account of C. Smythe For Sand Limited was debited with a draft of $2,611,769 and credited with a draft for $2,295,000.

The Toronto-Dominion Bank, Toronto, then paid:

Conn Smythe	$ 143,175
C. Stafford Smythe	84,763
C. H. Day	44,054
A. M. Boyd	3,344
	$ 275,336

On January 2, 1962 (Tuesday), in Vancouver, at the Bank of Montreal, the following took place:

(a) Mr. Cameron and Mr. Bone each drew cheques for $1,305,600 against the Bank of Montreal account of C. Smythe Limited, and deposited them in the accounts of F. H. Cameron Limited and Dabne Enterprises Limited;

(b) simultaneously, the accounts of F. H. Cameron Limited and Dabne Enterprises Limited were debited to repay to the Bank of Montreal the temporary loans or accommodations of December 28, 1961; and

(c) the safety cheques drawn on the account of C. Smythe Limited were returned by Mr. Peel to Mr. Cameron and Mr. Bone, who destroyed them.

On the same day, at a director's meeting of C. Smythe Limited at 4:30 p.m., that company was authorized to and did invest $2,611,200 in preference shares of F. H.

Cameron Limited and Dabne Enterprises Limited (to put the latter two companies in funds to pay off the said loan to the Bank of Montreal).

In this latter connection, as the evidence clearly indicates, it is a proper inference to make and I do make it, that these preference shares of F. H. Cameron Limited and Dabne Enterprises Limited at the time of acquisition by C. Smythe Limited were valueless; and that as a consequence on that day, C. Smythe Limited (subsequently changed in name to C. S. Enterprises Limited) had no assets of any value, and its shares were worthless.

On January 4, 1962 Letters Patent for C. Smythe For Sand Limited were recorded.

It is also a reasonable inference to make and I do make it, that F. H. Cameron Limited and Dabne Enterprises Limited were engaged at the material time in schemes aimed at "stripping the surplus" of "old" companies which had converted its assets into cash by selling its operations and operating assets to "new" companies and that the appellants through their agent Mr. Smith had "actual knowledge" of this, and also that the surplus of C. Smythe Limited was going to be "stripped" by the purchaser of these shares without paying income tax. (c.f. Devlin J. in *Roper v. Taylor's Central Garages (Exeter), Limited*[7].)

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[7] [1951] 2 T.L.R. 284 at 288-89

. . .There are, I think, three degrees of knowledge which it may be relevant to consider in cases of this kind. The first is actual knowledge, which the justices may find because they infer it from the nature of the act done, for no man can prove the state of another man's mind; and they may find it even if the defendant gives evidence to the contrary. They may say, "We do not believe him; we think that that was his state of mind." They may feel that the evidence falls short of that, and if they do they have then to consider what might be described as knowledge of the second degree; whether the defendant was, as it has been called, shutting his eyes to an obvious means of knowledge. Various expressions have been used to describe that state of mind. I do not think it necessary to look further, certainly not in cases of this type, than the phrase which Lord Hewart, C.J., used in a case under this section, *Evans v. Dell* ((1937) 53 The Times L.R. 310), where he said (at p. 313): ". . .the respondent deliberately refrained from making inquiries the results of which he might not care to have."

The third kind of knowledge is what is generally known in the law as constructive knowledge: it is what is encompassed by the words "ought to have known" in the phrase "knew or ought to have known." It does not mean actual knowledge at all; it means that the defendant had in effect the means of knowledge. When, therefore, the case of

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Mr. Cameron apparently, through his company and others had engaged in about forty-five of these "dividend stripping" schemes.

(The scheme invoked here, to state it summarily, was for the "old" shareholders to withdraw their funds "tax free" by selling their "old" shares at a discount of 5 per cent of the undistributed earned surplus plus $5,000 or $41,433. The purchasers of these shares, F. H. Cameron Limited and Dabne Enterprises Limited, who purchased equal amounts of these shares, then recovered their money and their profit of $41,433 by issuing worthless preferred shares from F. H. Cameron Limited and Dabne Enterprises Limited to C. Smythe Limited in return for the cash.)

It may appear obvious that what was done in C. Smythe Limited by Mr. Cameron and associates was illegal having regard, among other things, to the provisions of the Ontario *Corporations Act*; but notwithstanding this does not affect the basis for this determination.

It may also appear obvious, that Mr. Russell, the "tax expert" of Price Waterhouse & Co. at Vancouver, B.C. did not know of any "magic" whereby the undistributed earned income of any company could be got out and distributed legally to the shareholders without paying income tax. Mr. Russell said so in evidence. And it is a reasonable inference and I make it, that Mr. Russell knew that Mr. Cameron, F. H. Cameron Limited or Dabne Enterprises Limited did not know of any such method either.

It is also a reasonable inference that Mr. Russell communicated his opinion to the said Mr. Smith, Toronto partner of Price Waterhouse & Co. who acted as agent for

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the prosecution is that the defendant fails to make what they think were reasonable inquiries it is, I think, incumbent on them to make it plain which of the two things they are saying. There is a vast distinction between a state of mind which consists of deliberately refraining from making inquiries, the result of which the person does not care to have, and a state of mind which is merely neglecting to make such inquiries as a reasonable and prudent person would make. If that distinction is kept well in mind I think that justices will have less difficulty than this case appears to show they have had in determining what is the true position. The case of shutting the eyes is actual knowledge in the eyes of the law; the case of merely neglecting to make inquiries is not knowledge at all—it comes within the legal conception of constructive knowledge, a conception which, generally speaking, has no place in the criminal law.

the appellants and C. Smythe Limited and did all the negotiations and did all the dealing to cause this transaction to be completed. If Mr. Russell did not express his views to Mr. Smith, then Mr. Smith, in any event, it is a proper inference and I make it, would know this from his own training and experience.

It follows from this that it is a reasonable inference and I make it, that Mr. Smith knew at the material time that Mr. Cameron and his associates were going to employ some device while avoiding paying income tax, to get the undistributed earned surplus out of C. Smythe Limited, even if Mr. Smith did not know and could not be expected to know that the device that would actually be employed was to cause C. Smythe Limited to invest in worthless preferred shares in F. H. Cameron Limited and Dabne Enterprises Limited.

The appellants had actual knowledge of all the matters Mr. Smith wrote and told them; and it follows also as a matter of law that all Mr. Smith's actual knowledge must be imputed to the appellants because Mr. Smith was their agent for all purposes of these transactions.

So much for the facts and explicit inferences made.

I now come to the issues for determination in these appeals and the determination of them.

The main issue for decision is whether or not these transactions resulted in the conferral of a benefit on the appellants within the meaning of subsection (2) of section 137[8] of the *Income Tax Act*; and in the event that the decision on the main issue is in the affirmative, a subsidiary

[8] 137. (2) Indirect payments or transfers. Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatsoever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transactions or that one or more other persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending upon the circumstances, be

(*a*) included in computing the taxpayer's income for the purpose of Part I,

(*b*) deemed to be a payment to a non-resident person to which Part III applies, or

(*c*) deemed to be a disposition by way of gift to which Part IV applies.

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issue for decision is whether the amount of such benefit should be assessed under section 8(1)[9] or section 81(1) of the *Income Tax Act*.

In respect to the main issue reference was made by counsel to three other statutory enactments respecting the taxation of corporate distributions, two of them in other jurisdictions and the third in the *Income Tax Act* of Canada.

Enactments in the two other jurisdictions are section 260[10] of the Australian Act, and section 28[11] of the (UK) *Finance*

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[9] 8(1) Appropriation of property to shareholders—Stock dividends and stock rights. Where, in a taxation year,

(*a*) a payment has been made by a corporation to a shareholder otherwise than pursuant to a *bona fide* business transaction,

(*b*) funds or property of a corporation have been appropriated in any manner whatsoever to, or for the benefit of, a shareholder, or

(*c*) a benefit or advantage has been conferred on a shareholder by a corporation,

otherwise than

(i) on the reduction of capital, the redemption of shares or the winding-up, discontinuance or reorganization of its business,

(ii) by payment of a stock dividend, or

(iii) by conferring on all holders of common shares in the capital of the corporation a right to buy additional common shares therein,

the amount or value thereof shall be included in computing the income of the shareholder for the year.

[10] 1200 ss. 257-260

(1748)

260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—

(*a*) altering the incidence of any income tax;

(*b*) relieving any person from liability to pay any income tax or make any return;

(*c*) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or

(*d*) preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

[11] 28. Cancellation of tax advantages from certain transactions in securities.

(1) Where—

(*a*) in any such circumstances as are mentioned in the next following subsection, and

Act, 1960 as amended; the *Income Tax Act* of Canada, section 138A[12] (which was enacted in 1963).

In connection with these three enactments, the appellants say that section 260 of the Australian Act and section 28 of the (U.K.) *Finance Act 1960* as amended are equivalent legislation to section 138A of the *Income Tax Act* of Canada, while the respondent submits that section 260 of the Australian Act is more, in purpose and effect, like section

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(*b*) in consequence of a transaction in securities or of the combined effect of two or more such transactions,

a person is in a position to obtain, or has obtained, a tax advantage, then unless he shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained, this section shall apply to him in respect of that transaction or those transactions:...

[12] 138A. Dividend Stripping—Associated Corporations.

(1) Dividend Stripping. Where a taxpayer has received an amount in a taxation year.

(*a*) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,

(*b*) in consequence of a corporation having

(i) redeemed or acquired any of its shares or reduced its capital stock, or

(ii) converted any of its shares into shares of another class or into an obligation of the corporation, or

(*c*) otherwise, as a payment that would, but for this section, be exempt income,

which amount was received by the taxpayer as part of a transaction effected or to be effected after June 13, 1963 or as part of a series of transactions each of which was or is to be effected after that day, one of the purposes of which, in the opinion of the Minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified by the Minister shall, if the Minister so directs,

(*d*) be included in computing the income of the taxpayer for that taxation year, and

(*e*) in the case of a taxpayer who is an individual, be deemed to have been received by him as a dividend described in paragraph (*a*) of subsection (1) of section 38.

(2) Associated corporations. Where, in the case of two or more corporations, the Minister is satisfied

(*a*) that the separate existence of those corporations in a taxation year is not solely for the purpose of carrying out the business of those corporations in the most effective manner, and

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137(2) of the *Income Tax Act* of Canada, but concedes that section 28 of the (U.K.) *Finance Act 1960* as amended is similar in purpose and effect to section 138A of the *Income Tax Act* of Canada.

Decisions under these said Australian and United Kingdom statutes are helpful in considering the judicial approach to the matter of the taxation of certain corporate distributions. (See *Newton v. Commissioner of Taxation*[13]; *Hancock v. Commissioner of Taxation*[14]; *Bell v. Federal Commissioner of Taxation*[15]; *I.R.C. v. Brebner*[16].)

But in coming to a conclusion in this case, however, it is necessary to refer specifically only to the provisions of sections 8(1), 81(1) and 137(2) of the *Income Tax Act*, and to consider their meaning and effect as applied to the facts of this case.

Before considering the applicability of section 137(2) of the *Income Tax Act*, it is necessary to consider firstly

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(*b*) that one of the main reasons for such separate existence in the year is to reduce the amount of taxes that would otherwise be payable under this Act

the two or more corporations shall, if the Minister so directs, be deemed to be associated with each other in the year.

(3) Appeal. On an appeal from an assessment made pursuant to a direction under this section, the Tax Appeal Board or the Exchequer Court may

(*a*) confirm the direction;

(*b*) vacate the direction if

(i) in the case of a direction under subsection (1), it determines that none of the purposes of the transaction or series of transactions referred to in subsection (1) was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided; or

(ii) in the case of a direction under subsection (2), it determines that none of the main reasons for the separate existence of the two or more corporations is to reduce the amount of tax that would otherwise be payable under this Act; or

(*c*) vary the direction and refer the matter back to the Minister for reassessment.

[13] [1958] A.C. 450.

[14] (1962-63) 108 C.L.R. 259.

[15] (1952-53) 87 C.L.R. 548.

[16] [1967] 1 All E.R. 779.

section 137(3)[17] because that subsection puts a limit on the application of section 137(2), by prescribing that it does not apply to a transaction that was entered into by:

(a) persons dealing at arm's length,

(b) *bona fide,*

(c) not pursuant to, or as part of, any other transactions (and other matters not relevant here);

For all three reasons spelled out in it, I am of the opinion that this subsection is not applicable to this transaction, in that (1) this transaction was pusuant to and part of other transactions; (2) that this was not a *bona fide* transaction, not in the sense of being fraudulent but instead in the sense of being not for any legitimate business purpose, in that it was entered into solely as a means of avoiding the taxation consequences of complying with the provisions of section 105 or section 105B of the *Income Tax Act*; and (3) that one interrelated part of the whole transaction, namely, the transaction between C. Smythe Limited and C. Smythe For Sand Limited was not a transaction entered into by persons dealing at arm's length.

Section 137(2) of the *Income Tax Act* reads as follows:

> 137(2) Indirect payments or transfers. Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatsoever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transactions or that one or more other persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending upon the circumstances, be
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> (*a*) included in computing the taxpayer's income for the purpose of Part I,
>
> (*b*) deemed to be a payment to a non-resident person to which Part III applies, or
>
> (*c*) deemed to be a disposition by way of gift to which Part IV applies.

[17] 137. (3) Arm's length. Where it is established that a sale, exchange or other transaction was entered into by persons dealing at arm's length, *bona fide* and not pursuant to, or as part of, any other transaction and not to effect payment, in whole or in part, of an existing or future obligation, no party thereto shall be regarded, for the purpose of this section, as having conferred a benefit on a party with whom he was so dealing.

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In the consideration of the applicability of section 137(2) of the *Income Tax Act* to the facts of these cases, two tests may be and are now employed, namely, (1) by using some of the accounting employed in this transaction, and (2) by putting and answering in words four questions.

To demonstrate, by using some of the accounting, what was done here in relation to the applicability of section 137(2) of the Act, may be accomplished by reference to the journal entries dated December 15 and 28, 1961 made in the books of C. Smythe For Sand Limited. They show beyond the possibility of doubt what the "result" was of what was done when there is added to them, amounts representing the said payment in cash of $275,336 to the appellants and A. M. Boyd and of $41,433 to Cameron and associates.

These journal entries made are as follows:

C SMYTHE FOR SAND LIMITED
JOURNAL ENTRIES

1961		Dr	Cr
Dec. 15	Subscriptions Receivable .....$	4 00	
	To Common Shares		$ 4.00
	To record the subscription and issue on December 15, 1961 of four common shares of a par value of $1 00 each to the four incorporators of the company		
	(Directors' minutes December 15, 1961)		
Dec. 15	Subscriber—Conn Smythe	1.00	
	C. Stafford Smythe	1.00	
	C. H. Day	1.00	
	A. M. Boyd	1 00	
	To Subscriptions Receivable		4.00
	To transfer subscriptions receivable		
Dec. 15	Subscriber—Conn Smythe	5,199.00	
	C. Stafford Smythe	3,079.00	
	C. H. Day	1,599.00	
	A. M. Boyd	119.00	
	To Common Shares		9,996 00
	To record the subscription and allotment on December 15, 1961 of 9,996 common shares of a par value of $1.00 each as follows:		
	Conn Smythe	5,199	
	C. Stafford Smythe	3,079	
	C. H. Day	1,509	
	A. M. Boyd	119	
	(Directors' minutes December 15, 1961)		

Dec. 28	Subscriber—Conn Smythe	1,188,200.00	
	C. Stafford Smythe	703,820.00	
	C. H. Day	365,600 00	
	A. M. Boyd	27,380.00	
	To Non-interest Bearing Debentures		2,285,000 00
	To record the allotment and issue of non-interest bearing debentures on December 28, 1961 (full payment received in cash on that date) as follows:		
	Conn Smythe	1,188,200.00	
	C. Stafford Smythe	703,820.00	
	C. H. Day	365,600.00	
	A. M. Boyd	27,380.00	
	(Directors' minutes December 28, 1961)		
Dec. 28	Due to C. Smythe Limited .....$	2,611,769.00	
	To Toronto-Dominion Bank, Queen and Ossington Branch, Toronto, General Account		$ 2,611,769.00
	To record bank draft drawn payable to C. Smythe, Limited in full settlement of the amount due to that company		
Dec. 28	Toronto-Dominion Bank, Queen and Ossington Branch, Toronto—General Account	2,295,000.00	
	To Subscriber—Conn Smythe		1,193,400.00
	C. Stafford Smythe		706,900.00
	C. H. Day		367,200.00
	A. M. Boyd		27,500.00
	To amount credited by the bank to C. Smythe For Sand Limited representing payments by the above named individuals to the company (see copy of letter attached)		

To say in words what was done here in relation to the applicability of section 137(2) of the *Income Tax Act*, may be accomplished by putting and answering four (4) questions, *viz*:

1. WHAT WAS THE "RESULT" OF THESE TRANSACTIONS?

The old company (C. Smythe Limited) had assets worth $2,611,769.

(a) before the sale of its assets to the new company (C. Smythe For Sand Limited)

and

(b) also after the sale to new company, *but* after all these transactions took place

(c) the old company was left with assets that were valueless, *viz.*, preferred shares in F. H. Cameron Limited and Dabne Enterprises Limited.

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2. WHERE DID ASSETS OF OLD COMPANY GO?

The assets went:

(a) to the new company (which became owned by the shareholders of old company, by way of common shares and non-interest-bearing debentures);

(b) $275,336 in cash went to the appellant shareholders and A. M. Boyd; and

(c) $41,433 in cash went to Mr. Cameron and his associates as a fee.

3. WAS A "BENEFIT" CONFERRED ON THE SHAREHOLDERS OF THE OLD COMPANY BY THE DISPOSAL OF ITS ASSETS IN THIS FASHION?

The "benefit" conferred on the shareholders and A. M. Boyd of the old company was:

(a) $275,336 in cash;

(b) $453,316 of the total of non-interest-bearing debentures in the new company (which debentures had a real value because on the assets side of the balance sheet of the new company, C. Smythe For Sand Limited, were the working and other tangible and intangible assets formerly belonging to the old company).

(The amount of these debentures received as a part of the said "benefit" equals: the difference between $728,652 undistributed earned surplus of the old company, C. Smythe Limited, and the said $275,336 received in cash).

4. WHAT "PERSON" CONFERRED THE SAID "BENEFIT" ON THESE APPELLANT "TAXPAYERS", AND WERE THERE "ONE OR MORE PERSONS .... ALSO PARTIES THERETO"?

The "person" the old company (acting through its officers and directors, the appellants who were controlling shareholders of it) with the help of and as "parties thereto", the following namely, and others,

(a) F. H. Cameron Limited,

(b) Dabne Enterprises Limited,

(c) F. H. Cameron personally,

(d) The Bank of Montreal, Vancouver, B.C.,

(e) The Toronto-Dominion Bank at Toronto and Vancouver

conferred this said "benefit" (i.e. as set out in 3 above) on the appellant shareholders and A. M. Boyd.

To consider further the applicability of section 137(2) of the *Income Tax Act* to the facts of these cases, these facts may be summarized in the manner following, that is to say:

Immediately before the series of transactions, the situation was that the old company (C. Smythe Limited) had substantial assets and the appellants (and A. M. Boyd) owned all the shares in the old company.

The straightforward way for the old company to have conferred on the appellants (and A. M. Boyd) the benefit to which they were entitled *qua* shareholders was for the old company to pay each of them a dividend. (The reassessments herein were made on the basis that the appellants were deemed to have received a dividend.) (Such a benefit of course would have been subject to resultant income tax liability.)

If such a benefit (dividend) had been conferred (paid), the "result" would have been that the appellants would then have had the dividend (cash and securities) and they would still have had the shares in the old company which would then have had its original assets less the dividend.

But instead of the above, as a result of the series of transactions implemented in 1961, the situation was that the appellants had a "benefit" (cash and certain non-interest-bearing debentures in a new company, (C. Smythe For Sand Limited) and the shares in the new company which had all the assets of the old company minus that "benefit" and also minus the expense of carrying out the series of transactions. This is the important fact; for the only money or property that entered into the series of transactions, other than that which originated in the old company, was the money borrowed temporarily from the banks which went back to the banks.

The "result" of the whole series of transactions was therefore the same as if the old company had paid a dividend to the appellants (and A. M. Boyd) except that instead of the appellants (and A. M. Boyd) then owning

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shares in the old company and the old company having all its original assets minus the dividend, the appellants then owned shares in the new company that had all the old company's original assets minus the "benefit" and minus also the cost of carrying out the transactions. (From the appellants' point of view this was an immaterial difference except for the fact that the assets now belonging to the new company were somewhat less than if a dividend had been paid directly to them from the old company.)

The "result" of the series of transactions was therefore that the old company conferred a "benefit" on the appellants *qua* shareholders equal to the amount (cash and non-interest-bearing certificates in the new company) that they so acquired. Before the series, assets representing that amount belonged to the old company. After the series, they belonged to the appellants (and A. M. Boyd). If the appellants (and A. M. Boyd) had not been shareholders in the old company before the series, they would never have received these assets.

From all this it follows, in my view, that "notwithstanding the form or legal effect of the transactions", the said "benefit", because of section 137(2) of the *Income Tax Act* is deemed to be a "payment" to these appellant taxpayers "equal to the amount of the benefit conferred" and as a consequence such "payment" must be "included in computing the taxpayer(s)' income for the purpose of Part I" of the *Income Tax Act*.

"For the purpose of Part I" the amount of this benefit in the circumstances of this case could be assessed pursuant to the provisions of either section 8(1) or section 81(1) of the *Income Tax Act*.

The decision as to whether such benefit should be assessed under either section 8(1) or section 81(1) depends on a conclusion as to whether or not what was done here constituted a "winding-up, discontinuance or re-organization" of the business of C. Smythe Limited as those words are employed respectively in section 8(1) and section 81(1) of the Act.

The assessor in making the re-assessments for each of the appellants concluded that there was a "winding-up, discontinuance or re-organization" of C. Smythe Limited by reason of what was done here. As a consequence, because

section 81(2)[18] so prescribes, the benefit received by the appellants was "deemed to be a dividend" and the assessor in making such re-assessments allowed the appellants a dividend credit pursuant to the provisions of section 38(1)[19] of the *Income Tax Act*.

Without deciding, if I had been in the position of the assessor I think I would have come to the conclusion that there was no "winding-up, discontinuance or re-organization" of the business of C. Smythe Limited, by reason of what was done here, within the meaning of those words as employed in sections 8(1) and 81(1) of the Act; and as a consequence, I would have assessed the "benefit" as income received by the appellants within the purview of section 8(1) of the *Income Tax Act* and as a consequence there would have been no dividend credit allowed to the appellants.

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[18] 81. (2) Deemed to be dividend. Where a corporation, at a time when it had undistributed income on hand, has

(*a*) redeemed or acquired any of its common shares or reduced its common stock, or

(*b*) converted any of its common shares into shares other than common shares or into some obligation of the corporation,

a dividend shall be deemed to have been received at that time by each of the persons who held any of the shares at that time equal to the lesser of

(i) the amount received or the value of that which was received by him for or in respect of the shares on the reduction or conversion, or

(ii) his portion of the undistributed income then on hand.

[19] 38. (1) An individual who was resident in Canada at any time in a taxation year may deduct from the tax otherwise payable under this Part for a taxation year 20% of the amount by which

(*a*) the aggregate of all dividends received by him in the year from taxable corporations in respect of shares of the capital stock of the corporations from which they were received and of all dividends that he is, by subsection (3) of section 8 and section 81, deemed to have received from such corporation in the year, to the extent that the dividends so received or so deemed to have been received, as the case may be, were included in computing his income for the year,

exceeds the aggregate of

(*b*) the amount, if any, deductible from income in respect of those dividends by virtue of a regulation made under subsection (2) of section 11, and

(*c*) all outlays and expenses deductible in computing the taxpayer's income for the year to the extent that they may reasonably be regarded as having been made or incurred for the purpose of earning the dividend income.

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One other comment collaterally, perhaps should be made, namely, that an appeal from an assessment made under sections 8(1), 81(1) and 137(2) of the Act is processed in the usual manner which involves an adjudication by the Court upon the facts in relation to the provisions of these sections of the Act. Under section 138A, however, an appeal is from the "direction" of the Minister of National Revenue, where there has been included in income an amount by the exercise of a ministerial discretion, and on such appeal the Court in its adjudication is prescribed by the narrow limits of appeals from such a discretion.

One final comment, also, perhaps should be made, and that is the reference to use of the word "conspiracy" in the pleadings of the respondent in this case, and the connotation put on it by counsel for the appellants that such was tantamount to an allegation of fraud on the part of the appellants in this case. In my view, no such connotation can be inferred here. While not having the precise elements of "civil conspiracy", the wording of sections 8(1) and 81(1) and especially section 137(2) of the *Income Tax Act* (when it refers to a person conferring a benefit and the fact that there may be one or more persons as "parties thereto") permits in the pleadings the employment of the concept of civil conspiracy in cases such as this and at the trial the leading of evidence of all of the transactions in the whole series, as was done in these cases.

In the result, therefore, the re-assessments are confirmed, and the appeals are dismissed with costs.