Correspondence

The Estates of Fleck and Mills

TO THE EDITOR:

Mr. Stuart Thom's comment on *Re Fleck* and *Re Mills* at page 78 of your January issue and the letter supporting him from Mr. H. Heward Stikeman in the February issue at page 225 interest me greatly. I note Mr. Thom's reference to *Hill* v. *Permanent Trustee Company of New South Wales Limited*, [1930] A.C. 720, but I am concerned that he did not consider certain other cases worthy of comment. The cases I have in mind are those on which, in my opinion, is founded the one major branch of law determining whether stock dividends are income or capital. They are: *Bouch* v. *Sproule* (1887), 12 App. Cas. 385; *Eisner* v. *Macomber* (1920), 252 U.S. 189; and *Commissioners of Inland Revenue* v. *Blott*, [1921] 2 A.C. 171.

These decisions are all clear authority that in looking at any such transaction as was involved in the *Fleck* and *Mills* cases regard must be paid both to the form and the substance, and particular regard seems to be paid to the substance. Thus, in *Bouch* v. *Sproule* Lord Herschell said at page 398, "I think we must look both at the substance and form of the transaction". Lord Herschell looked at all the facts and as a result came to the conclusion that the company in that case did not pay or intend to pay any sum as dividend, but intended to, and did appropriate the undivided profits dealt with as an increase in the capital stock. Lord Watson at page 404 said that he was "unable to resist the conclusion that, in adopting the scheme recommended by the directors the company must have intended that each shareholder should get an allotment of new shares, and that the money declared to be payable as a dividend, which was not in the coffers of the company and did not exist in the form available for distribution, should not be paid to shareholders, but should simply, by means of an entry in the company's books, be imputed to payment of the call of £7 10s. upon each new share". And on page 405 he continued: "If I am right in my conclusion the substantial bonus which was meant to be given to each shareholder was not a money pay-

ment but a proportional share of the increased capital of the company". The great regard the court paid to the substance of the transaction is apparent from the form taken, which was a declaration of a special bonus dividend of £2 10d. a share accompanied by an allocation of stock to the existing shareholders and a call on the shares so allotted equal to the bonus dividend. As a result of the transaction, the dividend declared was subsequently capitalized through the call and no funds actually reached the hands of the shareholders.

In the *Macomber* case Pitney J., speaking for the majority of the Supreme Court of the United States, said of income as against a capital increase: "Here we have the essential matter, not a gain accruing to capital, not a growth or increment in value of the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed and coming in, being 'derived', that is, received or drawn by the recipient (the taxpayer) for a separate use, benefit and disposal; that is income derived from property. Nothing else answers that description." In the *Macomber* case the court went on to hold that a dividend of common shares on common shares, where there is no reduction of capital, is a capital distribution and not income. In other words, the dividend remained part of the permanent capital of the company.

In the *Blott* case Viscount Finlay at page 194 said, "The effect of this operation was that the amount of the bonus was retained by the company as additional capital, and that the shareholders got the new preference shares". Towards the foot of the page he quoted with approval the following words of Rowlatt J. in the court below, [1920] 1 K.B. at p. 133, "Now I do not think that there is a payment of a dividend to a shareholder unless a part of the profits of the company is thereby liberated to him in the sense that the company parts with it and he takes it". At page 200 Viscount Finlay continued: "The profits remained in the hands of the company as capital, and the shareholder received a paper certificate as evidence of his interest in the additional capital so set aside. The transaction took nothing from the company's coffers, and put nothing into the shareholder's pockets; and the only result was that the company, which before the resolution could have distributed the profit by way of dividend or carried it temporarily to reserve, came thenceforth under an obligation to retain it permanently as capital."

It appears then that the test is whether the company intended to retain the funds in question as part of the permanent capital or whether the intention was to put income in the form of money into the hands of the shareholders; that is, the diversion of company funds as such from the company to the shareholders creates income and is not a capitalization of surplus, no matter what

form the transaction takes. With all deference, I submit that the wording of the Income Tax Act has nothing whatever to do with the position between life tenant and remainderman in such cases and where, as the result of a transaction, funds are diverted from company account to shareholders' accounts in withdrawable form the principle of the cited English and American authorities applies and the funds so liberated or transferred to shareholders' accounts are income in the hands of the shareholders.

It still remains to consider the problem that arises when a stock dividend is declared either in the form of common shares or preferred shares and there is no accompanying reduction of capital or redemption of preferred shares. At a first glance one might assume that in such circumstances *Eisner* v. *Macomber* would be followed in Canada as it was in Great Britain in the *Blott* case.

The decision of the late Chief Justice Greenshields of the Quebec Superior Court in *Hosmer* v. *The Royal Trust Company* (June 10th, 1933, unreported) indicates otherwise. Here supplementary letters patent of the company, Consolidated Mining and Smelting Company of Canada Limited, contained a provision substantially to the same effect as section 83(3) of the Companies Act of Canada. In 1931 a dividend was declared amounting to 5% in cash on the paid-up stock; at the same time a dividend of fully paid-up shares of the capital stock of the company of a par value of $24.00 a share was declared at the rate of one fully paid-up share for every twenty fully paid-up shares of the capital stock then outstanding. It was held that the stock dividend followed the cash dividend and was income in the hands of the executors of the late Charles R. Hosmer. The basis of the decision appears to be summed up in these few words from the judgment, "These shares were fruits produced by the capital shares owned by the testator on his death". There is clear authority in the United States that a dividend giving the stockholder an interest different from what his former stock-holdings represented constitutes income (see *Koshland* v. *Helvering* (1936), 298 U.S. 441). It would seem that, if any company having statutory or charter powers like those expressed in section 83(3) of the Companies Act purports to declare a dividend payable in stock, the resulting distribution remains a dividend under the statute or letters patent and is properly classified as income in the hands of an estate, even though the stock so distributed has not been redeemed or reduced. In short, the statute or letters patent would support the position taken by Chief Justice Greenshields in the *Hosmer* case.

M. GERALD TEED*

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To THE EDITOR:

I read with some disagreement the case comment by Mr. Stuart Thom in the January issue of the Canadian Bar Review and the letter to you written by Mr. Heward Stikeman in the last issue of the Review. Both these learned writers criticize the Ontario judges as having erroneously decided that there was no conversion of income to capital where a company issues a preferred share dividend and then redeems the dividend shares in the circumstances outlined in those cases. I am prompted to observe that I remain in complete agreement both with the approach of the Ontario courts and with the conclusion that they reached.

Prior to the present income tax legislation the courts have been prepared to assume that when a corporation declared a stock dividend there was an evident intention on the part of the corporation (in so far as a corporation can be said to have an intention) to "capitalize" its undistributed profits. A long line of English and Canadian cases establishes that this fact may be taken to justify giving the resulting dividend to persons entitled to capital under any settlement. The Ontario *Fleck* and *Mills* decisions have greatly confused the application of that rule. The present confusion is attributable to the Parliament of Canada, which has provided company shareholders with a circuitous method of extracting corporation profits on payment by the corporation of an added flat rate of tax. In pursuing this method of tax avoidance the process of issuing stock dividends becomes a mere matter of form, to be followed by redemption, and that is exactly what the Ontario courts have said about it.

Mr. Thom and Mr. Stikeman would take issue with this suggestion that the legislation in question was intended to permit shareholders to obtain corporation profits on favourable tax terms and would maintain that it was, quoting the Minister of Finance, to enable family corporations (legislation has since been extended to *all* corporations) to *retain* profits essential for growth and expansion without imposing on shareholders an almost impossible potential tax burden. With due respect, I am wondering if Mr. Thom and Mr. Stikeman are fully prepared to view the Minister's comment in all seriousness.

I should like to draw attention to some of the implications of accepting the Minister's statement as representing the true view of the legislation. The English case law, contrary perhaps to popular belief, provides no authority for the proposition that where a preferred share dividend is declared on common stock the corporation income has been "capitalized" in the sense that the resulting share dividend is capital to the shareholder and not income for income tax purposes. Certainly *Inland Revenue Commission* v. *Blott*,

[1921] 2 A.C. 171, is no authority for that proposition. The American case law is, in fact, quite to the contrary. The main provision upon which shareholders can rely in such circumstances is section 127 (1) (j) of the Income Tax Act, which says that "dividends", which by section 6(a) are to be included in computing income for a taxation year, do not include stock dividends. But if the courts could be induced to accept the view of this amending legislation supported by Mr. Thom and Mr. Stikeman, the way is clear to taxing redemption of preferred share dividends in the hands of ordinary shareholders. Section 127 (1) (j) may merely permit *bona fide* capitalization by precluding the argument that a stock dividend is taxable as income received in money's worth at the time of its declaration and issuance. But when the private corporation does not need the profits thus credited to capital account and redeems the shares, the receipt by the shareholder of money raises the question whether there has been a resulting capitalization for purposes of income taxes. On this question, I submit that the common law is not nearly so satisfactory. This problem, as I have outlined it, is highly theoretical. No assessment is likely ever to be made on the ordinary shareholder in receipt of money from redemption of preferred shares obtained as a dividend. But this is true only because the Minister of Finance and the Minister of National Revenue intend what Mr. Thom and Mr. Stikeman are prepared to say was not intended.

It is unfortunate that the law governing trust administration has been placed in the unsatisfactory state in which it is almost impossible to determine whether a share dividend ought to go to the tenant for life or to the remainderman. However, the remedy lies where the confusion started—with the Parliament of Canada. There should be legislation permitting what the present legislation permits in a manner that is open and beyond dispute. If corporations, on paying the present flat rate of tax on their undistributed income, were permitted to pay the remainder to shareholders in money without further payment of taxes there would be nothing to prevent private corporations from obtaining funds "essential for growth and expansion" through reinvestment by shareholders of these money payments. There would not then be the present need for "sham-capitalization". The Minister of Finance, no doubt for political reasons, did not emphasize the tax advantage of capitalization under the amending legislation. The courts have taken judicial notice of that fact. In doing so they did rightly.

F. E. LaBrie*

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TO THE EDITOR:

I have read with great interest the comment of Mr. Stuart Thom, dealing with the cases of *Re Fleck* and *Re Mills*, and with equal interest the letter of Mr. H. Heward Stikeman, Q.C.

Mr. Stikeman suggests that it is clear from a reading of the budget speech for the year in which section 95A was introduced that the Minister was not providing a method by which companies could distribute earnings without tax by means of a "sham-capitalization formula", but instead was permitting companies to capitalize for their own purposes some portions of earned surplus. Later he rather apologizes for going to the budget speech to interpret the legislation, and suggests that the statute clearly shows the intent of the legislators in any event! Both Mr. Thom and Mr. Stikeman suggest that the courts in the *Fleck* and *Mills* cases have not given sufficient attention to the implications of their decisions.

One hesitates to disagree with two such eminent tax authorities, but I take some comfort from Mr. Thom's statement, in dealing with the *Fleck* case, that: "On the other hand, it is difficult to be critical of a finding of fact drawn from circumstances that were arranged to bring about just such a finding".

May the matter not be summed up in this way? (1) Parliament passed legislation to enable companies to pay a tax of 15% on undistributed income on hand and to capitalize the balance (after deducting the tax), called "tax-paid undistributed income", and this could be done without subjecting the shareholders of the company to tax. The legislation also enabled the payment of a stock dividend to the shareholders without tax.

(2) Regardless of what may be said about it now, there never was any doubt in anyone's mind that here was legislation providing a method by which a company could pay a 15% tax and then get the balance to the shareholders tax free, for example, by redeeming the stock so issued.

(3) Now a company might (a) decide to capitalize its undistributed profits upon payment of the tax, to keep this "tax-paid undistributed income" forever in its possession and really "devote it to capital purposes" or "blend it into the capital fabric of the company", or (b) decide to issue redeemable preference shares as a stock dividend and then cause the shares to be redeemed immediately—in other words, it decides to take advantage of the legislation and *not* "devote it to capital purposes", *not* to "blend it into the capital fabric".

(4) I suggest that in case (a) there is a true capitalization and in case (b) there is not. The cases seem to be clear that the intention of the company at the time of the so-called capitalization governs: Was the intent that the tax paid undistributed income

"pass from the company to the shareholder" or was it that "the entire sum remain in their [the company's] hands as paid up capital"?

What then was the intention of the companies in the *Fleck* and *Mills* cases? Surely it was to enable the payment of the tax-paid undistributed income to the shareholders. Surely there was no intention to "capitalize" in the true sense of the word. I suggest that in the circumstances the courts in these two cases made the only findings they could properly make on the particular facts of the cases.

On different sets of facts different conclusions might be reached. But in both the *Fleck* and *Mills* cases the substance of the transaction was *in fact* not a conversion into capital but the distribution by the companies involved of tax paid undistributed income. The capitalization was a capitalization in *form* only—a mere temporary capitalization—to take advantage of advantageous legislation, the only way it could be done. See Mr. Stikeman as editor of the Canada Tax Service, especially at page 95-511: "*It is important to be fully aware of the methods which must be employed in order that tax-paid undistributed income may reach shareholders tax free.* That there might be anything improper or evasive in such action is disposed of in the statements of the Minister of Finance, dealing with the mechanics which may be followed . . ." (italics added).

With respect to the two learned writers, there is not a tax lawyer in Canada who did not help a client take advantage of this legislation (a) to pay the tax, (b) to "capitalize", (c) to issue preference shares, and (d) immediately to redeem the shares; and *thus* in short pay tax free *income* to shareholders after the company had paid a 15% tax. Call it what you will—"A rose by any other name . . .".

Rather than criticize the courts in the *Fleck* and *Mills* cases, let us congratulate them on sound decisions on the particular facts. All they have done is (1) find the *true* facts, (2) find the intention of the companies accurately, and (3) say in effect: "In these circumstances perhaps there was a 'capitalization' to comply with the Income Tax Act, but there was not a *true* capitalization. There was the payment of *income*, not *taxable* income but *income* nevertheless."

FRANK M. COVERT*

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Stare Decisis and Lateral Support

TO THE EDITOR:

I wish to express my wholehearted approval of Professor Kennedy's

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comment on the doctrine of *stare decisis* at page 87 of the January issue. It seems to me that by subjecting the rule to the qualifications he proposes, he has opened up a possible avenue of approach for a reconciliation of the fundamental opposition between the rigid mechanical process used in some common-law jurisdictions and the unpredictable result of the French theory that no precedent is ever binding, that every judge should decide according to his own view of what the law is.

It seems to me singularly appropriate that in the same issue of the Review another comment, by Mr. Henderson, should draw attention to the possible injustice of following antiquated precedents. The common-law rule that a landowner is entitled to lateral support for his land in its natural state, but not entitled to it when there is superimposed upon the land the weight of a building, does not appear to accord with modern conceptions of the proper use of land and of the extent of one's duty not to injure one's neighbour.

In my view, Mr. Keith Turner's defence of the fairness of that rule, at page 220 of the February issue, seems to be based on a misconception. He contends that the rule "was not designed to restrict [the landowner] unduly in the use of his land, but rather to effect a reasonable balancing of interests between himself and his neighbour", and clearly implies that it does accomplish that purpose. This is where I suggest he is in error. Unless one is building on bedrock or on piles or at a great distance away from any neighbour, one cannot avoid loading the soil so as to require the support of the neighbour's soil. The depth at which this support is needed depends on soil characteristics and distance, but is never less than the level of the footings. If a landowner excavates his land below the level of the foundations of neighbouring buildings, he is making an abnormally dangerous use of his land and should be responsible for whatever damage he may cause. Otherwise, he is being permitted for his own private benefit to inflict injury upon a neighbour who is not afforded any means of protecting himself. As is pointed out by Mr. Henderson in his reply, the protection given by a strict-liability rule is reciprocal and makes the situation fair for both parties.

Strict liability was the rule of the Roman law (*si tam alte fodiam ut paries tuus stare non possit.* L. 24 §12 ff., de Damn. infect.) and the French authors are unanimously of the view that it is also the rule of the civil law (Jurisclasseur civil, art. 544, no. 135). The decisions of the courts in the province of Quebec are all the other way (*Falardeau* v. *Windsor Hotel Company* (1918), 57 S.C. 385, *McCabe* v. *Lafontaine et al.* (1920), 59 S.C. 250, *Cantin* v. *Corcoran*, [1952] R.L. 116). In the first of these judgments the Court of Review reversed P. Demers J., relying on a decision of the Cour de

Cassation (S. 1853. 1. 564) declining to interfere with a finding of fact that the accident was due to an insecure foundation. In the last two the Superior Court relied on Baudry-Lacantinerie, Aubry et Rau, Demolombe and Laurent. None of these authors lends the least support to the judgments. On the contrary, Demolombe contends for the Roman law rule (Vol. 12, no. 662), Aubry et Rau favour strict liability (Vol. 2, pp. 195-196) and Laurent (Vol. 6, no. 142) says that everybody agrees that such is the law ("Ainsi le propriétaire qui fait des fouilles et qui occasionne par là la ruine des constructions du voisin, est tenu à réparation: tout le monde est d'accord sur ce point").

I venture to disagree with the philosophy back of Lord Goddard's remark, quoted by Mr. Turner, that the right to compensation for injury should be restricted to cases where it is due to the fault of somebody who owes a duty to the victim. In my view the modern tendency towards strict liability where the damages are traceable to an abnormal risk created for private benefit (Planiol et Ripert, Vol. 3, no. 471) is just and fair. Otherwise employers would not be responsible for industrial accidents occurring without negligence on their part, the owners of dams would not be responsible for the destruction their rupture might bring about, and so on. The great step forward that requires to be taken in the sphere of legal responsibility for damages is a further gradual substitution of liability based on risk for responsibility based on fault or negligence. Strict liability is essentially based on risk, and it is eminently fair whether the risk is created by making excavations, impounding waters or employing workers in hazardous occupations.

LOUIS-PHILIPPE PIGEON*

Books Received

The mention of a book in the following list does not preclude a detailed review in a later issue.

Annuaire de Jurisprudence du Québec 1952. Sous la direction de ROBERT LÉVÊQUE. Montreal: Wilson et Lafleur (limitée). 1953. Pp. 534. ($7.00)

Canada's Need for Divorce-Reform: A Presentation of the Case for the Divorce Reform League of British Columbia. By THE REV. C. BERNARD REYNOLDS, M.A., B.D. Copies may be obtained from the author at 3865 West 15th Avenue, Vancouver 8, B.C. 1953. Pp. ix, 386. ($1.75)

Cases on Criminal Law. By J. W. TURNER, M.C., M.A., LL.B., and A. LL. ARMITAGE, M.A., LL.B. Cambridge: At the University Press.

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Toronto: The Macmillan Company of Canada Limited. 1953. Pp. xx, 568. ($8.50)

Le Conseil d'Etat: Livre jubilaire publié pour commémorer son cent cinquantième anniversaire. Paris: Recueil Sirey. 1952. Pp. 693. (3,800 francs)

The Doctrine of the Separation of Powers and Its Present-Day Significance. By ARTHUR T. VANDERBILT. Second Lectures in the Roscoe Pound Lectureship Series. The University of Nebraska Press. 1953. Pp. 144. (No price given)

Le Droit Civil de la Province de Québec: Modèle vivant de Droit comparé. By LOUIS BAUDOUIN. Montreal: Wilson et Lafleur (limitée). Pp. xvi, 1366. ($28.00)

Essays on the Australian Constitution. Edited by R. ELSE-MITCHELL. Sydney, Melbourne and Brisbane: The Law Book Co. of Australasia Pty Ltd. 1952. Pp. xxiv, 319. (42s. net)

Financing Canadian Federation: The Federal-Provincial Tax Agreements. By A. MILTON MOORE and J. HARVEY PERRY. Canadian Tax Papers, No. 6. Toronto: Canadian Tax Foundation. 1953. Pp. iii, 117. ($1.00)

The Law Relating to Wills with Precedents of Particular Clauses and Complete Wills. By W. J. WILLIAMS, B.A. Two volumes. London: Butterworth & Co. (Publishers) Ltd. Toronto: Butterworth & Co. (Canada) Ltd. 1952. Volume I, Law of Wills, pp. xvi, 624; Volume II, Precedents, Tables and Index, pp. xxii, 625-1389. ($29.50 the two volumes)

Pathways in International Law: A Personal Narrative. By ARTHUR L. KUHN. New York: The Macmillan Company. Toronto: The Macmillan Company of Canada. 1953. Pp. xii, 240. ($3.00)

Private International Law. By G. C. CHESHIRE, D.C.L., F.B.A. Fourth edition. Oxford: At the Clarendon Press. Toronto: Oxford University Press. 1952. Pp. 1, 687. (No price given)

La satisfaction comme mode de réparation en droit international. By PIERRE ANDRÉ BISSONNETTE. Genève. 1952. Pp. vii, 185. (No price given)

Select Legal Essays. By SIR P. H. WINFIELD, Q.C., F.B.A., LL.D., HON. LL.D. With an editorial preface by S. J. BAILEY. London: Sweet & Maxwell Limited. Toronto: The Carswell Company, Limited. 1952. Pp. xv, 292. ($8.00)

University of Notre Dame Natural Law Institute Proceedings. Volume V. Edited by EDWARD F. BARRETT. With a foreword by REVEREND JOHN J. CAVANAUGH, C.S.C. Notre Dame, Indiana: University of Notre Dame Press. 1953. Pp. 180. ($2.00)

Williams on the Law of Executors and Administrators. Thirteenth edition by SIR DAVID HUGHES PARRY, M.A., LL.D., D.C.L., assisted by DONALD CHARLES POTTER, LL.B. London: Stevens & Sons Limited. Toronto: The Carswell Company Limited. 1953. Two volumes. Vol. I, pp. ccxxviii, 502; vol. II, pp. 503-1347. ($30.00)

Whom We Shall Welcome. Report of the President's Commission on Immigration and Naturalization. Washington: Superintendent of Documents, U.S. Government Printing Office. 1953. Pp. xvi, 317. (75 cents)