IN THE MATTER OF THE ESTATE OF STELLA MAUD WATERS;

1956
*Feb. 10, 13, 14
*Oct. 2

COLONEL DONALD MACKENZIE WATERS (in his personal capacity) .... APPELLANT;

AND

THE TORONTO GENERAL TRUSTS CORPORATION, COLONEL DONALD MACKENZIE WATERS and MARJORY T. O'FLYNN, Executors of the will of the deceased; MARJORY T. O'FLYNN (in her personal capacity); LIEUTENANT-COMMANDER DONALD MACKENZIE WATERS; JOHN GAVIN WATERS; ST. ANDREWS PRESBYTERIAN CHURCH, BELLEVILLE; AND THE OFFICIAL GUARDIAN .... RESPONDENTS.

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO

Companies—Distribution of accumulated profits in form of stock dividend —Subsequent redemption of shares so issued—Effect—Whether shares, and proceeds of redeemed shares, income or capital in hands of trustee-shareholder—The Income Tax Act, 1948 (Can.), c. 52, s. 95A, enacted by 1950, c. 40, s. 32—The Companies Act, R.S.O. 1950, c. 59, ss. 78, 96.

Trusts and trustees—Trust assets including shares in incorporated company —Issue of stock dividend by company as means of distributing accumulated profits—Redemption of shares—Whether shares, and proceeds of redeemed shares, income or capital in hands of trustees— The Income Tax Act, 1948 (Can.), c. 52, s. 95A, enacted by 1950, c. 40, s. 32.

A company incorporated under the Ontario *Companies Act* obtained supplementary letters patent authorizing the creation of 500,000 new preference shares, redeemable by the company on notice to the shareholders, and, on redemption, to be cancelled and not reissued. These supplementary letters were obtained pursuant to a decision by the company to avail itself of s. 95A of the *Income Tax Act,* 1948, as enacted in 1950, as a means of making available to the shareholders a large undistributed surplus. After payment of the tax provided for in that section the company, pursuant to by-laws, issued 240,000 preference shares "as fully paid and non-assessable", and in the following two years about one-third of these shares were redeemed, at various times. A block of shares in the company was held by the trustees of an estate, and 64,000 of the new shares were issued to the trustees as a stock dividend; of these about 18,000 were subsequently redeemed.

Held: The trustees received the shares so issued, and the proceeds of those that were redeemed, as capital of the estate, for the benefit of the remaindermen, and not as income for the benefit of the life tenants.

*PRESENT: Kerwin C.J. and Rand, Kellock, Locke and Cartwright JJ.

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Once shares were issued as paid-up, the portion of the undistributed profits appropriated for the purpose of paying them up immediately became capitalized, and the shares were themselves an addition to the capital stock of the company.

APPEAL from the judgment of the Court of Appeal for Ontario (1), affirming the judgment of McLennan J. (2) on a motion for the opinion, advice and direction of the Court. Appeal dismissed.

R. N. Starr, Q.C., and *G. R. Colville,* for the appellant.

R. H. Sankey, Q.C., for Lt.-Cmdr. D. M. Waters, respondent.

G. F. Henderson, Q.C., for Marjory T. O'Flynn and St. Andrews Presbyterian Church, Belleville, respondents.

W. M. Montgomery, Q.C., for the executors and trustees, respondents.

F. T. Watson, Q.C., for the Official Guardian, representing infants and unborn and unascertained persons, respondent.

The judgment of Kerwin C.J. and Kellock, Locke and Cartwright JJ. was delivered by

KELLOCK J.:—The company, the proceeds of the redemption of whose preferred shares are in question in these proceedings, was incorporated as a private company under the Ontario *Companies Act* by letters patent dated May 2, 1893, with an authorized capital of 30,000 shares without nominal or par value, all of which were issued as fully paid. By supplementary letters patent, dated December 12, 1950, the authorized capital of the company was increased by the creation of 500,000 preference shares having a par value of $1 each, redeemable by the company on ten days' notice to the holders, such shares on redemption to be cancelled and not reissued.

On October 19, 1950, it was reported to the annual meeting of shareholders that the directors considered that the company should elect, under s. 95A of the *Income Tax Act,* 1948 (Can.), c. 52, enacted in 1950 by 11-12 Geo. VI, c. 40, s. 32, to pay a tax of 15 per cent. on its undistributed income as at April 30, 1949. The directors advised that after payment of the tax, $240,000 of the remaining profits should

(1) [1955] O.R. 268, [1955] C.T.C. 130, 55 D.T.C. 1052, [1955] 2 D.L.R. 176.

(2) [1954] O.W.N. 649, [1955] C.T.C. 126, [1954] 4 D.L.R. 852.

"be placed in the hands of the Shareholders" by creating preference shares to the value of $500,000 and issuing $240,000 of such shares by way of a stock dividend. It was also stated that the company "could" then redeem the preference shares "from time to time" and that the amount of the "redemption price" would not be taxable in the hands of the shareholders. The meeting duly resolved to follow this procedure.

On the following November 28, a by-law was passed authorizing the application for supplementary letters patent for the above increase in the authorized capital. These letters, as already mentioned, were obtained after the by-law had been confirmed by the shareholders. On November 28, 1950 also, another by-law was passed by the directors authorizing the issue of fully-paid shares for the amount of any dividends which might be declared.

The tax under s. 95A was paid on January 25, 1951, and on February 9 following, a stock dividend of $240,000 was declared payable by the allotment "as fully paid and non-assessable" of $240,000 redeemable preference shares.

Of these shares the respondent trustees received 64,000, of which, as at the date of the launching of these proceedings, May 14, 1953, 17,920 had been redeemed at various dates commencing March 1, 1951. The question involved is whether the remaining shares or the proceeds of those redeemed are to be regarded as capital or income in the hands of the trustees, who hold the corpus of the estate of the late Stella Maud Waters for the benefit of certain life tenants and remaindermen.

It was, of course, open to the company to have distributed the fund of $240,000 by way of dividend in cash, in which event it is perfectly clear on the authorities, to which I shall refer, that the trustees would have received the moneys as income to which the life tenants would have been entitled. Such a course, however, would have resulted in liability to income tax on the part of the trustees, as payment of the tax under s. 95A did not render free from taxation in the hands of the shareholders any cash dividends although paid out of the undistributed profits in respect of which the tax was paid. "Dividends" are rendered expressly liable to taxation by s. 6(1)(*a*)(i) of the statute.

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However, while it was provided by s. 73(3), as enacted by s. 28 of the amending statute of 1950, that where the whole or any part of a corporation's undistributed income on hand has been capitalized a dividend shall be deemed to have been received by each shareholder equal to the latter's portion of the undistributed income so capitalized, subs. (4) provided that in computing the taxpayer's income, his "portion of the payer corporation's tax-paid undistributed income as of the time the dividend is deemed to have been received" should be deducted from the amount of the dividend. Subsection (6) of s. 73 further provided that where a corporation has paid a stock dividend the corporation shall, for the purpose of subs. (3), "be deemed to have capitalized immediately before the payment undistributed income on hand equal to the lesser of (*a*) the undistributed income then on hand, or (*b*) the amount of the stock dividend". Accordingly, by using its tax-paid undistributed profits for the purposes of a stock dividend, thereby capitalizing them, the company could give to its shareholders the benefit of its payment of tax under s. 95A, and in this way only. But only by the payment of dividend in redeemable preference shares and the subsequent redemption thereof could the proceeds of redemption escape taxation in the hands of the shareholders, as subs. (2) of s. 73 specifically provided that, where a company having undistributed income on hand redeemed any of its *common* shares, the shareholders should be deemed to receive a dividend equal to the lesser of (*a*) the amount or value received, or (*b*) "his portion of the undistributed income then on hand".

It may be said that while, for the purposes of the *Income Tax Act,* a company's undistributed profits may be "capitalized", such need not be the result for all purposes. Such result must depend, for present purposes at least, upon company law, namely, in the case at bar, the relevant provisions of *The Companies Act,* R.S.O. 1950, s. 59. An examination of the relevant provisions of this statute, however, will show that the income tax legislation has the appropriate company law within its purview.

By s. 78 of the Ontario Act, by-laws "for creating and issuing any part of the capital as preference shares" may be enacted by the directors, who, by s. 80(1), may make provision "for the purchase or redemption" of such shares.

By subs. (2) no such by-law which has the effect of increasing or decreasing the capital of the company shall be valid unless confirmed by supplementary letters patent. Subsection (3) provides, however, that subs. (2) shall not apply to any by-law which creates or attempts to create redeemable or convertible preference shares. In the present case supplementary letters patent were issued.

Section 96 must also be taken into account. It provides that, for the amount of any dividend which the directors may lawfully declare payable in money, they may declare a stock dividend and issue therefor shares of the company "as fully paid or partly paid", or they may credit the amount of the dividend on shares already issued but not fully paid.

It would therefore appear clear upon the face of this statute that an issue of paid-up shares by way of stock dividend requires the contemporaneous appropriation of sufficient of the company's undistributed profits to provide for the payment up of the shares; in other words, for the capitalization of the requisite amount. It follows from this that the subsequent payment out to the shareholders of this paid-up capital in redemption of the shares would, so far as the company is concerned, also be a payment of capital no matter how soon or late after the employment of the profits in paying up the shares.

It is, however, contended on behalf of the appellant life tenant that there was no "permanent" addition to the company's capital of the fund here in question and that, the stated object of the issue of the preference shares having been "to place in the hands of the shareholders" the said fund, this is sufficient, regardless of the procedure actually adopted by the company, to enable the Court to declare that the proceeds of redemption constitute income and not capital. As this question has given rise to differences of opinion in recent Ontario decisions, it will be desirable to consider them. Before doing so, however, it is essential to consider the leading case on this branch of the law, namely, *Hill et al v. Permanent Trustee Company of New South Wales, Limited et al.* (1). In the course of delivering the opinion of the Judicial Committee in that case, Lord Russell of Killowen said, at p. 729:—

(1) [1930] A.C. 720.

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> . . . moneys paid in respect of shares in a limited company may be income or corpus of a settled share *according to the procedure adopted,* i.e., according as the moneys are paid by way of dividend before liquidation or are paid by way of surplus assets in a winding up.

(The italics are mine.)
His Lordship went on to say that

> Each process might appear to involve some injustice, the former to the remainderman, the latter to the tenant for life

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

Lord Russell, commencing at p. 730, laid down certain rules, in part as follows:—

> (1.) A limited company when it parts with moneys available for distribution among its shareholders is not concerned with the fate of those moneys in the hands of any shareholder. The company does not know and does not care whether a shareholder is a trustee of his shares or not. It is of no more concern to a company which is parting with moneys to a shareholder whether that shareholder (if he be a trustee) will hold them as trustee for A. absolutely or as trustee for A. for life only.
>
> (2.) A limited company not in liquidation can make no payment by way of return of capital to its shareholders *except as a step in an authorized reduction of capital. . . .*
>
> (4.) Other considerations arise when a limited company with power to increase its capital and possessing a fund of undivided profits, so deals with it that no part of it leaves the possession of the company, but the whole is applied in paying up new shares which are issued and allotted proportionately to the shareholders, who would have been entitled to receive the fund had it been, in fact, divided and paid away as dividend.

With respect to profits applied in accordance with rule 4, his Lordship said at p. 732:—

> In other words, moneys which had been capable of division by the company as profits among its shareholders have ceased *for all time* to be so divisible, and can never be paid to the shareholders except upon a reduction of capital or in a winding up. The fully paid shares representing them and received by the trustees are therefore received by them as corpus and not as income.

At p. 732, Lord Russell referred to the decision of the House of Lords in *Bouch and Bouch v. Sproule* (1), in the following words:—

In *Bouch v. Sproule* (1), no moneys, in fact, left the company's possession at all. It is not an authority which touches a case in which a company parts with moneys to its shareholders. The essence of the case was that the company, not by its statements, but *by its acts,* showed that what the shareholders got from the company was not a share of profits divided by the company, but an interest in moneys which had been converted from divisible profits into moneys capitalized and rendered *for ever* incapable of being divided as profits.

(The italics are mine throughout.)

In *Hill's Case* the company had made a distribution in cash.

In my opinion there is nothing in any part of the judgment delivered by Lord Russell which lends any countenance to the contention that undistributed profits of a company which have become capitalized by "conversion by the company of the profits into share capital" (p. 730) must remain permanently with the company in order to retain that character. He himself recognized that they might be paid out "upon a reduction of capital", and payment out may occur at any time after capitalization so long as what is done is in accord with the governing legislation.

Nor is there any support for any such contention in anything that was said or decided in *Bouch and Bouch v. Sproule* (1). As already pointed out, that case is to be treated as one in which in fact no money left the company at all. What their Lordships contradistinguished in that case was the situation where, in the language of Lord Herschell, at p. 397, the company has accumulated profits and used them, *in fact,* for capital purposes, and the quite different situation where (p. 403) it being

within the power of the company to capitalise these sums by issuing new shares against them to its members in proportion to their several interests,

a

permanent appropriation of the moneys to the capital purposes to which they had already been temporarily appropriated

has actually occurred by their being converted into share capital.

(1) (1887), 12 App. Cas. 385.

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The decision of the Court of Appeal in England in *In re Duff's Settlements, National Provincial Bank, Ltd. v. Gregson et al.* (1), is useful in this connection. In that case the trustee of certain settlements held shares in a company which, from time to time, had allotted shares at a premium, the aggregate amount of which premiums had been paid, in conformity with s. 56(1) of the *Companies Act, 1948,* c. 38, into a "share premium account". The section stipulated that the provisions of the Act relating to reduction of share capital of a company should apply to the share premium account as if it were paid-up share capital of the company. The company, having obtained the approval of the Court, paid to shareholders certain moneys out of this account and the question was whether such moneys in the hands of the trustee constituted capital or income of the trust funds. It was held to be capital. In the course of his judgment, at pp. 929-30, Jenkins L.J., who delivered the judgment of the court, referred to *Hill's Case* as well as certain other decisions and continued:—

> The cases to which we have referred show that the character, as a matter of company law, of any given distribution as it leaves a company determines its character in the hands of the recipient. The relevant company law in the present case seems to us to require that the distribution here in question should be treated from the point of view of the payer, that is, the company, as a distribution by way of return of capital. It follows, to our minds, that the trustees' proportion of the distribution should similarly be treated in their hands as paid-up capital returned by the company. . . . The provision in sub-s. 2 permitting the application of a share premium account in paying up bonus shares does not, in our view, assist the tenants for life. This merely enables a company to substitute actual capitalization for the notional capitalization produced by the section itself. The section, as we read it, produces the same result on a direct distribution of a share premium account *as if the company had first gone through the formality of actual capitalization by bonus shares and then paid off the bonus shares by way of reduction of capital* . . . If the terms of s. 56 are concerned, as Mr. Walton submitted, with the "mechanics" of the distribution of premiums received on the issue of shares, still the "mechanics" are, in our judgment, an essential factor in determining the character as between capital and income of the sum distributed. A company, having an artificial person, can (as it has been laid down) make a distribution amongst its members (otherwise than in a winding up) in one of two ways—*but only in one of two ways*: that is, by a distribution of divisible profit, that is, by way of dividend; and by way of a return of capital pursuant to an order of the court on a petition for reduction of capital in accordance with the Act. The question whether a given distribution lawfully made by a company is of the former or of the latter description may thus justly be determined by reference to the method or

(1) [1951] Ch. 923, [1951] 2 All E.R. 534.

mechanics of distribution, permitted or enjoined by the Act, which the company has adopted in regard to it; and the answer to that question must prima facie also determine the question whether the distribution is capital or income as between tenant for life and remainderman of a settled shareholding: see *per* Lord Russell in *Hill v. Permanent Trustee Company of New South Wales.*

(The italics are mine.)

In his use of the words "prima facie" in *Hill's Case* at p. 731, Lord Russell indicated that "some provision in the trust deed" would be required to change the result produced by the rule he had just enunciated.

Subject to the effect of s. 61 of the (Dominion) *Companies Act, 1934,* c. 33 (now R.S.C. 1952, c. 53), in cases where that statute is applicable, the principles enunciated by Jenkins L.J. in the language above set out apply in the case at bar and are in accord with the view which I have expressed as to the effect of the provisions of the Ontario *Companies Act* upon the procedure or "mechanics" adopted by the company here in question. This view is in accord with that reached by McRuer C.J.H.C. in *Re McIntyre* (1).

McLennan J., the judge of first instance in the case at bar, followed the decision in *McIntyre's Case* and held the moneys in question were part of the corpus of the estate (2). This judgment was affirmed on appeal (3). A similar view was expressed by Ferguson J. in *Re Hardy Trusts* (4), but he felt himself bound by *Re Fleck, infra,* and his judgment was affirmed on appeal (5).

The appellant relies upon the decisions in *Re Fleck* (6), and the later decision of Gale J. in *Re Mills* (7). *Fleck's Case,* which was binding on the Court of Appeal in the present case, was distinguished by that court.

(1) [1953] O.R. 910, [1954] 1 D.L.R. 192.

(2) [1954] O.W.N. 649, [1955] C.T.C. 126, [1954] 4 D.L.R. 852.

(3) [1955] O.R. 268, [1955] C.T.C. 130, 55 D.T.C. 1052, [1955] 2 D.L.R. 176.

(4) [1955] O.W.N. 273, [1955] C.T.C. 138, 55 D.T.C. 1062, [1955] 2 D.L.R. 296.

(5) [1955] O.W.N. 835, [1955] C.T.C. 220, 55 D.T.C. 1175, [1955] 5 D.L.R. 10.

(6) [1952] O.R. 113, [1952] C.T.C. 196, [1952] D.T.C. 1050, [1952] 2 D.L.R. 657, affirmed [1952] O.W.N. 260, [1952] C.T.C. 205, [1952] D.T.C. 1077, [1952] 2 D.L.R. at 664.

(7) [1953] O.R. 197, [1953] C.T.C. 115, [1953] 2 D.L.R. 80.

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In *Fleck's Case* the company in question had been incorporated under the *Companies Act,* Canada. Having paid income tax pursuant to s. 95A, the directors declared a stock dividend in redeemable preference shares and subsequently, on the same day, provided for their redemption. Hogg J.A., the judge of first instance, after considering *Hill's Case, supra,* and *Bouch and Bouch v. Sproule, supra,* deduced their principle as follows (p. 119):—

> The principle to be deduced from these judgments is that there must be, in fact, a conversion by the company of its profits or surplus into share capital in order that they shall be regarded as corpus and not income in the hands of a trustee, or as between a life tenant and a remainderman. Furthermore, that where a company has the power to deal with profits by converting them into capital of the company such exercise of its power is binding upon the person interested under a trust of the original shares set up by the testator's will.

Having so laid down the principle, the learned judge felt himself able, however, to come to the conclusion that the preferred shares there in question

> did not form part of the paid-up capital of the Company and therefore the surplus profits represented by them were not capitalized.

To my mind, with respect, if this is to be taken as a statement of fact, it is in conflict with the evidence, as the stock dividend to which the shares owed their issue was expressly declared to be "out of said tax paid undistributed income", which was thereby inescapably capitalized. In so far as the learned judge's statement is a conclusion of law, I find it impossible to reconcile it with his earlier statement of principle that

> where a company has the power to deal with profits by converting them into capital of the company such exercise of its power is binding upon the person interested under a trust of the original shares.

The company can, in the language of Lord Halsbury in *Commissioners of Inland Revenue v. Blott; The Same v. Greenwood* (1), "convert them into capital as against the whole world". In my opinion, the fact that, as Hogg J.A. says, "the steps taken by the Company were induced because of the provisions of the Income Tax Act" is irrelevant.

The learned judge referred to s. 61 of the Dominion *Companies Act* and then proceeded as follows, at p. 120:—

(1) [1921] 2 A.C. 171 at 182.

To use the language, in part, of Lord Herschell in *Bouch et al. v. Sproule, supra,* and applying it to contrary circumstances, it was obviously contemplated and was, I think, certain that no money would in fact remain in the hands of the Company as paid-up capital. The substance of the whole transaction and the intention of the Company as well as the form or manner in which it was carried out shows that the share of surplus profits represented by the $20,000 in question was not converted into capital by newly-created shares but was distributed as a dividend to the trustee shareholders. The real pith and substance of the arrangements were to distribute the surplus profits of the Company in the form of money, and they were not dealt with so that, to use the words of Lord Russell in the *Hill* case, *supra,* they could "never be paid to the shareholders except upon a reduction of capital or in a winding up". The issue of redeemable shares was in the nature of a conduit-pipe to convey or transfer the surplus profits accumulated by the Company to the pockets of the shareholders as cash.

In this view the learned judge held the moneys in the hands of the trustee to be income. As already mentioned, this decision was affirmed on appeal without extended reasons (1).

In my opinion, with respect, the reasoning in *Fleck's Case* is erroneous. Once shares are issued as paid-up shares, that portion of the undistributed profits in the hands of the company appropriated for the purpose of paying up the shares, immediately becomes capitalized. The provisions of the Ontario Act to which I have referred so provide and I am unable to read the relevant provisions of the Dominion Act in a contrary sense. That Act, by ss. 7 and 12, provides for the creation of redeemable preference shares by either letters patent or supplementary letters patent or, under s. 59, by by-law. Section 61, to which Hogg J.A. referred, provides that if redemption, instead of being effected by payment to the shareholders of the capital behind the shares, the paid-up capital of the company being thereby reduced, is effected out of undistributed profits, the paid-up capital is deemed not to have been reduced. The plain implication of this provision is that if the redemption is effected by repayment to the shareholders of the paid-up capital in respect of such shares, a reduction of paid-up capital does occur which can be validly effected only upon the sanction of the shareholders, confirmed by supplementary letters patent under s. 49(2). These provisions, there-

(1) [1952] O.W.N. 260, [1952] C.T.C. 205, [1952] D.T.C. 1077, [1952] 2 D.L.R. at 664.

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fore, perhaps even more plainly than s. 96 of the Ontario Act, completely reject any idea that payment to shareholders in accordance with such provisions is payment of anything other than capital.

In *Fleck's Case* the company had on hand a fund of over $515,000 after payment of tax under s. 95A, and had declared a stock dividend of 1,000 redeemable preferred shares of a par value of $100 which it immediately proceeded to redeem. The company had, therefore, sufficient funds left in its undistributed profit account after payment up of the par value of the issued shares, to effect their redemption. In view of s. 61, it must be considered that redemption took place out of profits, that being the only way it could validly have taken place without supplementary leters patent being obtained. Hogg J.A. would appear to have thought that the employment by the company of profits for the purpose of redemption rendered the proceeds income in the hands of the trustee. As this point does not arise in the case at bar, I express no final opinion upon it, although it is not obvious how a capital asset in the hands of trustees, namely, the shares, can become transformed into income merely because the company employs surplus profits to redeem them. It is further to be observed that s. 61 provides that

> the surplus resulting from such redemption or purchase for cancellation shall be designated as a capital surplus, which shall not be redeemed or distributed by the company except as provided in sections forty-nine to fifty-eight, both inclusive, of this Act.

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

In my opinion, therefore, as already stated, *Fleck's Case*, apart from the point above mentioned, as to which I express no final opinion, is out of harmony with the earlier authoritative decisions to which I have referred.

I would dismiss the appeal but, in the circumstances, I think the costs of all parties should be taxed and be paid out of the estate, those of the trustees as between solicitor and client.

RAND J.:—The question here is between a life tenant and a remainderman whose interests are in shares of the capital stock of a company incorporated under the Ontario *Companies Act*. The dispute arises through the fact that at the death of the testator the company had accumulated a large amount of earnings which thereafter were capitalized into redeemable preference stock over the beneficial ownership of which the issue is joined.

The nature of a life interest in property depends upon the kind of property. If land, it will be possession and use or income of rents; if money or money obligations, it will be income of interest; where the asset is common stock of a commercial company, the income consists of dividends. The large amount of accumulated earnings, in this case, was, at the death, reflected in the value of the stock; the testator might have made it clear that the shares, in the value based on the assets then existing, were to be treated as capital and the income thereafter to be related to subsequent earnings only; but he did not do that; what he did was to bequeath the "income".

The question, in such circumstances, of what is income has been before the Courts in a number of cases and the principles applicable have been considered in both the House of Lords and the Judicial Committee. From them the following considerations, among others, emerge. A joint stock company, having modern powers and, in the absence of special provisions, bound to the preservation in its capital asset structure of property representing its share capital, is in absolute control of the profits which its business produces. They may be distributed as dividends, kept in reserves, applied to restore lost capital assets or be capitalized by appropriating them as assets representing or fulfilling the payment of unpaid existing or newly issued share capital.

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Rand J.

In *Hill et al. v. Permanent Trustee Company of New South Wales, Limited et al.* (1), Lord Russell of Killowen summarizes some settled propositions dealing with payments of money to shareholders and speaks of the "capitalization" of accumulated profits as follows:—

> (4.) Other considerations arise when a limited company with power to increase its capital and possessing a fund of undivided profits, so deals with it that no part of it leaves the possession of the company, but the whole is applied in paying up new shares which are issued and allotted proportionately to the shareholders, who would have been entitled to receive the fund had it been, in fact, divided and paid away as dividend.

And at p. 735:—

> Their Lordships desire to adopt the language used by Eve J., and to say in regard to the funds out of which the sums of 19,380*l* and 8,360*l* were paid by the Buttabone Company to the trustee company: "Unless and until the fund was in fact capitalized it retained its characteristics of a distributable property . . . no change in the character of the fund was brought about by the company's expressed intention to distribute it as capital. It remained an uncapitalised surplus available for distribution, either as dividend or bonus on the shares, or as a special division of an ascertained profit . . . and in the hands of those who received it it retained the same characteristics."

Knowledge of that control over this type of property is to be attributed to the testator: it is with this actually or imputedly in mind that he confers the life interest: he knows or is held to know that the receipt of income or capital will depend on the acts of the company.

When accumulated earnings are capitalized, the precise theory according to which the transformation takes place is by no means clear. If a dividend has been declared which the shareholder has the option of receiving either in cash or in paid up new shares, the latter alternative is to be deemed to consist of two steps: the creation of a real credit in the amount of the dividend to the shareholder, a debt owing by the company to him; and the application of that debt by way of release as payment for the new stock. The right to receive the dividend and its constructive receipt constitute a payment of income to the shareholder which belongs to the life tenant to whom the substituted stock goes as to a purchaser. On this stock he will be liable to tax as for income: *Swan Brewery Company, Limited v. The King* (2).

(1) [1930] A.C. 721 at 731. (2) [1914] A.C. 231.

On the other hand, the capitalization of the accumulation directly without the option of a dividend presents difficulty in theoretical conception. In substance the interest of the shareholder represented by the original stock merely changes its form: from being X percentage of Y it becomes X plus A percentage of Y plus B. Nothing is withdrawn from the company and no immediate additional value passes to the shareholder. The company by declaration appropriates an asset available for dividends to the capital asset structure and creates for the shareholder a new capital stockholding, with the same fractional interest in a new total capital asset as before.

In *Bouch and Bouch v. Sproule* (1), the question was considered. Although the reasons, following the facts, are less than assured on the matter of an alternative right to elect for the dividend, they seem to me to hold that what was to be determined was the intention of the company as that was evidenced by its corporate acts interpreted in the total circumstances. At p. 399 Lord Herschell says:—

> I cannot, therefore, avoid the conclusion that the substance of the whole transaction was, and was intended to be, to convert the undivided profits into paid-up capital upon newly-created shares.
>
> * * *
>
> Upon the whole, then, I am of opinion that the company 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 of the capital stock in the concern.

At p. 401, Lord Watson:—

> But in a case like the present, where the company has power to determine whether profits reserved, and temporarily devoted to capital purposes, shall be distributed as dividend or permanently added to its capital, the interest of the life tenant depends, in my opinion, upon the decision of the company.

And at pp. 402-3:—

> In these circumstances it was undoubtedly within the power of the company, by raising new capital to the required amount, to set free the sums thus spent out of the reserve fund and undivided profits for distribution among the shareholders. It was equally within the power of the company to capitalize these sums by issuing new shares against them to its members in proportion to their several interests. I am of opinion that the latter alternative was, in substance, that which was followed by the company.

(1) (1887), 12 App. Cas. 385.

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And at p. 405:—

> If I am right in my conclusion the substantial bonus which was meant to be given to each shareholder was not a money payment but a proportional share of the increased capital of the company.

In the present case a new element is introduced by the provisions of[3] the *Income Tax Act,* 1948 (Can.), c. 52, as amended, enabling a company by paying a tax, in this case 15 per cent., on earnings accumulated up to 1949, to capitalize the remaining fund by the issue of a stock dividend free from income tax in the hands of the shareholders. The earnings, if distributed as dividend, would have been taxable. This power furnishes a means by which, through the issue, as authorized by the appropriate company law, of redeemable preference shares, an amount of money equal to that of the earnings converted will reach the shareholders by the redemption; the nature of that payment, capital or income, will depend on the proper interpretation of what the company has done.

The corporate action in this case was embodied in a resolution of the shareholders electing under s. 95A of the *Income Tax Act,* 1948 (Can.), c. 52, enacted by 1950, c. 40, s. 32, to pay the required tax of 15 per cent. on the undistributed income on hand as of April 30, 1949 and to issue the necessary redeemable preferred shares to take up the amount remaining. Following this the directors passed by-laws to implement the resolution. Preferred shares were issued in the amount of $240,000 at the rate of $1 a share which absorbed approximately the total of the remaining accumulation. They contained provisions for redemption; they also carried a right to non-cumulative dividends at the rate of 3 per cent. per annum but only when as and if they were declared in any year by the directors. The redemption was to take place on notice at any time or from time to time and in such amounts as the company might decide. Dividends at 3 per cent. per anum were paid annually from the time of issue in 1951 until the proceedings started in June 1953. The number of shares redeemed as of May 11, 1953 was 17,920 out of a total of 64,000 owned by the estate. The redemption was in the number of 1,280 shares every two months, the first having been made on March 1, 1951; and at that rate, the redemption would be completed in approximately $8\frac{1}{3}$ years. In these circumstances can it be found that the preferred shares were income and enured to the benefit of the life tenant?

I take the principle laid down to be that unless the earnings as such actually or constructively pass from the company to the shareholder there is, for all purposes, capitalization. But the argument is that the machinery of capitalization and redemption can be used to effect a transfer of the earnings as such to the shareholders.

Here, the retention of the preferred shares as part of the capital stock is sufficient of itself to negative the conclusion that the shares belong to the life interest as dividends: but I have reached the same conclusion on a broader ground.

When earnings are "capitalized", they cease at that moment to be "earnings"; they become part of the capital assets; and if the transaction has not the elements of dividend and purchase, the shares, *prima facie,* are not income. Mr. Henderson urged very plausibly that the company's intention was to release those earnings and pass them to the shareholders as such in a single act consisting of several parts. The fallacy lies in overlooking what has taken place. The company undoubtedly intends by its total act to pass money to the shareholder: but if what the company does converts the earnings into capital, the "intention" of the company must take account of that fact: it "intends" that fact; and to carry the intention to a conclusion it intends to distribute capital assets by means of an authorized reduction in capital stock. Here form is substance; and the moment form has changed the character of the earnings as assets, the intention follows that change.

In the absence of a statutory provision, a stock dividend, so-called, would not appear to be "income": and the exemption from taxation provided for the shares here simply suspends the provision of the *Income Tax Act* imposing tax. From the standpoint of tax, it is indifferent to the company and the shareholder whether the ultimate receipt of money is capital or income: in neither case is it taxable. But its form is fixed and determined: and in the absence of special directions in the will, we are not at liberty to disregard what the testator is to be deemed to have foreseen as the possible action of the company.

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Rand J.

I would, therefore, dismiss the appeal with costs of all parties to be paid out of the estate, those of the trustees as between solicitor and client.

Appeal dismissed.

Solicitors for the appellant: Sinclair, Goodenough, Higginbottom & McDonnell, Toronto.

Solicitors for the executors and John Gavin Waters, respondents: Malone, Malone & Montgomery, Toronto.

Solicitors for Marjory T. O'Flynn (in her personal capacity), respondent: Cameron & Sprague, Belleville.

Solicitors for Lt.-Cmdr. D. M. Waters, respondent: Borden, Elliot, Kelley, Palmer & Sankey, Toronto.

Solicitor for St. Andrews Presbyterian Church, Belleville: S. Gordon Robertson, Belleville.

The Official Guardian, Toronto, representing infants.

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*PRESENT: Kerwin C.J. and Rand, Locke, Cartwright and Nolan JJ.