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# Income Taxation: M.N.R. v. Sedgwick [1964] S.C.R. 177

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## INCOME TAXATION

*M.N.R. v. Sedgwick*, [1964] S.C.R. 177.

JAMES BLAKE\*

## INCOME TAX — INCOME OR CAPITAL GAIN — SALE OF PARTNERSHIP SHARE OR DISSOLUTION

In this case the Supreme Court of Canada decided that the profits of a partnership which are distributed on dissolution of the partnership are income in the hands of the recipients and therefore taxable. There is nothing revolutionary about this decision. Both the majority and dissenting opinions, and the judgment of the Exchequer Court here appealed from proceed on the same view of the law which may be stated as follows:

On dissolution of a partnership, after payment of creditors the profits are handed over to the erstwhile partners and constitute taxable income in their hands. But upon the mere sale of a share in a partnership, the selling partner is giving up a capital asset consisting in part of his right to share in the profits (as opposed to his share of them) and the money he receives is a capital receipt exempt from taxation.

The problem raised by this case is the meaning to be attached to the categories "mere sale of a share" and "dissolution". Is there really any difference between a dissolution and the sale of a share, or between a share of the profits and the right to share in the profits? The majority judgment does not answer this question and affords little assistance to the lawyer who wants to predict how the Courts will classify future fact situations.

The facts of the case were these: Five individuals including the Respondent entered into an agreement with P under which they agreed to lend P money to be used as working capital for his brokerage business and to obtain a seat on the Toronto Stock Exchange. No interest was payable on the loan but the lenders were to take a share of the profits. The lenders reserved considerable control over the operation. A clause in the agreement expressly stipulated that the relationship between the parties was to be that of debtor and creditors and was not to be construed as a partnership.

After having obtained a seat on the Exchange the parties were obliged to terminate their arrangement due to a Stock Exchange rule forbidding the participation in profits by persons not actively participating in the brokerage business. Consequently a new agreement was entered into by the parties under which the borrower, P, bought out the interests of the lenders. This agreement provided for the payment of \$550,000 to the lenders which was made up of five separate items. The largest was a \$300,000 item designated as the lenders' share in the profits. The Respondent's share in this sum was \$30,000 and the issue was whether he was taxable in respect of it.

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In the Exchequer Court it was decided that the arrangement between the parties constituted a partnership and this point was not disputed in the Supreme Court. Section 6(c) of the Income Tax Act taxes the taxpayer's income from a partnership whether or not he has withdrawn it. The problem therefore was whether the \$30,000 receipt was income from a partnership, which in turn depended upon whether the transaction was a sale of a share or a dissolution of the partnership.

The dissenting judgment of Spence J. parallels the reasoning in the Exchequer Court. First he concludes that what transpired was not a dissolution:

I am of the opinion that a dissolution of a partnership necessarily implies a division of the assets of a partnership after payment of the creditors, amongst the partners in proportion of their respective shares in the partnership. In the present case there was no attempt at realization of the partnership assets either by money or in specie between the former partners . . .<sup>1</sup>

After studying three English cases<sup>2</sup> in detail he decides that:

The recital of the sum of \$300,000 as being the fixed share of the creditors in the net profits of the business for the fiscal year ending March 31, 1956 is merely a recital of how one of the items used to determine the sale price was arrived at . . . such a device . . . cannot change the fact that the actual price calculated and paid was a capital receipt and not a receipt of income.<sup>3</sup>

Thus he held that no tax was payable in respect of it.

The majority of the Court disagreed, in a judgment delivered by Martland J.. The close reasoning and the careful reference to authority displayed in both the dissent and the Exchequer Court judgment are disregarded, and Martland J. simply states:

I cannot construe the agreement as one for the sale of the interest in a partnership. It is rather an agreement for the winding up of the partnership, which had been necessitated by the decision of the Board of Governors of the Toronto Stock Exchange. As a result of that decision, the lenders were thereafter precluded from sharing in the profits of the business. That right they gave up in the agreement because they had been compelled to do so.<sup>4</sup>

The Court did not comment on the remarks of Lord Wrenbury made in the *Glenboig* case referred to in the dissent:

Is a sum profit which is paid to an owner of property on the terms that he shall not use his property so as to make a profit? The answer must be in the negative. The whole point is that he is not to make a profit and is paid for abstaining from seeking to make a profit.<sup>5</sup>

In the result the \$300,000 item was characterized as a share in the profits, the character of which was not altered by being added to the other items on the list.

<sup>1</sup> [1964] S.C.R. 177 at 187.

<sup>2</sup> *Glenboig Union Fireclay Co. v. C.I.R.* [1922] S.C. (H.L.) 112; *Rutherford v. C.I.R.* (1926) 10 Tax Cas. 683; *Van Den Bergh Ltd. v. Clark* [1935] A.C. 431.

<sup>3</sup> *Supra*, footnote 1.

<sup>4</sup> *Id.* at 182.

<sup>5</sup> [1922] S.C. (H.L.) 162 at 164.

No cases are referred to by the majority in support of its conclusions. *Johnston v. M.N.R.* is cited as authority for the proposition that unless the taxpayer can prove that his income is less than the amount for which he is assessed he must pay tax on the whole of it. This begs the question as to what is meant by income and as to whether any of the \$30,000 here in issue is income or not.

It is impossible to say that the case was wrongly decided in view of the finding that there was a dissolution. But similarly it is impossible to say that the dissent is wrong. The paradox arises from the absence of any real distinction between the categories into which the facts are being fitted.

The sale of a share in a partnership is necessarily a dissolution, at least to the extent that the agency relationship and the profit sharing arrangement subsisting before such sale is terminated by the sale. Yet the word 'dissolution' has been used in at least two other senses. Spence J. in his dissent states that a dissolution of a partnership "necessarily implies a division of the assets of the partnership after payment of the creditors among the partners in proportion to their respective shares". This would suggest that the partnership business completely comes to an end on a dissolution. But as far back as 1832<sup>6</sup> it was held that where one partner sells his share to another who continues the partnership business as a sole proprietorship, a dissolution of the partnership has taken place. Thus there is only one situation where it makes any sense to distinguish between a dissolution and a sale of a share, and that is where there is no sale at all but the partners simply close down their operations. In all other situations the transaction must be both dissolution and sale. Some of the cases<sup>7</sup> recognize this and talk in terms of 'the dissolution agreement under which a retiring partner sells his share'. Without a more refined definition of terms the suggestion that there is a distinction to be made is unrealistic. While Spence J. spells out the sense in which he uses the term "dissolution" so as to distinguish it from the "mere sale of a share", the majority wastes no words on either category which might conceivably help the taxpayer or his lawyer to differentiate between them. Martland J. appears to make an unexplained choice between two labels for the same transaction.

Having chosen between the categories "dissolution" and "sale of a share in the partnership" the choice between profits and the right to share in the profits follows. The Courts only use the concept of "the right to share in profits" when they have found the sale of a share in a partnership. The distinction between these two categories must be purely consequential since the sale price of the right to share in the profits is measured with reference to the actual amount of profits. Nevertheless, the consequential difference is of the utmost significance.

<sup>6</sup> *Heath v. Sansom* (1832) 4 B. & Ad. 172.

<sup>7</sup> e.g. *Rutherford v. C.I.R.*, *supra*, footnote 2.

Spence J. quotes Lord Macmillan in the *Van den Bergh* case:

But even if payment is measured by annual receipts it is not necessarily itself an item of income. As Lord Buckmaster pointed out in the case of *Glenboig Union Fireclay Co. v. Commissioners of Inland Revenue*, 1922 S.C. (H.L.) 112, 115. 'There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of that test.'<sup>8</sup>

The majority may have had sound reasons for deciding that the \$300,000 was profit but the argument to the contrary is not answered. It is ignored.

The key point of difference between the majority and dissenting judgments lies in the characterization of the transaction as a dissolution or the sale of a share in a partnership. All the remaining differences flow from that. The sole criticism to be levelled at the majority is the *ipse dixit* form of its opinion. No law is cited having a bearing on the vital matter of characterization, and no comment of any kind is made on the Respondent's contentions or the authorities cited in support of them. These authorities are neither criticized nor distinguished. No notice is taken of them at all. The effect of the decision is that for reasons best known to the majority judges the line of reasoning supporting the view of the transaction as the sale of a share in a partnership is not applicable to the situation where the 'sale' is not entirely voluntary and one of the partners continues to carry on the partnership business.