CASES

DETERMINED BY THE

EXCHEQUER COURT OF CANADA

AT FIRST INSTANCE

AND

IN THE EXERCISE OF ITS APPELLATE JURISDICTION

BRITISH COLUMBIA ELECTRIC RAILWAY COMPANY LIMITED } APPELLANT;

1956 Apr. 17, 18

1957 Jan. 15

AND

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

Revenue—Income tax—Income Tax Act 1948, S. of C. 1948, c. 52, s. 12(1)(a) and (b)—Capital or income—"An outlay or expense . . . made or incurred . . . for the purpose of gaining or producing income . . ."—"An outlay, loss or replacement of capital . . ."—Appeal dismissed.

Appellant carried on business as a public utility for transportation of freight and passengers through certain municipalities situate in the Lower Fraser Valley of British Columbia. It also controlled a subsidiary company, B.C. Motor Transportation Ltd., operating as a motor carrier of passengers. Appellant's passenger service had been carried on for a number of years at a heavy annual loss. In 1950, permission was granted to appellant Company by the Public Utilities Commission to discontinue its passenger car service and B.C. Motor Transportation Limited was at the same time authorized to substitute its motor bus facilities against B.C. Electric Railway Co. paying a lump sum of $220,000 to the five municipalities concerned, this money being a contribution towards the improvement of their local roads.

B.C. Electric Railway wrote off this $220,000 contribution to operations over a 10-year period, deducting for the taxation years 1950 and 1951 from its gross income proportionate amounts of such amortization. These deductions were disallowed by the Minister of National Revenue and an appeal from that decision was taken to this Court.

Held: That the outlay made by the appellant Company was primarily expended for the purpose of putting an end to a continuing loss and not for the direct purpose of gaining or producing income within the meaning of the Income Tax Act.

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2. That the outlay made by appellant is a payment on account of capital within the meaning of *The Income Tax Act*, and, therefore, the appeal must be dismissed.

APPEAL under the Income Tax Act.

The appeal was heard before the Honourable Mr. Justice Dumoulin at Vancouver.

John L. Farris, Q.C. and *W. H. Q. Cameron* for appellant.

K. E. Eaton for respondent.

DUMOULIN J.:—This appeal was heard at Vancouver, B.C., on the 17th and 18th of April, 1956.

The appellant objects, in respect of taxation years 1950 and 1951, to the disallowance of two items in the sums of $5,499.99 and $22,000, as deductions from gross revenue in computing its taxable income.

On April 13 last, the parties signed and filed an Agreed Statement of Facts, which simplified many of the points at issue and lent added conciseness to the respective and conflicting arguments of the litigants.

The pertinent facts may be set out as follows:

British Columbia Electric Railway Company Limited carries on business as a public utility for transportation of passengers and freight and has been in existence since 1897. It also controls a wholly-owned subsidiary called B.C. Motor Transportation Limited, operating in British Columbia as a motor carrier of passengers.

In 1907, another company, Vancouver Power, had concluded agreements with five British Columbia municipalities, all situate in the Lower Fraser Valley, viz.—Surrey, Langley, Matsqui, Sumas and Chilliwack, under which this Company "agreed to construct and operate a line of railway for the transportation of passengers and freight between the cities of New Westminster and Chilliwack . . ." (Agreed Statement of Facts, para. 4).

Vancouver Power extended the stipulated carrier accommodation to the public from 1910 to 1924, when it transferred its railway service to appellant who assumed the rights and obligations relating thereto.

Apparently this deal failed to fulfil appellant's expectations since it is admitted that "over a period of years prior

to 1950, the passenger revenue per annum, the number of passengers carried per annum and the revenue per passenger on the railway had declined substantially." (Statement of Facts, para. 7).

In 1950, "... it was estimated by the appellant that if bus service were substituted for rail service for the carriage of passengers in the Fraser Valley, an annual improvement in income of $65,702 could be achieved as follows:

Annual saving on railway passenger service		$ 167,440
Less railway passenger revenue	$ 82,495	
Less deficit from bus operations	19,243	
		101,738
Net annual improvement ..		$ 65,702"

The deficit in the cost of passenger service—"including a net fair return" of unrevealed percentage, was set at $309,094, whereas freight service netted a profit of $779,183, in 1949.

The Agreed Statement of Facts then points out (para. 12) that maintaining passenger service would entail immediately or almost "one of two classes of capital expenditures of major proportion." "If the line were to remain electrified, then (a) because the electric transmission voltage throughout the lower Fraser Valley was being changed over in the fall of 1950 from 34,000 to 60,000 volts; and (*b*) because of obsolescence in the electric substations built to serve the railway when it was originally constructed, capital expenditures of about $490,000 would have to be made on electric installations, and in addition some $200,000 would have to be spent on the replacement of passenger tram cars which had also been in operation since about the time the railway was constructed. The total would be approximately $690,000." The substitution of diesel equipment, if resorted to, would cost between $400,000 and $600,000. As a finishing touch to this more than sombre picture, no practical rate structure could be made to stabilize the operating costs of passenger service on the railway.

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Rail passenger service could not be abandoned without the authorization of the Public Utilities Commission of British Columbia, (called the P.U.C. for short). See the Public Utilities Act of British Columbia, R.S.B.R. 1948, chapter 277, particularly sections 7 and 20.

In 1949, the appellant sought to obtain permission from the P.U.C. to discontinue its passenger line "and at the same time caused its subordinate company, B.C. Motor, which already operated bus service on other routes in the Fraser Valley, to make a concurrent application for the right to operate in the five municipalities above referred to." This demand, of course, was contingent upon leave being granted to discontinue the unprofitable rail passenger service.

Both applications were heard jointly in March 1950 by the P.U.C., but met with strong opposition on the part of the five municipalities concerned, who argued that their roads were too narrow to allow a satisfactory bus service, and, in winter, liable to periodical closings.

These objections were eventually dispelled by means of negotiations; British Columbia Electric Railway undertaking to pay to the Districts of Surrey and Langley $50,000 each and again $40,000, respectively to the Matsqui, Sumas and Chilliwack Districts, making a sum total of $220,000.

These contributions towards the improvement of local roads were effected in 1950, with the consequent results that, on September 20 of that year, the P.U.C. issued an order, sanctioned by Order-in-Council (Ex. E), enabling appellant to discontinue its passenger railway service in the above named municipalities, substituting therefor B.C. Motor's bus transportation system. British Columbia Electric also agreed to resume *temporarily* passenger service on its line if autobus transportation were "cancelled for more than a short while" (Exhibit D).

It was then decided by the appellant company to write off to operations, over a ten year period approximately, the payments totalling $220,000. For the taxation year 1950, an amount of $5,499.99 was deducted accordingly, and a further sum of $22,000 was written off in 1951, but, as seen, were disallowed by the Minister of National Revenue.

The oral evidence consisted entirely in Mr. George Grainger Richardson's testimony, on appellant's behalf. This witness, a chartered accountant since 1927, belonging to the firm of Clarkson, Gordon & Company, periodically audits the appellant's books.

Mr. Richardson briefly outlined his professional belief that the $220,000 disbursed by the Company for the above mentioned purposes "should be deducted from profit over a certain period of years, and charged against income because made with a view of producing income", noting, however, that "he could point to no established precedent in text books for a specific payment comparable to the present one." It is Mr. Richardson's opinion that a correct application of accountancy principles would lead him to charge to income a payment made to get rid of an "onerous franchise" while any payment for a "new franchise" should be chargeable to capital. His final statement was that any payment producing an asset "which could not be capitalized properly, although made with a view of increasing income by reducing expenditure, should be imputed against income".

I am confronted with the oft-recurring complication of having to draw a dividing line between a capital outlay, therefore non-deductible from gross income, and an operational expenditure exempted from taxation if incurred for the purpose of gaining or producing income.

Both parties rely upon practically identical statutory provisions: the appellant on sections 4, 12(1)(*a*) and 12(1)(*b*) of the Income Tax Act, Statutes of Canada, 1948, Chapter 52; the respondent on the latter provisions of the Act plus sections 2 and 3.

The paramount clauses, needless to say, are subsections (1)(*a*) and (*b*) of section 12 which although of current knowledge may suffer repetition.

12 (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense *except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer.*

(*b*) *an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.*

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Let us now examine the conflicting claims raised.

On May 5, 1955, the respondent confirmed his previous re-assessment "as having been made in accordance with the provisions of the Act and in particular on the ground that the amounts of $5,499.99 in 1950 and $22,000 in 1951, being parts of payments amounting to $220,000 made to five municipalities, were not outlays or expenses incurred by the taxpayer for the purpose of gaining or producing income within the meaning of paragraph (*a*) of subsection (1) of section 12 of the Act, but were capital outlays within the meaning of paragraph (*b*) of the said subsection (1) of section 12".

Appellant, on the other hand, attempts to rebut this interpretation by alleging that the payments or expenses concerned were of a revenue character, and especially intended to produce income by lessening the operating expenses. Basically the Company's franchise would not be "affected nor cancelled but merely altered or modified".

From a practical point of view what were originally the main objects and motives which eventually brought about this transaction? The severance of a deteriorating contractual tie, entailing heavy deficits, coupled with an attempt to escape the imminent obligation of incurring capital expenditures necessitated to increase the power line voltage; for substituting modernized electric substations for "obsolescent" ones, and to renew the Company's worn out rolling stock.

Regarding the three latter needs, had they been lived up to, as such, none would have challenged the true character of expenses incurred as being capital outlays, specifically within the taxing field of section 12(1)(*b*). It therefore remains that this matter, in its incipient stage at least, related, in a considerable degree, to taxable operations.

Regarding its primary objective: stopping the yearly outflow of funds occasioned by an unprofitable railway passenger service, British Columbia Electric bargained for and obtained, against due monetary consideration, its release from this serious predicament (*vide* Ex. D and E).

Of this the immediate consequence was not so much an "increase or production of income", though it could indirectly lead to such a result, as a reduction of an accruing

deficit susceptible, eventually, of being written off against capital reserves. For argument's sake, let us reverse the situation and suppose that in 1950-51 British Columbia Electric Railway had expended moneys in fitting up passenger service with a consequent profit instead of a $309,000 loss, *then* the requisite expense would primarily have been "incurred for the purpose of gaining or producing income from property or a business of the taxpayer".

To better illustrate this opinion, may I quote from Sir Lyman Duff C.J. in *The Montreal Light, Heat & Power Consolidated v. The Minister of National Revenue* (1):

> From a business point of view the main object of the transaction was to secure a reduction in the rate of interest and thereby, of course, to increase profits. Every one of these expenditures was part of the cost of borrowing capital from the lenders who took up the new issue of bonds, or of repaying the borrowed capital to the holders of the existing bonds; in other words, part of the cost of acquiring borrowed capital, or of repaying borrowed capital. Such expenses do not appear to me to come within section 6(*a*) as expenses incurred *in the process of earning the income, which is the test to be employed in the application of that subsection.*

The learned Chief Justice continues:

> Of course there is a sense in which, as a rule, all expenditure properly made by a joint stock company . . . may be said to be an expenditure incurred for the purpose of earning profits, *but the distinction between the expenditures made in the actual process of earning profits and other expenditures made on account of capital, or otherwise, is one which it is absolutely essential to maintain, if the Statute is to be workable.*

Still, at page 94, The Chief Justice cautions against any hard and fast rule when he approvingly cites Lord Justice Romer who, in *The European Investment Trust Co. Ltd. v. Jackson* (2), said that "the effect of the decisions mentioned is that the question in each case is a question of fact".

Previously, and in similar vein, Mr. Justice Maclean, then President of this Court, in the same affair of *Montreal Light, Heat & Power* (3), also had opined that

> It (the issuing of redeeming bonds and incidentals) did not increase the revenue but *it decreased the fixed capital charges of the business, and could not, therefore, have been incurred exclusively to earn the net profits or gains to be assessed.*

(1) [1942] S.C.R. 89 at 91. (2) 18 Tax Cases 1.
(3) [1941] Ex. C.R. 21 et seq.

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Here it may be in order to reproduce the appropriate section as it read in 1941 (R.S.C. 1927, c. 97, s. 6).

6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*a*) disbursements or expenses *not wholly, exclusively* and *necessarily* laid out or expended for the purpose of earning the income.

The present text, prescribed by the Statutes of Canada, 1948, c. 52, s. 12(1)(*a*), has suppressed the apparently stringent adverbs, without appreciably altering the meaning and aim of the law, as will be sensed by comparing its former and latter wordings.

I would now quote at some length from Lord MacMillan's notes, again in the *Montreal Light, Heat & Power v. Minister of National Revenue* (1). In those three excerpts, the nice distinction between outlays with income producing intent and payments on account of capital is thoroughly elaborated. His Lordship wrote at page 133:

It is important to attend precisely to the language of s. 6. If the expenditure sought to be deducted is not for the purpose of earning the income, and wholly, exclusively and necessarily for that purpose, then it is disallowed as a deduction. If the expenditure is a payment on account of capital it is also disallowed.

Regarding the statutory criterion, Lord MacMillan is of opinion (p. 133, *in fine*) that

Expenditure, to be deductible, *must be directly related to the earning of income*. The earnings of a trader are the product of the trading operations which he conducts.

These operations involve outgoings as well as receipts, and the net profit or gain which the trader earns is the balance of his trade receipts over his trade outgoings. It is not the business of either of the appellants to engage in financial operations. The nature of their businesses is sufficiently indicated by their titles. It is to those businesses that they look for their earnings . . . their financial arrangements are quite distinct from the activities by which they earn their income. No doubt, the way in which they finance their businesses will, or may, reflect itself favourably or unfavourably in their annual accounts, but expenditure incurred in relation to the financing of their businesses is not in their Lordships' opinion, expenditure incurred in the earning of their income within the statutory meaning.

Some twenty-five lines further down, at page 134, we find that:

In the history of both companies, the financial readjustment of their borrowed capital *was an isolated episode, unconnected with the day to day conduct of their businesses, and the benefit which they derived was not earned by them in their businesses.*

(1) [1944] A.C. 126.

It should be said of the actual appellant company that "the businesses it looks to for its earnings" cannot consist in a curtailment of its franchise—a capital asset if ever there was one,—through buying off the opposition manifested by five municipalities. And again, assuredly,: "in the history of . . . (British Columbia Electric Ry.), this financial readjustment, (for such it was to all practical intents), . . . was an isolated episode, unconnected with the day to day conduct of its businesses, and the benefit derived was not earned in the course of its business." Abating a loss, such as the present one, doubtless bears a collateral relationship to possible profit-making, but it is not, as would be essential, its parent in the direct line (*si ita dicere licet*).

At trial, the gist of the arguments, regarding the accurate analysis of this compromise, was on appellant's behalf, that "basically the Company's franchise is neither annulled nor cancelled but altered or modified, nothing but a change in the mode of operation"; to which respondent retorted that relief from passenger service liability "amounted to an abandonment of a portion of the Company's charter, a cancellation of the railway passenger service".

The Public Utilities Commission's order of discontinuance (Exhibit E), December 20, 1950, certainly brought about more than "a change in the mode of operation", since the Company, thereafter, waived its right, and completely ceased to operate the passenger line, if one keeps in mind that B.C. Motor Transportation Limited is, at law, a totally distinct entity, operating, moreover, a different "mode" of transportation.

Neither can I derive much weight from the claim that we would have here a mere alteration or modification of the franchise.

Etymologically, "altering", if not a radical transformation, is, at the least, a partial change. In the present instance, altering the charter undeniably worked a material change in one of those component obligations pertaining to the essence of corporate existence.

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I am strongly impelled to hold that an outlay of $220,000, under the known circumstances, was not expended for the purpose, primarily, "of gaining or producing income" within the statutory meaning.

In his reply, counsel for the appellant argued that "the permission granted to abandon passenger service may at any time be revoked and annulled", quoting sections 120 of the Public Utilities Act (1948 Statutes of British Columbia, c. 277) and 3 of Exhibit E.

Once more, I feel unable to share this opinion. Section 120 simply purports that "The powers vested in the Commission by this Act shall apply notwithstanding that the subject-matter in respect of which the powers are exercisable is the subject-matter of any agreement or Statute . . . ", while clause 3 of the Order (Ex. E—Dec. 20, 1950) provides for the maintenance of passenger car service pending the improvement of municipal roads, and also that British Columbia Electric Ry. . . . "shall, as an emergency measure, whenever bus service is cancelled for more than a short while, operate them, i.e. passenger cars, by means of a diesel locomotive to restore rail passenger service temporarily . . ."

Such texts hardly support a claim that the P.U.C. order "may, at any time, be revoked or annulled"; particularly in view of the fact that its article 2 expressly sets out the schedule of indemnities to be paid as a prerequisite condition. Surely so onerous an undertaking is not open to any arbitrary abrogation.

Reverting anew to the Supreme Court's decision in *Montreal Light, Heat & Power Consolidated v. The Minister of National Revenue* (*supra*), it seems of interest to cite the following lines from Davis J.'s notes (p. 105):

> Once the practical necessity appears for amortization over a period of years of any large expenditure actually incurred in a particular taxation year, the real character of the expenditure emerges as something quite different from those ordinary annual expenditures which fall naturally into the category of income disbursements.

Spreading over a period of ten years, on a strictly amortization scale, a disbursement of this kind, in my mind, imparts added plausibility to its being a capital expenditure.

The decision in *Anglo-Persian Oil v. Dale (Inspector of Taxes)* (1) was frequently relied upon by the appellant as a clear instance of amortized payments which, nevertheless, were held to be of a revenue character and deductible by the latter company in ascertaining its net profits.

It could well be that any similitude between that and the present case would reach no deeper than a superficial level as briefly analysing the facts may show.

In 1914, Anglo-Persian Oil Company entered into an agreement with S.S. & Co. under which the latter were appointed agents of the company to manage its business in Persia and the East for a term of ten years. The remuneration having proved larger and more onerous than had been anticipated by the Company, the Company determined to bring the agency to an end, and thenceforth to do their own agency work in the East. Accordingly in 1922 the Company entered into an agreement with S.S. & Co. by which it was agreed that "the agency should be terminated . . . while in return the Company should pay S.S. & Co. 300,000 pounds". This huge forfeit . . . "was treated in the Company's accounts as a revenue payment, and was (successfully) charged to revenue in instalments of 60,000 pounds for five years".

A material difference between that case and the present one becomes immediately apparent. To buy out S.S. & Co. Anglo-Persian Oil did not need to "alter or modify" their Letters Patent or Act of Incorporation. Neither were they, in so doing, changing their "charter" powers, but only changing their agent, something quite different. No public authority, such as the P.U.C. was required to sanction this purely bilateral deal. Hence, it would appear to follow that the amortization factor, in Anglo-Persian Oil, lends but a rather pale and insignificant colour to the subject-matter.

British Columbia Electric Railway also focussed its transaction in the light of a re-arrangement of affairs, reducing yearly expenses, but which failed to bring any new asset into existence.

Even this submission seems doubtful, since one might argue that, in 1950, the Agreement (Exhibit D) and corresponding P.U.C. order (Exhibit E) indirectly brought an

(1) [1932] 1 K.B.D. 124, 146.

"asset" into functional being, namely, the B.C. Motor Transportation Limited, the appellant's subsidiary, whose gains were expected to relieve appellant's gross income to the tune of $65,702 annually, reducing, *pro tanto*, the operating deficit.

A litigation somewhat more in line with our case than *Anglo Persian Oil* is that of *Countess of Warwick Steamship Company v. Ogg* (1), where a company contracted for the construction of a ship and paid down 30,000 pounds. Subsequently, the contract was cancelled on payment of an additional 30,000 pounds. Held: "that the whole 60,000 pounds (to get rid of an onerous contract) was capital outlay".

Finally, I will cite two other precedents, those of *Vallambrosa Rubber Company v. Farmer* (2) and *British Insulated & Helsby Cables v. Atherton* (3).

In the first of these two cases, Lord Dunedin, President of the Court of Sessions, wrote (p. 525):

> . . . in a rough way I think it is not a bad criterion of what is capital expenditure, as against what is income expenditure, to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year. . . .

Viscount Cave, L.C., in *British Insulated & Helsby Cables v. Atherton* (*supra*), approvingly mentioned this opinion (p. 213, *in fine*):

> . . . when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or *an advantage* for the enduring benefit of a trade, I think that there is very good reason, in the absence of special circumstances leading to an opposite conclusion, for treating such an expenditure as properly attributable not to revenue but to capital. For this view there is already considerable authority.

Perhaps a last but ancillary question remains to be disposed of: the relative interplay of accountancy principles, which can be attended to by way of a reference to Shaw and Baker's work on *The Law of Income Tax* at page 147:

> The profits are to be arrived at on ordinary commercial principles, subject to such provisions as require a departure from such ordinary principles, e.g., the prohibition of certain deductions.

(1) [1924] 2 K.B. 292. (2) [1909-10] S.C. 519; 5 Tax Cases, 529, 536.
(3) [1926] A.C. 205.

At page 183:

The general rule as regards trade expenses is that a deduction is permissible which is justifiable on business and accountancy principles; but this rule is affected by certain specific statutory provisions. To the extent (but to that extent only) that ordinary business and accountancy principles are not invaded by statute, they prevail.

Accountancy rules to the contrary, if such they be, I must persist in my belief that the outlay of $220,000 incurred by the appellant in 1950 was "a payment on account of capital" within the statutory meaning of Chapter 52 of the Statutes of Canada, 1948, section 12(1)(*b*), and properly assessable.

Therefore, I hold that the tax payable by the appellant for its 1950-1951 taxation years having been lawfully and correctly assessed, this appeal of the appellant from its 1950-1951 income tax assessment should be dismissed with costs.

Numerous other authorities were examined, but are not inserted here because they either would be deemed repetitious or inapplicable.

Judgment accordingly.