1956 Oct. 2 — 1957 Apr. 9

THE MINISTER OF NATIONAL REVENUE .... APPELLANT;

AND

VANCOUVER TUGBOAT COMPANY LIMITED .... RESPONDENT.

Revenue—Income—Income Tax Act, S. of C. 1948, c. 52, s. 12(1)(b)—Capital or income—"An outlay, loss or replacement of capital . . ." —Installation of new engine in tugboat replacement of capital asset—Appeal from decision of Income Tax Appeal Board allowed.

Respondent operates a tugboat service on the Pacific coast of Canada in the performance of which its tugboats often cover distances exceeding 800 miles in a single voyage, and a trip may last from five to fifteen days. In 1951 it placed a new engine in one of its tugboats at a total cost of $42,086.71 which amount it claimed as a deduction from income for that year. This claim was allowed by the Income Tax Appeal Board from whose decision the Minister of National Revenue appealed to this Court.

Held: That the expenditure on the new engine was an outlay or replacement of capital within the meaning of s. 12(1)(*b*) of the *Income Tax Act* and not deductible from income since such expenditure, rather than repairing the old one, was undertaken once and for all in the expectation that the new engine would be more reliable than the rehabilitated old one would be and would operate more constantly and with fewer repairs and over a greater number of years than could be expected from the old one even if it were rehabilitated. The expenditure was not an annual one nor was it made solely to cover the accumulations of wear and tear incurred in a number of past years but was to prevent the necessity for so many repairs and loss of time in the future. The respondent's trade gained an advantage by the expenditure in that it has provided an engine which makes the tug more reliable, keeps it more constantly in service and enables it to earn greater revenue, at the same time avoiding the abnormal repairs formerly required and such advantage is of an enduring nature in that the anticipated life of the new engine is ten years, and the expenditure of $42,068.71 to replace a single part of the tug is one to replace a substantial portion of a capital asset rather than to renew some minor item in the course of carrying out the ordinary run of repairs.

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APPEAL from a decision of the Income Tax Appeal Board.

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

D.T.B. Braidwood and *T. Z. Boles* for appellant.

William Murphy, Q.C. for respondent.

THURLOW J.:—This is an appeal by the Minister of National Revenue from the judgment of the Income Tax Appeal Board (1) allowing the appeal of the respondent against its income tax assessment for the year 1951.

The respondent company had an operating loss in the year 1952 which was augmented by an expenditure of $42,086.71 made in that year to purchase and install a new engine in one of its tugboats. It treated this expenditure as an operating expense, and pursuant to s. 26(*d*) of *The Income Tax Act,* S. of C. 1948, c. 52, it claimed a deduction from its 1951 income in respect of the loss incurred by it on its operations for the year 1952. The Minister, in assessing the appellant for the year 1951, disallowed the expenditure as a charge against revenue and thereby reduced the amount of the 1952 loss in respect of which the deduction could be claimed from the respondent's income for 1951. The expenditure was disallowed on the ground that it was capital. The respondent thereupon appealed to the Income Tax Appeal Board, which held that the expenditure was a current expense incurred by the taxpayer for the purpose of gaining or producing income from its business and that the engine was a replacement in the nature of a repair of a subsidiary part of an integral whole, *i.e.* the tugboat, and was not an outlay of capital. From this judgment, an appeal to this Court, as above mentioned, was taken by the Minister.

The grounds of appeal taken by the appellant are that the expenditure in question was not an outlay or expense incurred for the purpose of gaining or producing income within the meaning of s. 12(1)(*a*) of *The Income Tax Act* and, further, that it was an outlay on account of capital within the meaning of s. 12(1)(*b*) of the Act.

(1) 14 Tax A.B.C. 160.

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The respondent, on the other hand, submits that the expenditure was not a capital expenditure but a normal recurring repair item known to the towing industry in British Columbia, that the installation of the engine was the restoration or replacement of a subsidiary part of the whole rather than a replacement of the entirety, that the installation of the engine involved no change of design or over-all improvement of the tug and brought about no lasting benefit and that, accordingly, the expenditure was properly charged against revenue.

The respondent company operates a tugboat service on the Pacific coast of Canada. Its tugs operate between Vancouver and many other ports and cover distances up to and exceeding 800 miles in a single voyage. Trips from Vancouver to the ports and return take from five to fifteen days, depending on the distances to be covered. The voyages take the tugs and the barges and cargoes which they are towing into open waters, where there is always the danger of storms. A tug, the two barges it tows, and the cargo together frequently represent a value in excess of a million dollars. Many of the ports served have no rail service, and it is necessary to operate the towing service on a schedule in order to maintain satisfactory continuity in supplying and serving these ports and their industries. Facilities for repairing tugs and their engines are available at Vancouver, but only very minor repairs can be effected at the other ports. The service is carried on throughout the year, and regardless of weather, and it is clear that the success of the operation depends to a very great extent on maintaining the tugs, their engines and equipment in an efficient and dependable state of repair.

In 1951 the respondent company had nine tugs engaged in the service, seven of which it owned and two of which it had chartered. One of the tugs owned by the respondent company and operated by it in 1951 was the *LaVerne*. This was a wooden motor vessel which had been built in 1944 as a mine sweeper and had been purchased by the respondent company in 1947 from War Assets Corporation for $20,000. When purchased, the vessel was equipped with a single 600 b.h.p. Vivian diesel propulsion engine which had had practically no use up to that time. The

respondent company had the *LaVerne* refitted to suit its purposes as a tug at an additional cost of approximately $24,000. In 1949 she was employed in the respondent's towing service and operated satisfactorily, using the same engine which was in her when the respondent company bought her. However, in 1950 and 1951 more and more repairs to this engine were required and, as a result of frequent breakdowns of the engine the tug was tied up for repairs an abnormal amount of its time. In 1952 the respondent company was faced with the necessity of carrying out a complete overhaul and rebuilding of this engine, which would have cost $20,000. To replace the engine with a new Vivian engine of the same type would have entailed a cost estimated at $60,000. An opportunity having arisen for the respondent company to purchase a suitable new engine at a greatly reduced price, the respondent company did so and had it installed, the engine costing some $26,500 and the freight and installation of it costing $15,586.71, thus making up the $42,086.71 in dispute in this proceeding. The Vivian engine removed from the tugboat was not repaired but was scrapped, the respondent having tried without success to sell it. The new engine installed in the *LaVerne* was a 1944 model 600 b.h.p. Washington diesel engine, heavier in weight than the Vivian engine but not regarded as capable of producing more power than the Vivian engine. When it had been installed, the tug could not go any faster than before and thus could not make additional voyages by reason of increased speed. She could haul the same number of barges as before, but because the engine did not break down so often and the vessel did not spend so many hours undergoing repairs she was able to make more voyages and thus earn greater revenue.

The tugs operated by the respondent company have no definite predictable life span, but some are in service after thirty years, and it is not unreasonable to expect of a new one that it will have a useful existence of twenty years. Engines, on the other hand, have a shorter useful existence, some lasting five years, some eight, some ten. It will be observed that the useful life of the Vivian engine was apparently three years. The respondent company hoped that the Washington diesel installed in its

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place might last for more than ten years, but, of course, there is no means of knowing whether it will do so or not. In any case, it is not expected to last as long as the tug. With a fleet of tugs in operation, the matter of replacing engines is obviously one that must be faced frequently, though at irregular intervals.

The financial statement attached to the respondent's income tax return for 1951 shows the capital cost of the *LaVerne* as $44,052.17, that to the end of the year 1951 total capital cost allowance in respect of the tug amounted to $18,216.02, and that the undepreciated capital cost at December 31, 1951 was $25,836.15. The evidence, however, shows that the cost of replacing the *LaVerne* would be in the vicinity of $225,000.

While the appellant relies on both s-ss. (*a*) and (*b*) of s. 12 of *The Income Tax Act*, the real problem, as I apprehend it, is to determine whether or not the expenditure in question was one of a capital nature, as mentioned in s. 12(1)(*b*). If so, the expenditure is not deductible. In my opinion, it requires no detailed analysis to classify the expenditure in question as one made in accordance with the ordinary principles of commercial trading or well accepted principles of business practice, as that consideration is explained in *Royal Trust v. Minister of National Revenue* (1), for I think it is clear beyond doubt that the expenditure was not merely reasonable but one such as any prudent businessman would make under similar circumstances, in carrying on a business of the kind carried on by the respondent. I am also of the opinion that the expenditure meets and passes the test of s. 12(1)(*a*) as one made or incurred for the purpose of gaining or producing income from property or a business of the taxpayer, at the very least in the sense that it enabled the taxpayer to use the tug for more working hours each year. The problem thus narrows down to a consideration of whether or not the expenditure is excluded by s. 12(1)(*b*) as an admissible deduction. That subsection is as follows:

(1) [1957] C.T.C. 32.

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

* * *

(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,

The line between what are capital expenditures in general and what are revenue expenditures is not easy to define, and it is no less difficult to lay down any hard or fast rule to determine when expenditures similar to the one in question on capital assets will and when they will not be considered to be capital expenditures within the meaning of the subsection above quoted. Nor is the problem simplified by the consideration that good business practice would probably sanction the charging of the expenditure in question to either capital or revenue, depending pretty much on how cautious the attitude of the particular businessman or accountant in computing profits may be. Moreover, in seeking to solve the problem by reference to cases decided in other countries it must be borne in mind that there are very material differences in the taxing statutes from one country to another, which often accounts for the difference in the results of cases having many factual features in common. For example, in *Rhodesia Railways Ltd. v. Collector of Income Tax, Bechuanaland* (1) the provisions of the income tax proclamation there considered were quite different from those of *The Income Tax Act*. While prohibiting the deduction of losses or outgoings of a capital nature, the proclamation expressly authorized the deduction of expenditures for repairs to property occupied for the purpose of trade—in that case, a railway. It also expressly prohibited any allowance for depreciation on structures or works of a permanent nature. It did, however, make provision for an allowance for wear and tear on machinery but directed the Collector, in making the allowance, to take into account the amount allowed for repairs. The appellant sought to charge to revenue the cost of renewing rails and sleepers on about one-fifth of its line, but only insofar as the cost of such renewal was necessary to restore the line to its original condition. Lord Macmillan, in delivering the judgment of the Privy Council, after holding that

(1) [1933] A.C. 368.

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such expenditure was not capital but was chargeable to revenue as a cost of repairs within the meaning of the proclamation, said at p. 375:

> The appellants received no allowance for depreciation of their rails and sleepers under para. (*c*) and the Court below, following a decision of the Appellate Division of the Supreme Court of the Union under a similar statute, held that they were not entitled to any such allowance, on the ground that a railway line was a work of a permanent nature. Oddly enough, the inference was drawn from this that what the appellants could not get by way of depreciation they cannot have been intended to get by way of repairs. The inference, their Lordships would have thought, was rather the other way—namely, that having been allowed a deduction in name of repairs the appellants were not intended to get a deduction in name of depreciation in respect of the same permanent structure.

And in *Samuel Jones and Co. (Devonvale) Ltd. v. Commissioner of Inland Revenue* (1), where the cost of replacing a chimney which was an integral part of a factory was allowed as a proper charge against revenue, it is to be noted that the expenditure for the chimney was one to restore property on which there was no allowance for depreciation.

The Income Tax Act, on the other hand, has provision for deduction from income of such part of the capital cost of property as may be allowed by regulation and mentions such allowance in the same subsection, that is, 12(1)(*b*), by which the deduction of capital expenditures from revenue is prohibited. Moreover, s. 12(1)(*b*) is precise and comprehensive in its prohibition in that it prohibits the deduction of any outlay, loss, or replacement of capital, any payment on account of capital, or any allowance in respect of depreciation, obsolescence, or depletion except as expressly permitted by the Act.

I think it makes no difference whether the expenditure here in question is called an outlay or a replacement. If it is capital in its nature, it seems to me to be equally well described as an outlay or a replacement, depending on the time in relation to which it is viewed. Contemplating the tug as it was in 1947, the provision and installation of a new engine in 1952 is readily classified as a replacement. Considering the expenditure in relation to the tug as it was immediately before the work was done, it seems to me that the word "outlay" is apt to describe it.

(1) 32 T.C. 513.

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How then is the question whether or not this expenditure was of a capital nature to be resolved? While there is no single determining test, a number of tests have, from time to time, been expressed, their usefulness in any particular case depending more or less on the particular circumstances. In *Vallambrosa Rubber Co. Ltd. v. Farmer* (1) the Lord President at p. 536 stated a test as follows:

Now I don't say that this consideration is absolutely final or determinative, but 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.

The annual or continuous or recurring nature of the expense is thus one indication of an income, as opposed to a capital, expenditure. The test above mentioned was commented on by Rowlatt J. in *Ounsworth v. Vickers Ltd.* (2) at p. 273 as follows:

. . . I take it, and indeed both sides agree, that no stress is there laid upon the words "every year": the real test is between expenditure which is made to meet a continuous demand, as opposed to an expenditure which is made once for all. Mr. Foote was, I think, right in saying that, assuming that dredging the channel is income expenditure if the respondents dredged year by year, it is none the less income expenditure because the dredging was not done for a year or two because it was not worth while to do so and was only done when it was seriously required to get rid of the mischief which had been growing all the time and which, theoretically, ought to have been kept down coincidently with its growth. Mr. Foote contended that, so far as the dredging of the channel was concerned, what was actually done was on the same footing as dredging actually done in the year, that is, that the respondents did in a single year dredging which they ought to have spread over a series of years, and therefore that the expenditure was income expenditure which as a matter of fact has been defrayed in one year although it ought to have been spread over several years. As regards the construction of the deep water berth, Mr. Foote contended that the expenditure was incurred in order to get out the particular ship, the *Princess Royal.* He argued that expenditure might be income expenditure although the work on which it was incurred endured beyond the year. I do not differ from that altogether, but it seems to me that the question must always be one of fact whether particular expenditure can be put against particular work, or whether it is to be regarded as *enduring expenditure* and serving the business as a whole.

In applying the test so expressed to the facts before him, Rowlatt J. said at p. 276:

. . . After lengthy negotiations they, as I understand it, did this: they did not simply put right the default of the harbour authority; they entered into an agreement by which a new thing was done. They did not dredge only to enable their ships to get out merely by virtue of the dredging;

(1) (1910) 5 T.C. 529.

(2) [1915] 3 K.B. 267.

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they adopted a different plan, namely, by constructing a deep water berth in which their ships could lie between the two tides, and therefore it seems to me that being placed in a difficulty they said to themselves "While we cannot get rid of this difficulty we shall create a new state of things to get round it". The position is just the same as if they had found that there was some new way by which they could get to the sea by digging a new channel at an insignificant expense. I think the true view of the facts in this case is that the whole of this expenditure by the respondents was incurred in making what was in fact a new means of access from their works to the sea, and that it was therefore not income expenditure but capital expenditure, and cannot therefore be deducted.

The creation of a new means of access to replace the old one was thus a capital item, even though the new means may not have been as advantageous as restoration of the old would have been. It was a new means of access, it was *enduring expenditure* for the benefit of the business as a whole rather than to enable the company to get one particular ship through the channel, and accordingly it was classified as a capital item. This case indicates that the method adopted to provide for something which might otherwise be a matter chargeable to revenue may stamp the expenditure as a capital one.

In *British Insulated and Helsby Cables v. Atherton* (1), a test which has been quoted and applied many times since was propounded by Lord Cave, L.C., at p. 213 as follows:

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

In this test, the elements indicating that the expenditure is capital are, first, that it is made once and for all and, secondly, that it is made with a view to bringing into existence an asset or an advantage for the enduring benefit of the trade.

Yet another test is propounded by Lord Sands in *Commissioners of Inland Revenue v. The Granite City Steamship Co. Ltd.* (2), where he says at p. 14:

Under the Income Tax legislation no allowance is permissible, in estimating annual profits, by way of deduction from annual income of capital outlay during the year of charge. As I had occasion to point out in the *Law Shipping Co., Ltd. v. Inland Revenue* (12 T.C. 621), 1924 S.C. 74, this is an arbitrary and artificial rule when the subject is a wasting

(1) [1926] A.C. 205. (2) (1927) 13 T.C. 1.

one that exhausts the capital, so that, if the business is to continue, there will have to be a renewal of capital outlay in a few years. In such a case a portion of the capital outlay is consumed in each year in earning the annual income. But the Income Tax Acts take no account of this consideration. Broadly speaking, outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment.

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It was conceded at the argument that the cost of repairs to capital equipment is ordinarily a deductible item provided they have become necessary through the income-earning operations of the taxpayer. And it was not disputed that in general such repairs would ordinarily entail the replacement of parts that have become worn out. On the other hand, one of the arguments advanced by the appellant in the case was that the life of the tug was limited by the life of its engine and that consequently when the engine was worn out the tug ceased to exist as a tug. Thus in essence the tug was substantially being replaced when a new engine was installed. The same argument could be applied in the case of the wearing out of any minor, though vital, part, such as a drive shaft, a propeller, or a rudder, and would lead to the conclusion that replacement of such minor parts would be capital expenditure. This would leave small scope for repairs as a revenue item. The argument for the respondent, on the other hand, stressed the view that the capital unit is the tug and that all repairs including replacements necessary to restore the tug to its initial condition are revenue items so long as the parts replaced are subsidiary parts of the tug and not in substance a replacement of the tug itself. No doubt the meaning of the expression "repairs" is broad enough to encompass all items necessary to restore the property to its original condition, but unlike the proclamation applied in *Rhodesia Railways Ltd. v. Collector of Income Tax, Bechuanaland* (*supra*) *The Income Tax Act* nowhere mentions or declares all repairs to be deductible, and I do not think, especially in view of the provisions in the statute for capital cost allowances, that the costs of all items that can be classed as repairs are *ipso facto* revenue items.

In my opinion, the provisions of *The Income Tax Act* are converse to those interpreted in *Rhodesia Railways Ltd. v. Collector of Income Tax, Bechuanaland* (*supra*) with

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respect to structures or works of a permanent nature. One might usefully paraphrase the last clause of the passage above quoted to apply it to this case as follows: ". . . that, having been allowed a deduction for wear and tear in the name of capital cost allowance, the respondent is not entitled to a deduction in the name of repairs to restore the same property to its original condition." This view does not eliminate as a revenue item the ordinary run of repairs necessary to keep the tug in operation but, in my opinion, it does introduce the necessity to judge each expenditure for repairs by the tests above-mentioned in the light of the particular facts to determine whether or not such repair item is of a capital nature.

In the case at bar, the Vivian engine might have been restored to its original condition at a cost of $20,000. And on the evidence this would probably have been the course followed if the opportunity to purchase the new engine at a low price had not presented itself. Had this course been followed, presumably the prospect would have been that the engine would become unsatisfactory again in approximately the same length of service and again require abnormally heavy repairs and become undependable. I do not think it is necessary to resolve whether or not such expenditure, had it been made, could have been wholly charged to revenue. To overcome the drawbacks with the Vivian engine, whatever they were, when the opportunity to do so arose, the respondent undertook another, and undoubtedly a very reasonable course, namely the replacement of the engine with a new one. It was, nevertheless, a different course, one that resulted in an expenditure more than twice as great as that of restoring the Vivian engine, and one that, in my opinion, was undertaken once and for all in the expectation that the new engine would be more reliable than the rehabilitated Vivian would be and would operate more constantly, and with fewer repairs and over a greater number of years than could be expected from the Vivian even if it were rehabilitated. This expenditure was not an annual one, nor was it one made solely to cover the accumulation of wear and tear incurred in a number of past years. Presumably, that much could have been accomplished by the complete overhaul of the Vivian engine estimated to

cost $20,000. Presumably too, the respondent expected something additional for the expenditure of twice that amount. I think it may safely be said that the expenditure was to cover the accumulations of past wear and tear and to prevent the necessity for so many repairs and so much loss of time in the future. While the expense of replacing engines is a recurring one in the sense that it recurs in respect to each tug once in five, eight, or ten years, I do not think the expenditure can be classed as one made to meet a continuous demand. There may be more or less continuous demand for repairs to the tug and to the engine in it, but there is no continuous demand for replacement of the engine any more than there is continuous demand for replacement of the hull as a whole. Moreover, in my opinion, the respondent's trade has gained an advantage by the expenditure, in that the expenditure has provided an engine which makes the tug more reliable, keeps it more constantly in service, and enables it to earn greater revenue and at the same time avoids the abnormal repairs formerly required. And such advantage is of an enduring nature in that the anticipated life of the new engine is ten years. No doubt there will be wear and tear each year beyond what is restored by repairs in the year and the advantage will ultimately be exhausted, but in my opinion that does not affect the nature of such advantage as capital. If any deduction from income is to be allowed in respect of such exhaustion, in my view, it must be by way of an allowance of the kind permitted under the exception to s. 12(1)(*b*).

In arriving at my conclusion, I attribute little, if any, importance to the fact that the expenditure to replace the engine exceeds the undepreciated capital cost of the tug and is almost equal to the whole original capital cost of the tug to the respondent. The price at which the respondent bought the LaVerne was, no doubt, affected by many factors other than the cost of replacement, and I do not regard the price paid as any indication of the replacement value of the ship at that time. But I am somewhat influenced by the size of the expenditure in question in relation to what were described as abnormally high repairs to the tug in the years 1949, 1950, and 1951, amounting to $15,833, $12,849, and $10,899.59 respectively.

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These amounts were for repairs to the tug as a whole, not to its engine alone. In the light of this evidence and the evidence that a normal year's repairs should run to somewhat less than $10,000, I think it is apparent that the expenditure of a sum of $42,068.71 to replace a single part of the tug is one to replace a substantial portion of the capital asset rather than to renew some minor item in the course of carrying out the ordinary run of repairs.

I find that the outlay in question was an outlay or replacement of capital within the meaning of s. 12(1)(*b*) of *The Income Tax Act* and, accordingly, was not deductible from income. The appeal will, therefore, be allowed and the assessment restored. The appellant is entitled to his costs.

Judgment accordingly.