1948
May 25
Sept. 9

BETWEEN:

J. E. McCOOL LIMITED.....APPELLANT

AND

THE MINISTER OF NATIONAL REVENUE.....RESPONDENT

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 5(1)(a)(b), 65(1)—Depletion allowance on timber limits to be determined by the Minister on the basis of the actual cost thereof to the taxpayer but limited by the actual value thereof and not on the basis of the cost to a predecessor in title—Interest, not being interest paid on borrowed capital used in the business to earn the income, cannot be claimed as an operating expense—Appeal allowed in part.

Appellant company which is controlled by one McC. purchased from the latter certain assets including timber limits for which limits McC. had previously paid $35,000 00. In the agreement for sale no specific value was assigned to the timber limits but appellant among other considerations, gave McC. a demand note for $123,097.34 bearing interest at 5 per cent per annum.

In its tax return for the taxation year 1942 appellant claimed a depletion allowance on the timber limits on a valuation of $150,000.00 which it represented was the price paid for the limits and also, as an operating expense, certain interest paid on its note to McC. The Minister of National Revenue allowed depletion on the basis of cost price of the limits to McC. of $35,000.00. He disallowed all interest paid on the note as it was not interest on borrowed capital. Appellant company appealed from the Minister's decisions.

Held: That in considering what depletion allowance should be made the duty of the Minister is to consider the cost of the timber to the taxpayer and the actual value thereof. Fixing depletion allowance to the appellant on the basis of the cost to a predecessor in title is to proceed on a wrong principle and the assessment should be set aside.

2. That the interest paid by appellant to McC. on his note was not interest paid on borrowed capital used in the business to earn the income and was properly disallowed.

APPEAL under the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Cameron at Ottawa.

Lee A. Kelley, K.C. for appellant.

Alastair Macdonald and *T. Z. Boles* for respondent.

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

The facts and questions of law raised are stated in the reasons for judgment.

CAMERON J. now (September 9, 1948) delivered the following judgment:

This is an appeal from assessments to income tax and excess profits tax for the taxation year 1942. The appellant had claimed a normal depletion allowance in the sum of $51,874.36, and also, as an expense, certain interest paid on its note for $123,097.34 to one T. E. McCool. In assessing the appellant on February 9, 1945, the respondent had allowed normal depletion in the sum of $10,445.94 only and had disallowed entirely all interest paid on the said note. It is in respect of these two items that the appeal is now taken.

In order to appreciate the issues in the case it is necessary to set out the facts in some detail. The president and chief shareholder of the appellant Company is one T. E. McCool. For some years prior to 1940 he owned and operated a farm near Pembroke, Ontario, and during the winter months operated a small log and pulp-jobbing business. On March 27, 1940, he secured from one Gertrude A. Booth an option to purchase for $35,000.00 certain timber licenses held by her from the Province of Ontario on lots in the County of Renfrew. This option to purchase (Exhibit 7) was open for acceptance until June 1, 1940, and could be taken up by payment of $10,000.00 by the date named, a further payment of like amount being due on January 2, 1941, and the balance on May 1, 1941, all without interest. After cruising the Limits, McCool estimated that he would be able to cut 20,000,000 feet B.M. from the properties, took up the option and made the down payment of $10,000.00.

Mr. McCool considered it advisable to operate the said Limits (which will hereafter be referred to as "the Booth Limits") and his other assets through the medium of an incorporated company. On August 31, 1940, he entered into an agreement (contained in Exhibit 3) with one Lawrence S. Ryan, Chartered Accountant, as trustee on behalf of the Company to be formed, by the terms of which he agreed to sell and transfer to the Company to be formed all the lands and assets set out in Schedule "A" to that

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

agreement, which schedule included the Booth Limits, other limits, real estate and buildings, machinery, equipment, horses, cattle, camp equipment, trucks and cars, accounts receivable, shares in a certain company and a specified amount of cash on hand and in bank. Except in regard to accounts receivable and cash on hand and in bank, no values were assigned to the assets to be transferred. In consideration of the transfer of the assets to the Company to be formed, the Company was to (1) assume liabilities of the vendor in the sum of $37,684.20, (2) pay the vendor $400.00 in cash to be used in payment for the four shares of the incorporators of the Company, (3) allot to the vendor 596 fully paid up and non-assessable shares in the Company of a par value of $100.00 each, and (4) to make and give to the vendor a demand note for $123,097.34 bearing interest after September 1, 1941, at 5 per cent per annum. In the said agreement it was provided that the transfer of the assets from the vendor should be deemed to have effect from August 31, 1940, and the benefit of any operations carried on prior to such transfer was to enure to the Company. Any subsequent asset required by the vendor in connection with his business and prior to the transfer was, at the option of the Company, to be transferred to it.

The appellant Company was incorporated on October 20, 1941 by Dominion charter. By an agreement dated November 28, 1941 (contained in Exhibit 3), between the said T. E. McCool, the said Lawrence S. Ryan as trustee, and the Company, the said McCool, with the consent of the said trustee, agreed to sell and convey to the Company, and the Company agreed to purchase from him, all the assets mentioned in Schedule "A" to the agreement of August 31, 1940, together with one additional property in the town of Pembroke on the terms and conditions and for the consideration mentioned in the agreement of August 31, 1940. The said agreement was duly carried out, the assets transferred to the Company and the vendor received the consideration above mentioned, including the note for $123,097.34. On November 28, 1941, the said vendor directed the secretary-treasurer of the appellant Company to issue and allot the 596 shares to which he was entitled, in

a certain manner between his eight children and himself; and following that date and taking into consideration the incorporator's shares, the said T. E. McCool held 360 shares and each of his eight children 30 shares, a total of only 600 shares being issued.

At the Directors' Meeting held on November 28, 1941, T. E. McCool, after stating that he had entered into the agreement with Ryan dated August 31, 1940, and that he had an interest in the matters which would come before the meeting regarding the purchase of his assets, withdrew from the meeting. Subsequently, the directors considered these matters, approved of the acquisition of his assets on the basis of that agreement and passed a by-law authorizing the execution of the agreement above referred to and dated November 28, 1941. They further authorized the issue of the shares to T. E. McCool, as provided in the said agreement and the execution of its note to him for $123,097.34.

As stated above, the agreement of August 31, 1940, placed no individual valuation on the Booth Limits nor did the said agreement state the total value placed on all the assets to be conveyed to the Company. Under date of November 10, 1941, the said Lawrence S. Ryan—who was the chartered accountant of the appellant Company—addressed a letter to the shareholders of the Company, attaching a balance sheet of the Company outlining its opening position as of August 31, 1940. The letter and statement comprise Exhibit 5. In that statement the assets in all are valued at a total of $220,781.54 the Booth Limits being valued at $150,000.00. The liabilities also total $220,781.54, being made up of current liabilities of $37,684.20; issued capital stock (600 shares of a par value of $100.00 each) at $60,000.00, and the demand note to T. E. McCool for $123,097.34.

I shall first consider the appeal in regard to depletion allowances. During its fiscal year ending August 31, 1942, the appellant had cut 6,916,581 feet B.M. from the Booth Limits. In its tax return it had claimed an allowance for depletion at the rate of $7.50 per 1,000 feet B.M. so cut. Assuming that there were 20,000,000 feet in all in the Limits (as had been estimated by T. E. McCool), it had divided the sum of $150,000.00 (which it represented was

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

the cost of the Limits to it) by 20,000,000 feet and thereby ascertained the figure of $7.50 per 1,000 feet B.M. as a proper depletion allowance. The respondent, in assessing the appellant, rejected the appellant's computation. In a letter accompanying its Notice of Assessment, and dated February 9, 1945, the following paragraph appeared:

> It has been ruled by the Deputy Minister of National Revenue (taxation) that the Timber Limits will be valued for the purpose of the Income War Tax Act and the Excess Profits Tax Act at the cost price to T. E. McCool of $35,000 00, that the depletion allowable will be the result of dividing $35,000 00 by the total cruise and multiplying by the cut during the period, and that interest will not be allowed on the balance of the T. E. McCool account in arriving at the taxable profit. A depletion schedule "C" is attached. Depletion has been allowed in accordance with section 5(*a*) of the Income War Tax Act and the interest has been disallowed under section 6(*a*) of the Income War Tax Act.

The respondent, therefore, in fixing the depletion allowance, assumed that there were 20,000,000 feet B.M. in all in the Booth Limits and by dividing $35,000.00 by 20,000,000 feet, allowed depletion at the rate of $1.75 per M B.M., thereby reducing the normal allowance to $12,104.02 for the 6,916,581 feet cut in the fiscal year ending August 31, 1942. In the assessment, however, the respondent took into consideration the fact that the Company was incorporated only on October 20, 1941, and therefore allowed depletion to the appellant only for the period October 21, 1941, to August 31, 1942, a total of $10,445.94.

Notice of Appeal was given, the appellant stating inter alia that the Booth Limits were transferred to the Company at a valuation of $150,000.00 and giving as one of its reasons for appeal:

> (*a*) It should be allowed depletion on the basis of a valuation of $150,000 00 and not $35,000 00, the sum of $150,000 00 being the price paid by it for the said Limits when purchased from Mr. McCool and *being less than the actual market value of the said Limits at the date of acquisition by the appellant.*

Following the service of the Notice of Appeal, the Minister gave his Decision on November 23, 1945, and so far as this item of the Appeal is concerned, stated:

> The Honourable the Minister of National Revenue, having duly considered the facts as set forth in the Notice of Appeal and matters thereto relating * * * hereby affirms the said Assessment in other respects on the ground that a just and fair allowance has been made under the

provisions of paragraph (*a*) of subsection (1) of section 5 of the Income War Tax Act of the amount of $10,445.94 in respect of depletion of a timber limit.

Notice of Dissatisfaction was given by the appellant on December 18, 1945, followed by the reply of the respondent affirming the assessment as levied. By order of the Court pleadings were delivered.

In 1942, sec. 5(1) (*a*) of the Income War Tax Act was as follows:

Sec. 5. *Exemptions and deductions*—1. "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—

(*a*) Depletion.—The Minister in determining the income derived from mining and from oil and gas wells and timber limits may make such an allowance for the exhaustion of the mines, wells and timber limits as he may deem just and fair, and in the case of leases of mines, oil and gas wells and timber limits the lessor and the lessee shall each be entitled to deduct a part of the allowance for exhaustion as they agree and in case the lessor and the lessee do not agree the Minister shall have full power to apportion the deduction between them and his determination shall be conclusive.

This subsection and the nature of the discretion to be exercised by the respondent were recently under consideration in the case of *D. R. Fraser and Company* v. *Minister of National Revenue* (1). The judgment in that case establishes that the taxpayer has now no statutory right to a depletion allowance; and that the section confers on the Minister a discretion not merely as to the amount, but also as to whether any allowance for depletion should be made. But having determined that an allowance should be made, he must then fix an amount which "he may deem just and fair."

In the *Fraser Case* Estey J. said at p. 169:

The nature and character of the duties imposed upon the Minister under this section 5 (1) (*a*) would appear to be unchanged by the amendment. They remain, as stated by Lord Thankerton in Pioneer Laundry and Dry Cleaners Limited *v.* Minister of National Revenue:

* * * so far from the decision of the Minister being purely administrative and final, a right of appeal is conferred on a dissatisfied taxpayer; but it is equally clear that the Court would not interfere with the decision, unless, as Davis J. states, "It was manifestly against sound and fundamental principles."

In reaching a conclusion as to whether the Decision of the respondent was against sound and fundamental

(1) (1947) S.C.R. 157.

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

principles it is necessary to consider what material he had before him at the time he exercised his discretion and made the assessment, and at the time he gave his decision following the Notice of Appeal, and the reasons given by him.

Mr. W. F. Williams, Director-General of the Corporation Assessments Branch of the Taxation Division, Department of National Revenue, was examined for discovery and all of that examination was made part of the appellant's case. From that examination it appears that the Deputy Minister had before him the following documents:

(*a*) The option given to T. E. McCool by Miss Booth to purchase the Limits for $35,000.00.

(*b*) The trust agreement dated August 31, 1940, between T. E. McCool and Lawrence S. Ryan, referred to above.

(*c*) The balance sheet purporting to be the closing balance sheet as of August 31, 1940, for T. E. McCool personally, and in which the Booth Limits were valued at $35,000.00.

(*d*) The opening balance sheet of T. E. McCool Limited as of August 31, 1940, in which the Booth Limits were valued at $150,000.00.

(*e*) The appellant's income tax return for its fiscal year ending August 31, 1942, and the schedules attached thereto.

(*f*) A report of his assessor showing that the appellant Company had issued 600 of its 1,000 authorized shares, of which 360 were issued to T. E. McCool personally and the remaining 240 by the direction of T. E. McCool were issued in equal proportions of 30 shares to each of his eight children. This report also indicated that the 240 shares were given by T. E. McCool to his children and that on a valuation of $24,000.00 he had paid a gift tax of $1,000.00 in regard thereto. The minute book of the Company was not before the Minister but no doubt was examined by the assessor who made the report.

Mr. Williams was not in the Department at the time the assessment was made, but stated that in his opinion the division of the shares by Mr. McCool between himself and the members of his family would have influenced the decision of the Deputy Minister. He stated, "I would consider that the Company was Mr. McCool's company, that

he would have control as to the price to be fixed on any assets that were purchased from himself, and consequently that that was not a transaction as between strangers."

He added that he thought that the fact that Mr. McCool controlled the company might have had some bearing on the decision of the Deputy Minister.

In answer to a question as to whether any effort was made by the Deputy Minister to ascertain the market value of the Booth Limits in 1942, he said, "Yes, as far as market value is concerned they had a transaction. The Department usually looks at a transaction in regard to market value, if there is not a ready market * * * such as there is on the stock exchange, for example, or over the counter trading * * * at the last transaction that took place for cash, at arm's length or as between strangers. Now here was a transaction, the last transaction for cash between strangers, that only took place a month or two months before and was turned over immediately, approximately on the same day, from $35,000.00 to $150,000.00."

It is also in evidence that the Department of National Revenue (taxation) on February 19, 1942, adopted recommendations of the Timber Depletion Committee of the Income Tax Division and such recommendations were made public to the various timber associations. Included therein was the following:

> That the depletion allowance be such as to permit the owner of timber or the holder of a right to cut timber from Crown or private lands to recover successively and ratably out of income before tax such capital sums as he may have invested in acquiring such ownership or rights, and no more.

It is quite clear, therefore, that in making the assessment and affirming it in his Decision, the respondent, by his Deputy Minister, rejected the statements of the appellant that the Limits had cost the appellant $150,000.00 and that that sum was less than the actual value of the Limits at the time the appellant acquired them. Quite obviously the respondent did not consider that the sale to the appellant established a market value of $150,000.00. The respondent, in the letter to the appellant, stated very clearly that he

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

would value the Limits at the cost price thereof to T. E. McCool—namely, $35,000.00. In so doing, did he violate sound and fundamental principles?

In general terms I think it may be said that the principle of taxation under the Income War Tax Act is the taxation of the net gains of the taxpayer. That principle as to depletion was put into practice by the Department of National Revenue (taxation) when it accepted the recommendation of the Timber Depletion Committee. That recommendation declared that the allowance should be such as to permit a taxpayer to recover out of income before tax such capital sums as he had invested in acquiring his timber. I do not suggest that such a general declaration of policy is in all cases binding on the respondent, for, as stated in the *Pioneer Laundry and Dry Cleaners Case* (1):

> These Departmental circulars are for the general guidance of the officers and cannot be regarded as the exercise of his statutory discretion by the respondent in any particular case.

In the *Fraser Case* (supra), Rand, J. stated at p. 164:

> It is, therefore, sufficient to say that whatever the effect of depletion allowance may, in particular cases, be, it nevertheless is designed only to enable the Minister broadly in time, factors and basis, *to afford assurance of the recovery of investment committed to the risk undertaken.* But what is to be the basis of returnable value? For instance, cost may be inapplicable to property demised: special considerations might affect it in mining ventures, and, as in the United States, place it either at the fair market value at the time of discovery, or a value ultimately ascertained by a percentage of gross return. But, apart from the latter, where there has in fact been a return of basic value or investment, the warrant for allowance has been removed. If here the measure, under the statute, is to be taken to be cost, then without more the case for the appellant disappears.
>
> Even conceding an absolute right to an allowance, *it is necessarily bound by the limitation of value* spread evenly over the asset as a whole; and since the statute does not prescribe the basis, the Minister must be free in any case to adopt one reasonably designed to carry out the purpose intended. On this assumption, I take the word "may" to include a discretion in that choice; and that the basis of actual capital investment may be used by him in any case is, I think, beyond doubt. Ordinarily the increments of return would attach to every unit of asset and value, but here the whole has been recovered by relation to part only of the asset.

In my view, the instant case is similar in many ways to *Pioneer Laundry and Dry Cleaners Limited* v. *Minister of National Revenue* (2). It is to be kept in mind that that

(1) (1940) A.C. 127 at 134. (2) (1939) S.C.R. 1.

appeal had to do with a depreciation allowance under the then section 5 (1) (*a*) which then read as follows:

"Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:

(*a*) such reasonable amount as the Minister, in his discretion, may allow for depreciation, and the Minister in determining the income derived from mining and from oil and gas wells and timber limits shall make such allowance for the exhaustion of the mines, wells and timber limits as he may deem just and fair. And in the case of leases of mines, oil and gas wells, and timber limits, the lessor and lessee shall each be entitled to deduct a part of the allowance for exhaustion as they agree and in case the lessor and lessee do not agree, the Minister shall have full power to apportion the deduction between them and his determination shall be conclusive.

That case is very well known and I do not consider it necessary to do more than quote a few passages from the dissenting judgments of the Chief Justice and Davis J., later approved in the Judicial Committee of the Privy Council.

At p. 5 Davis J. said:

The Commissioner of Income Tax put his denial of any amount for depreciation on the said machinery and equipment upon the ground that "there was no actual change of ownership of the assets" and they were "set up in the books of the taxpayer at appreciated values." In my view that was not a proper ground upon which to exercise the discretion that had been vested in the Minister. The Commissioner was not entitled, in the absence of any fraud or improper conduct, to disregard the separate legal existence of the Company and to inquire as to who its shareholders were and at what figures these assets had been carried on the books of some other individual, partnership or corporation.

And, at p. 6:

The appellant was a new owner for all legal purposes and its predecessor's depreciation allowance is immaterial when considering what is a reasonable amount to be allowed for its own depreciation. What is virtually said here against the appellant is—You are entitled to nothing because the beneficial ownership of your company is the same as the beneficial ownership of another company from which, indirectly, you purchased your machinery and equipment and we are entitled to look right through your legal existence and say that you are entitled to nothing at all for depreciation on your machinery and equipment.

In my view that is not a legitimate exercise of the discretion which Parliament vested in the Minister. I have not the slightest doubt that the Commissioner was as anxious to do justice as I am, but the public have been given the right to appeal to the Court from the decision of the Minister and if the Court is of the opinion that in a given case the Minister or his Commissioner has, however unintentionally, failed to apply what the Court regards as fundamental principles, the Court ought not to hesitate to interfere. I confess that I am influenced in this case by the insistence of many great judges upon the full recognition of the

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

separate legal entity of a joint stock company and the impropriety in dealing with its affairs of ignoring its legal status as if it had never been incorporated and organized.

And, at p. 8:

The Income War Tax Act gives a right of appeal from the Minister's decisions and while there is no statutory limitation upon the appellate jurisdiction, normally the Court would not interfere with the exercise of a discretion by the Minister except on grounds of law. But here the Commissioner acting for the Minister did exercise a discretion upon what I consider to be wrong principles of law and it is the duty of the Court in such circumstances to remit the case, as provided by section 65(2) of the Act for a reconsideration of the subject-matter stripped of the application of these wrong principles.

The judgment of the Judicial Committee of the Privy Council is reported in 1940 A.C. 127. At p. 137 Lord Thankerton, in delivering the judgment of the Board, stated:

Their Lordships agree with the Chief Justice and Davis J. that the reason given for the decision was not a proper ground for the exercise of the Minister's discretion and that he was not entitled, in the absence of fraud or improper conduct to disregard the separate legal existence of the appellant company and to inquire as to who its shareholders were and its relation to its predecessors. The taxpayer is the company and not its shareholders. Their Lordships agree with the reasons given by these learned judges, and their application of the authorities cited by them and it is unnecessary to repeat them.

In this case, as in the *Pioneer Laundry Case,* the Deputy Minister has based his decision on two grounds: (*a*) that there was no actual change of ownership of the assets, and (*b*) the assets (the Booth Limits) were "set up in the books of the appellant Company at appreciated values."

As held in the *Pioneer Laundry Case,* these were not proper grounds upon which to exercise the discretion vested in the Minister. As Davis J. said at p. 5:

The Commissioner was not entitled, in the absence of any fraud or improper conduct, to disregard the separate legal existence of the company and to inquire as to who its shareholders were and at what figures these assets had been carried on the books of some other individual, partnership or corporation.

What is virtually said against the appellant here is—You are entitled to some depletion allowance but only on the basis of the cost of the timber to your predecessor in title and not on the basis of the cost to you or its actual value. But the appellant was a new owner for all legal purposes and, in my view, is entitled to have the Minister

determine what is a just and fair allowance to it and not to a predecessor in title. In effect, the allowance for depletion given to the appellant is precisely the same as would have been allowed to T. E. McCool had he continued as owner of and had he operated the Limits.

In considering what depletion allowance should be made, I think that the first duty of the Minister is to ascertain the cost of the timber to the taxpayer. In the instant case there is now no doubt that the cost to the appellant was $150,000.00. It may be argued that on the material before the Minister there was no clear proof that such was the case; but I think that the evidence before him did fairly indicate that that was the cost and there was no evidence to establish that such was not the case. In any event, it has been esablished in evidence before me by both McCool and Ryan that the price put on the Limits at the time of the agreement of August 31, 1940, was $150,000.00. I think it may be fairly assumed that page 8 in Exhibit 5 (the opening balance sheet of the appellant Company as submitted by its auditor on November 10, 1941, and before the Directors' Meeting at which the purchase was authorized) contained the same values as T. E. McCool and Ryan had in mind when they signed the agreement on August 31, 1940. I do not see how otherwise the amount of the note at $123,097.34 could reasonably have been arrived at—the other unvalued assets being relatively of a minor nature.

But, as stated by Rand J. in the *Fraser Lumber Case* (supra), *the allowance is necessarily bound by the limitation of value* spread evenly over the asset as a whole. If cost to the taxpayer were the only matter to be considered, the statutory discretion of the Minister would be seriously interfered with and grave abuses could quite easily result. It is the duty, therefore, of the Minister to ensure that the cost on which depletion is to be based does not exceed the value of the wasting asset. It was asserted by the appellant in its Notice of Appeal that the cost of $150,000.00 was not in excess of the actual value of the timber. Again, it may be argued that this was not proven and that the only clear proof of value then before the Minister was the sale by Miss Booth to T. E. McCool of $35,000.00 some few months earlier.

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

Be that as it may, it is now well established by the evidence given at the hearing that the value of the timber Limits when acquired by the Company was not less than $150,000.00. Objection was taken by counsel for the respondent to the admissibility of evidence as to the then market value. I reserved by finding in regard thereto but have reached the conclusion that it should be admitted. The question of value is clearly relevant to the issue and it is not barred by the provisions of section 65 (1) of the *Income War Tax Act,* as the appellant clearly raised that issue in its Notice of Appeal. The evidence of experienced, disinterested and competent valuators of timber with a full knowledge of the then values in that area indicates that the Limits were then worth from $150,000.00 to $250,000.00. That evidence is not contradicted in any way. The evidence also indicates that Miss Booth had no knowledge of the real value of her timber licenses, that she had inherited them from her father, had held them for about twenty-five years, and in 1940 was anxious to get rid of them.

I find, therefore, that in fixing depletion allowance to the appellant on the basis of the cost to a predecessor in title, the Minister proceeded on a wrong principle and the assessment should be set aside. In the case of *Minister of National Revenue* v. *Wright's Canadian Ropes Limited* (1) the Judicial Committee of the Privy Council (p. 125) stated that the power conferred on the Court under section 65 (2) of the *Income War Tax Act* to refer the matter back to the Minister for further consideration was limited to cases of the kind referred to in subsection (1) of section 65, namely, where matters not referred to in the Notice of Appeal or Notice of Dissatisfaction were admitted by the Court. Inasmuch as this was not the case here, I am unable to refer the matter back to the Minister for further consideration as I had at first thought it my duty to do. The issues have been fought out by action in this Court and inasmuch as I have found that the cost to the appellants of the Limits in question was $150,000.00, an amount which did not exceed the actual value of the timber, I think it is now my duty to allow the appeal on this point, and, as was done in the *Wright's Canadian Ropes Case,* direct that, under the in-

(1) (1947) A.C. 109.

herent jurisdiction of the Court, the assessment be referred back to the Minister for an adjustment of the figures consequential on the allowance of the appeal.

I find, therefore, that the appellant is entitled to depletion allowance at the rate of $7.50 per M.B.M. for all timber cut on the Booth Limits by it in its fiscal year ending August 31, 1942. It is now admitted that 6,916,581 feet B.M. were so cut by the appellant after its incorporation on October 20, 1941, and before March 1, 1942. I therefore refer the matter back to the respondent for a proper adjustment of the assessments, both under the Income War Tax Act and Excess Profits Tax Act consequential on the allowance of the appeal on this point. In making a new assessment under the Excess Profits Tax Act the appellant is entitled also to the additional allowance for depletion provided for in the memorandum of February 19, 1942, in the manner therein set out and on the basis of $7.50 per M.B.M. In view of the provisions of clause 2 of such recommendation in respect to additional allowance for depletion, the proper amount of such additional allowance would appear to be $20,582.41, as stated in a memorandum signed by counsel for both parties. If, however, there is any disagreement on this point, the matter may be spoken to.

The remaining point for consideration is the interest paid on the note to T. E. McCool under the circumstances above mentioned. The appellant claims that this should be allowed as an operating expense on the ground that the note represents borrowed capital used in the earning of its income and should be allowed under section 5 (1) (*b*) of the Act, which is as follows:

"Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:

(*b*) *Interest on borrowed capital.*—Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security; by virtue of which the interest is payable.

1948

J. E. McCOOL LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

For the respondent it is argued that the payment of interest here is not interest on borrowed capital used in the business of the appellant to earn its income. In the letter of February 9, 1945, referred to above, it was stated that the interest was disallowed under section 6 (*a*) of the Act, but Mr. Williams in his Examination for Discovery stated that the disallowance was made under section 5(1) (*b*).

From that subsection it is apparent that interest may be allowed on borrowed capital secured to the lender by a note. But it is allowed only on borrowed capital. In my opinion, if there is to be borrowed capital, the taxpayer would have to be in the position of a borrower and some other party would have to be a lender. In this case the taxpayer was never a borrower from T. E. McCool and the latter did not at any time lend anything to the appellant. As between the appellant and the payee of the note, the relationship of borrower and lender did not exist at any time. The relationship between them at the time of the sale was that of vendor and purchaser and following the giving of the note the relationship was that of creditor and debtor. The note was given in respect of the unpaid part of the purchase money.

Reference may be made to the recent case of *Inland Revenue Commissioners* v. *Rowntree & Co. Ltd.* (1), in which it was held:

> The words "borrowed money" in paragraph 2 (1) in law required the relationship of a borrower and a lender, a relationship which did not exist in this case, but, even if the words were to be given some wider interpretation, the finding of the Commissioners that in ordinary commercial usage the relationship between the parties was not that of borrower and lender ought not to be disturbed.

In that case Tucker, L. J., in the Court of Appeal, said at p. 486:

> I find it difficult, if not impossible to appreciate how there can be borrowed money unless the legal relationship of lender and borrower exists between A and B. After all the words "borrow" and "lend" are not words of narrow legal meaning. They represent a transaction well known to business people which has taken its place in the law as a result of commercial transactions among the merchants of this country, and when the law, under the Bills of Exchange Act, or elsewhere, has to deal with matters of this kind, it is dealing with commercial transactions.

(1) (1948) 1 A.E.R. 482.

In the case of *Dupuis Frères Ltd.* v. *Minister of National Revenue* (1) Audette, J., dealing with the same section as I am now considering, stated at p. 209:

> Therefore these shares used to pay for the purchase, and which go to make the capital authorized by the company cannot be classed as borrowed capital.

The interest paid by the appellant to T. E. McCool on his note was not in my view interest paid on borrowed capital used in the business to earn the income and was properly disallowed. The appeal on this point will be dismissed.

The appellant, having succeeded on the main point raised in the appeal, is entitled to its costs after taxation.

Judgment accordingly.