1964
Sep. 8
1965
Mar. 31

BETWEEN:

GEORGE H. STEER ..... APPELLANT;

AND

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

Revenue—Income—Income tax—Deductibility as an income loss of amount paid by taxpayer as guarantor on default of payment by borrower—Guarantee of loan for consideration as a "business" and adventure in the nature of trade—Meaning of "source" of income—Deductibility of loss in subsequent year with respect to a "source" of income falling outside statutory definition of "business"—Scheme of Income Tax Act as to taxation of net profit or gross revenue—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 12(1)(a) and (b), 139(1)(e) and (x).

In 1951 the appellant and another person contracted with the two owners of all the shares of Locksley Petroleums Ltd. to endorse or guarantee the company's promissory notes at the bank to the extent of $125,000, and in consideration for so doing they were to receive one-half of the shares of the company and certain royalty interests. The appellant received his share of the consideration under the contract in 1951 and was assessed in that year for income tax thereon, the consideration being valued at $4.500. In 1957 the appellant was required to pay to the bank the sum of $62,500, being his share of the loan to Locksley Petroleums Ltd. which he had guaranteed and in payment of which the company had defaulted.

The respondent refused to take the $62,500 payment made by the appellant into consideration in assessing him for income tax for the 1957 taxation year and the appellant unsuccessfully appealed his assessment to the Tax Appeal Board. This appeal follows from that decision.

Held: That the transaction between the appellant and the owners of the shares of Locksley Petroleums Ltd. was a business transaction and whether or not it was a venture in the nature of trade so as to be a "business" within the statutory definition of that term, it was clearly a "source" from which income might arise within the meaning of s. 3 of the *Income Tax Act*, and, this being so, there is no doubt that the $62,500 paid by the appellant is deductible in computing his 1957 income.

2. That s 3 of the *Income Tax Act* defines "income for a taxation year", to be "income for the year from all sources", which is a single concept. It is not merely the aggregation of one's income from all sources from which there were incomes in the year but it is made up of the gains from all sources minus the losses from these sources or, expressed otherwise, the net income from all sources of income taken together.

3. That the transaction in question was a venture in the nature of trade and therefore a "business" within the statutory definition.

4. That even if the transaction be regarded as a "source" of income that falls outside the statutory definition of business, a loss arising in a subsequent year with respect thereto is deductible.

5. That it would take very clear language to indicate a parliamentary intention to tax gross receipts from "sources" falling outside the classes specifically named in s. 3 of the *Income Tax Act*, rather than "income" in the sense of profit or gain, and, in the absence thereof, s. 12(1)(a) should not be interpreted as altering the general scheme of the Act, in respect of certain sources, and its meaning should not be extended so as to tax gross revenue rather than net profit.
6. That the respondent chose to tax the appellant for the 1951 taxation year on a form of "cash basis" and cannot be heard to refuse to now accept the same basis for determining the profit or loss from the same source for 1957.
7. That the appeal is allowed.

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Noël at Ottawa.

H. H. Stikeman, Q.C. and *P. N. Thorsteinsson* for appellant.

D. S. Maxwell, Q.C. and *D. G. H. Bowman* for respondent.

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

NOËL J. now (March 31, 1965) delivered the following judgment:

This is an appeal from a decision of the Tax Appeal Board[1] confirming the appellant's income tax assessment for the 1957 taxation year. The only question raised by the appeal is whether the appellant was entitled, when computing his income for the year, to deduct an amount of $62,500 paid by him in 1957 to a bank pursuant to an obligation incurred by him in an earlier year (1951) in which he, in effect, guaranteed a loan made by the Bank to a limited company.

The relevant facts are very fully set out in the Reasons for Judgment of the Tax Appeal Board and I shall not review them at length. There is no dispute as to the basic facts. The question to be decided depends upon the proper characterization of certain transactions fully described in the Board's Reasons. In other words, the question is what inferences are to be drawn from the basic facts.

The appellant is a well-known and highly respected practising lawyer in the Province of Alberta who, quite apart from his practice of law, has, on at least one occasion,

[1] 30 Tax A. B. C. 176.

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embarked on a business venture in connection with oil and gas properties resulting in profits upon which he has paid income tax. In my view, neither of these facts is particularly relevant or helpful in determining the issue in this appeal which depends rather upon the proper analysis of an isolated transaction or group of transactions. Indeed the tax consequences would, in my view, be the same regardless of the appellant's profession and, similarly, unrelated ventures in the nature of trade are irrelevant to the particular problem raised by this appeal.

The transaction which gave rise to the disbursement in issue here was a contract between the appellant and one Montague on the one hand and two persons, whose names were Buechner and Yeske, on the other hand. Buechner and Yeske owned all the shares in a company called Locksley Petroleums Ltd., which company was in need of funds. By the contract, which was entered into on February 15, 1951, the appellant and Montague agreed to furnish $125,000 to the company "by endorsing or guaranteeing" the company's promissory notes "at the . . . Bank"; and, as consideration for the money so "furnished", Buechner and Yeske agreed to transfer to the appellant and Montague one-half the shares in the company and certain "royalty interests".

The appellant fulfilled his part of the bargain, by guaranteeing the company's notes at the Bank, and received the promised consideration therefor. The respondent thereupon assessed him for income tax for 1951 upon the value of the property so received (the shares and the royalty interests) which it established at $4,500.

In 1957, the appellant was required to pay to the Bank his share of the loan, which the company could not pay, namely, $62,500.

The respondent now says that that payment is not one that can be taken into account in determining the appellant's income under the *Income Tax Act* for the 1957 taxation year.

The relevant provisions of the *Income Tax Act* are the following:

> 3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all
>
> (a) businesses,

(b) property, and

(c) offices and employments.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

. . .

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,

. . .

139. (1) In this Act

(e) "business" includes a profession, calling trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment;

. . .

(x) "loss" means a loss computed by applying the provisions of this Act respecting computation of income from a business *mutatis mutandis* (but not including in the computation a dividend or part of a dividend the amount whereof would be deductible under section 28 in computing taxable income) minus any amount by which a loss operated to reduce the taxpayer's income from other sources for purpose of income tax for the year in which it was sustained;

In considering whether the amount of $62,500 is deductible in computing the appellant's income for 1957, it is helpful to consider whether the appellant was properly taxed on the amount of the consideration received by the appellant in 1951 and, if so, on what basis he was so taxable.

The Tax Appeal Board, at p. 199, appears to have analyzed the agreement of February 15, 1951, as one for the acquisition by the appellant and Montague of an interest in the Locksley Petroleums Ltd:

The substance of the transaction was the acquisition of shares and a royalty interest in Locksley Petroleums Ltd., and deferring payment therefor...

There is some justification for that view, in that the agreement describes Buechner and Yeske as "the Vendors" and the appellant and Montague as "the Purchasers". It would then appear to me that if that is the correct characterization of the transaction, the respondent was wrong in taxing the appellant on the value of the property so acquired in 1951 and the Tax Appeal Board is now correct in holding that the

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$62,500 is not deductible in computing the appellant's income for 1957.

I do not believe, however, that the above is a correct appraisal of the agreement of February 15, 1951. By its terms, that agreement is, in substance, one whereby the appellant and Montague agreed to guarantee the company's loans from the Bank and, in consideration therefor, Buechner and Yeske agreed to transfer certain property to them. In other words, the appellant received the property from Buechner and Yeske as consideration for pledging his credit for the company. On that view of the character of the agreement, the appellant was properly taxed on the value of the property received by him in 1951 and this would be in conformity with the decision in *Ryall v. Hoare* and *v. Honeywill*[1] where two gentlemen who were directors of a company and who received a commission for guaranteeing the company's overdraft with a bank were held liable to be assessed to income tax in respect of those commissions.

It is clear that this was a business transaction pursuant to which the appellant received a payment for doing certain things. Now, whether such a transaction is a venture in the nature of trade so as to be a "business" within the statutory definition or cannot be so regarded, it is clearly, in my view, a "source" from which income may arise within the meaning of section 3 of the *Income Tax Act*.

Once it is accepted that the transaction in question is a "source" from which income may arise, there is no doubt in my mind that the $62,500 is deductible in computing the appellant's 1957 income. Section 3 of the *Income Tax Act* defines "income for a taxation year" to be "income for the year from all sources" which is a single concept. It is not merely the aggregation of one's incomes from all sources from which there were incomes in the year but it is made up of the gains from all sources minus the losses from these sources or, expressed otherwise, the net income from all sources of income taken together. Support for such a view can be found in section 139 (1)(*x*) of the Act referred to above which also confirms that this is the proper meaning of income for a taxation year when it states that:

[1] (1923) 8 T.C. 521.

> (*x*) "loss" means a loss computed by applying the provisions of this Act respecting computation of income from a business *mutatis mutandis* ... minus any amount by which a loss operated to reduce the taxpayer's income from *other sources* for purpose of income tax for the year in which it was sustained. (the emphasis is mine)

There is however still further confirmation of this in the very history of the legislation which dealt with this matter prior to the year 1952 when section 13 of chapter 52 of 1948 would have operated to prevent such a loss from reducing the appellant's income below his income from "his chief source of income". This rule however was abrogated by section 4 of chapter 29 of 1952, and the enactment and its repeal would now clearly indicate that losses from one source are otherwise deductible in computing income from all sources.

It therefore follows that as the 1951 arrangements are a "source" within the meaning of that word in section 3, the loss arising from that source in 1957 must be taken into account in determining the appellant's income from all sources in 1957.

Counsel for the respondent, however, argues that section 12 (1) (*a*) operates to prohibit the deduction of the $62,500 because it is an outlay or expense that was not incurred for the gaining or producing of income "from property or a business". The argument is that under the authority of *Ryall v. Hoare, supra,* the consideration that was received by the appellant was for an isolated service, that the expenditure of $62,500 was not therefore an expenditure in relation to a "business" and that its deduction is therefore prohibited by section 12 (1) (*a*). There are, I believe, two answers to this.

In the first place, in my view, the transaction in question is a venture in the nature of trade and therefore a "business" within the statutory definition. There is indeed no doubt that if the appellant kept an office and employed a staff on a permanent basis for the purpose of entering into transactions whereby he pledged his credit for a consideration, he would be carrying on a business or at least some sort of an undertaking as comprised in the word business under the definition of same under the Act. If that is so, then an isolated transaction of that kind is a venture in the nature of trade, or should be regarded as a business for the purposes of the *Income Tax Act* and the following two cases are

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sufficient authority for this view: *Barry v. Cordy*[1] and *Drumheller v. Minister of National Revenue*[2] per Thurlow J. at pp. 286-7.

However, even if the transaction be regarded as a "source" that falls outside the statutory definition of business, I am of the view that a loss arising in a subsequent year is deductible. Section 3 defines income for a taxation year as being "income . . . from all sources" for the year, which concept necessarily involves the setting off of losses from income sources for the year. Had the necessity of paying the $62,500 arisen in 1951, it would have been quite clear that there was no income from the transaction but rather a loss and it would seem to me that the effect of the payment can be no different when the necessity for the payment arose in a later year.

The obvious purpose of section 12 (1)(*a*) is to prohibit the deduction of an outlay or expense, in computing income from property or a business "except to the extent that it was made or incurred . . . for the purpose of gaining or producing income from property or a business". Now while the language of the provision, read literally, might be taken to prohibit the deduction of any outlay or expense involved in earning income from a "source" that falls outside the classes of sources of income specifically named in section 3 (i.e., businesses, property, and offices or employments), it would take very clear language to indicate a parliamentary intention to tax the gross receipts from such sources (if there be any such sources) rather than "income" in the sense of profit or gain. Such a parliamentary intention is clearly indicated, subject to many exceptions, in relation to income from an office or employment, by the words "but without any other deduction whatsoever" at the end of section 5. However, in the absence of any such clear indication with regard to sources that fall outside the classes of sources specifically named in section 3, section 12 (1)(*a*) should not be interpreted as altering the general scheme of the Act, in respect of certain sources, and its meaning should not be extended so as to tax gross revenue rather than net profit.

[1] [1946] 2 All E.R. 396. [2] [1959] Ex. C.R. 281.

In *Gresham Life Assurance Society v. Styles*[1], Lord Halsbury, at p. 315, stated clearly the underlying scheme of any taxation statute as follows:

> The thing to be taxed is the amount of profits and gains. The word "profits" I think is to be understood in its natural and proper sense—in a sense which no commercial man would misunderstand. But when once an individual or a company has in that proper sense ascertained what are the profits of his business or his trade, the destination of those profits, or the charge which has been made on those profits by previous agreement or otherwise, is perfectly immaterial. The tax is payable upon the profits realized, and the meaning to my mind is rendered plain by the words "payable *out* of profits".
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> It would be an extraordinary thing to suggest that where a business consists of granting annuities it is to be taxed upon a different principle from any other commercial concern, and no one I suppose could doubt that in any other commercial concern the cost of the thing sold to the trader is one of the expenses incident to the carrying on of the trade.
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> If an annuity seller is to be treated differently from a seller of any ordinary article of commerce—coals or corn or the like—one would have expected to find some words in the statute rendering him obnoxious to a different system of taxation and enforcing a different mode of ascertaining profits, whereas it seems to me that the application of the general words "profits and gains" or "balance of profits and gains" are equally applicable whatever the commercial concern carried on may be.

At p. 316, Lord Halsbury further stated:

> Profits and gains must be ascertained on ordinary principles of commercial trading, and I cannot think that the framers of the Act could be guilty of such confusion of thought as to assume that the cost of the article sold to the trader which he in turn makes his profit by selling was not to be taken into account before you arrived at what was intended to be the taxable profit.

In the same case, with regard to this matter, Lord Herschell, at pp. 321 and 322, stated:

> It cannot, of course, be denied that, as a matter of business, profits are ascertained by setting against the income earned the cost of earning it; nor that, as a general rule, for the purpose of assessment to the income-tax, profits are to be ascertained in the same way. "Money wholly and exclusively laid out or expended for the purposes of a trade, manufacture, adventure, or concern" may, by the first of the "rules applying to both the preceding cases", be taken into account in estimating the balance of profits or gains to be charged. It seems to me beyond question that the payments made by the society to its annuitants are within these words. And those carrying on the business of selling annuities would be assessed on quite a different principle to those carrying on other businesses if their gross receipts were to be treated as profits without regard to the payments to which, in consideration of those receipts, they had bound themselves.

[1] [1892] A.C. 309.

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Finally, I should refer to the suggestion by counsel for the respondent that the appellant was entitled, if he had sought it, to set off against the $4,500 receipt in 1951 the value of the guarantee liability as of that time, and that that is the only relief to which he might have been entitled in respect of that liability. I cannot accept that suggestion.

When two businessmen enter into a contract negotiated at arm's length, there is an exchange of rights or obligations which, having regard to the arm's length nature of the transaction, are, *prima facie*, of equal value. If I pay $X in the open market for a parcel of land, that is evidence that that parcel of land is worth $X. There can never be a profit or loss on a mere purchase or sale. It is only when a person whose business is to buy and sell buys for $X and re-sells for more or less than $X, that, as a matter of business, he makes a gain or a loss. That is why, in an ordinary trading business, profit for a year is estimated by the ordinary formula involving proceeds of sales during the year, acquisitions during the year and inventories at the beginning and end of the year. cf. *Minister of National Revenue v. Irwin*[1]. That formula is designed to determine the profit made on all sales completed during the year.

If the problem were merely one of determining the profit from the whole life span of a business undertaking or other source of income, it would be relatively simple. When the undertaking or other source comes to an end, you add up all the receipts therefrom and deduct all the expenses thereof and the balance is the profit or loss. Under the *Income Tax Act*, it is not so simple because you must determine the taxpayer's profit from a source for each taxation year. This raises problems of allocation as between various years where the life of the undertaking or other source extends over more than one year. These problems have been solved for the most part in the case of businesses and other sources that fall into common categories. The solutions adopted, however, vary greatly even within the same categories. It may well be acceptable to adopt a "cash basis"—i.e., taking into account for each year any cash receipts and cash expendi-

[1] [1964] S.C.R. 662.

tures in the year—for one business and equally acceptable to adopt, for a very similar business, some quite sophisticated so-called "accrual basis".

In *Sun Insurance Office v. Clark*[1], Earl Loreburn, dealing with the case of an insurance company that, each year, had to make allowances for unexpired risks on policies outstanding at the end of the year, stated at pp. 450 and 451:

> If it were practicable the accurate way, I suppose, would be to add together the premiums which the company became entitled to receive in each year, say 1903, upon contracts made in that year, and then to add up the losses which the company became bound to pay upon those contracts made in the year 1903. The difference between these two sum totals would shew precisely what the gain of the company or their loss in respect of the contracts made in the year 1903.
>
> But this is impracticable because contracts of fire insurance are made all through the year, from January 1 to December 31, and most of them, or at all events many of them, are made to cover fire risks for a year, some, we are told, for five or six or seven years, from the date of their making. The premium is paid in advance. So the result in the way of gain or loss could not be ascertained as a fact until after the period of time had elapsed. Now the tax collector cannot be asked under the Income Tax Acts to wait till the end of that period.
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> Thus it appears that you cannot base the assessment of income tax upon the actual facts of the business done and the actual pecuniary results of it in the case of fire insurance companies who take single premiums to cover risks for a year or for more years. This is such a company, and I believe nearly all companies are in the same position.
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> If that be so, it follows that in assessing such fire insurance companies you must proceed wholly or in part by estimate.
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> An estimate being necessary and the arriving at it by in some way using averages being a natural and probably inevitable expedient, the law, as it seems to me, cannot lay down any one way of doing this. It is a question of fact and of figures whether what is proposed in each case is fair both to the Crown and to the subject.

In the present case, the respondent chose to tax the appellant for the 1951 taxation year on a form of "cash basis" and cannot, in my view, be heard to refuse to now accept the same basis for determining the profit or loss from the same source for 1957.

It would also appear to me that on the same reasoning, dividends from the company's bankrupt estate received by the appellant since 1957 ($6,119 on December 7, 1959, and $3,200 on February 1, 1961) in respect of the payment to

[1] [1912] A.C. 443.

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the Bank, may be profits from the same source in the years in which they were received. This indeed would seem to be the proper approach when losses from a particular source have been determined on a "cash basis". However, even if some form of "accrual basis" had been adopted, the result would probably be the same with reference to the dividends. Until 1957, when the appellant was required to implement the guarantee by paying $62,500 to the Bank, the appellant had no claim against the company. Once he made that payment to the Bank, he became entitled to have the company reimburse him. Whether or not he would be reimbursed was contingent upon the outcome of the winding up of the insolvent company.

This right to a contingent dividend or dividend is comparable to the contingent right that was the subject-matter of the decision of the House of Lords in *John Cronk & Sons Ltd. v. Harrison (H. M. Inspector of Taxes)*[1] where it was held that the contingent claims dealt with therein (i.e., guarantees given by builders to a building society for sums advanced to purchasers) should be brought in at actual value and not at face value, when they arose, but that in the event of a valuation being impracticable they shall not be treated as receipts of the business except insofar as they are actually received during the particular trading period.

The appeal is allowed with costs and the assessment is referred back to the Minister for adjustment of the figures consequential upon permitting a set-off of the loss of $62,-500 against the appellant's income from other sources for the 1957 taxation year.

[1] 20 T.C. 612 and 613.