1964
Sept. 17
1965
Jan. 13

BETWEEN:

HARRY TOPPER ..... APPELLANT;

AND

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

Revenue—Income—Income tax—Deductibility of interest paid on money borrowed by taxpayer and lent to a limited company—Participation of taxpayer, through borrowed funds, in furtherance of real estate project —Income Tax Act, R.S.C. 1952, c 148, ss. 11(1)(c) and 12(1)(a)

This is an appeal by the taxpayer from his reassessment for income tax for the taxation years 1954 to 1957 inclusive. The appellant, a resident of Toronto, Ontario and a fur dresser and presser by trade, formed with others in 1953 an investment company called Forest Hill Building Limited and, as a condition of acquiring a one-third interest in the common shares of the Company, he was required to lend certain sums of money to the Company for the purpose of financing construction of a proposed building On five occasions between July 1954 and February 1955 the appellant borrowed a total of $59,000 from his bank and immediately re-lent it to the Company. The appellant and the others associated with him in Forest Hill Building Limited were also associated in a like manner with respect to a similar company, 124 Richmond West Limited, incorporated in 1956, in which share participation was likewise conditional on the appellant lending certain sums of money to the Company Although the appellant had also borrowed money at interest to lend to 124 Richmond West Limited, the Company at no time paid him any interest on the loans and yet there was a profit distributed to the shareholders on its liquidation

For the taxation years under review the appellant had claimed as a deduction in calculating his taxable income the interest he had paid in each of the years to the bank for the said sum of $59,000 he had borrowed and lent to Forest Hill Building Limited and on which he had received no interest from the Company.

Forest Hill Building Limited, in 1961, nearly a year after notices of reassessment of the appellant's income had been delivered, authorized payment of interest at the bank rate on the loans made to it by the appellant and others and this was at least six years after the loans were made, the payments being made retroactive to the dates of the loans.

Held: That the appellant's acquiescence in not receiving any interest on the money borrowed by him from the bank at interest for more than six years and then receiving interest from the Company only at the rate he was required to pay to the bank effectively disposes of his allegation that he had lent the money to the Company in the hope and expectation of receiving interest on the loans when the Company was in a position to pay interest out of revenue.

2 That if the urge for dividends really prompted the appellant to borrow money at interest and lend it to the Company, as alleged by him, the financial forbearance of the appellant for nearly a decade appears to be more consonant with an outright participation, through borrowed funds, in the furtherance of the real estate projects.

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3. That the enabling condition for availing oneself of the exception set out in s. 12(1)(*a*) of the *Income Tax Act* is that the "outlay or expense" be invested directly in the taxpayer's personal trade, business or calling, and not fused with the funds or working capital of a distinct legal body.

4. That the appeal is dismissed.

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Dumoulin at Toronto.

Wolfe D. Goodman for appellant.

S. Silver and *D. G. H. Bowman* for respondent.

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

DUMOULIN J. now (January 13, 1965) delivered the following judgment:

This is an appeal from a decision of the Tax Appeal Board, dated June 28, 1963, respecting the income tax assessments of the appellant for taxation years 1954, 1955, 1956 and 1957.

Harry Topper, of the City of Toronto, pursues the trade of fur dresser and presser. In the statement of facts introductory of his appeal, at paragraph 1, he states that:

1. During the year 1953, the Appellant and others formed an investment company, Forest Hill Building Limited, herein called "the Company". As a condition of acquiring a one-third interest in the common shares of the Company, the Appellant was required to lend certain sums to the Company for purposes of financing construction of a proposed building.

In order to clarify the ratio linking loans and shares, Harry Topper testified to a respective proportion of forty percent of the funds advanced and one third of the shares issued; (loans, 40%; shares, 33%).

On five occasions, spreading between July 28, 1954, and February 23, 1955, the appellant borrowed a total of $59,000 from the Toronto Dominion Bank "and immediately re-lent the said sums to Forest Hill Building Limited" (statement of facts, para. 2).

It should be noted that according to the evidence adduced by one Steven Polon, erstwhile President of the now defunct real estate enterprise whose corporate style was "124 Richmond West Limited", this company stood as a twin

venture to Forest Hill, both firms proposing to erect buildings in Toronto for investment purposes.

Polon also identified "the shareholders...beneficially interested in each of these companies as the Topper group, the Tannenbaum group and my own group", the former of the three consisting of "Victor and Harry Topper" and Mrs. Florence Topper, the latter's wife. (cf. transcript, at pages 9 and 10).

Mrs. Florence Topper is not a party to this case, but a son, Victor Topper, also lodged, simultaneously with his father, appeal no. A-1620 of this Court's records for 1963; both issues being heard jointly, on similar facts and points of law, the sole difference relating to dates, amounts of money lent and bank interest paid.

Resuming the thread of the instant suit, Harry Topper's payments in respect of bank interest for the taxation period 1954 to 1957 inclusive reached a total of $5,279.17.

As for the two companies, one, 124 Richmond West Ltd., now wound-up, obtained its incorporation January 8, 1956, the other, Forest Hill Building Ltd., December 28, 1953 (cf. transcript, pages 9 and 10).

The crucial explanations of the joint schemes are vouchsafed in paragraphs 1 and 2 of Part B of the appeal and may be summarized thus:

1 the monies borrowed from the Toronto-Dominion Bank were expected to produce income in the form of interest at six per cent per annum to be received from the two companies.

2. the loans to Forest Hill Building Limited and 124 Richmond West were a condition precedent to the acquisition of shares, which in turn would earn income "in the form of company dividends".

To these averments, the respondent, striking at the root of the matter, counters concisely that "...if the appellant did pay interest to a bank in the years in question, he was not entitled to deduct any such interest...as (it) was not interest on borrowed money used for the purposes of earning income within the meaning of paragraph (c) of subsection (1) of section 11 of the *Income Tax Act* (Reply to Notice of Appeal, para. 6).

Written briefs were filed by the litigants elaborating at greater length their contending viewpoints.

Counsel for the appellant, in the closing lines of his memorandum, submits this two fold conclusion:

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17 (a) . . . the evidence clearly indicates that the monies borrowed by the Messrs Topper from their bank were relent by them to Forest Hill Building Limited and 124 Richmond West Limited in the hope and expectation of receiving interest on these loans when these companies were in a position to pay interest out of revenues, and,

(b) that, in any event, even if the monies which they borrowed from the bank were relent to these companies without any hope or expectation of receiving interest on these loans (which is not admitted but expressly denied), the monies were nevertheless relent in the expectation that by doing so the Messrs. Topper would be enabled to earn dividends on their shares in these companies, and that, in either event, the Messrs Topper are entitled to deduct the Bank interest which they paid as "interest on borrowed money used for the purpose of earning income . . from property", under section 11(1)(c) of the Income Tax Act.

The course of my review will be set along those lines, whose factual and legal appropriateness I shall attempt to probe.

The oral evidence indisputably established, in relation to the purported interest incentive, a sequence of rather untoward incidents. To begin with, it must be pointed out that Steven Polon, former President of 124 Richmond West Ltd., still is Secretary of Forest Hill Building. This executive's cross-examination on the interest topic is quite revealing, as the undergoing excerpts may prove. Mr. S. Silver, for respondent, is the examining counsel:

Q Mr Polon, my question was whether the company itself was a party to these arrangements (i.e. future payment of interest on eventual loans) at the time they were made?

A At the time they were made, there was no company

Q Forest Hill Building Limited wasn't in existence at the time?

A No

Q So, in fact, the company didn't agree to pay interest on these loans? That must follow, mustn't it?

A Yes, but the principals, of course, agreed and whatever the principals agreed to do naturally would necessarily follow (transcript, pp 28, 29, lines 23 to 33 and 2 to 6).

Nonetheless, this asserted effect did not trigger so instantaneous a "follow-up" on the part of the executive boards, chosen after both incorporations, of which Harry Topper was not a member.

Mr. Polon has this to say in the matter of 124 Richmond West Ltd.:

Q Was interest, in fact, ever paid by 124 Richmond West Limited?

A No, it wasn't (Transcript, p 25, lines 31 to 33 and repeated on p 32, lines 7 to 9)

This omission is all the harder to explain when coupled with a surplus bearing liquidation as told by Mr. Polon in these words:

After the property (owned by 124 Richmond West Ltd) was sold there was somewhat of a profit which was distributed in accordance with our arrangements and the company was wound up, actually, because it was a single purpose thing. (Transcript, page 26, lines 24-29).

I would subscribe to the respondent's apt comment recorded on pages 7 and 8 of his brief, from which I quote:

It is submitted that nothing could be a clearer indication that the parties to these loan transactions never contemplated the payment of interest Had the purpose of these loans been to earn income in the form of interest, it is submitted that they would have insisted on the payment of interest in priority to the distribution of profits. Their failure to do so and their acceptance of the presumably tax free capital gains distributed to them on the winding-up of the company confirm the Respondent's submission that the receipt of interest was not their purpose in making the loans

The twin venture, Forest Hill Building Limited, offers a somewhat different picture, but this could well be in appearance only. Harry Topper does not dispute the suggestion of respondent's counsel "that Forest Hill Building never set up an amount on its balance sheet or in its financial statement for the relevant years to indicate that it owed you interest."

On May 26, 1961, (cf. ex. A-2) a directors' meeting passed a resolution enacting that "...the Company (Forest Hill Building Ltd.) do pay interest at the rate of 6% per annum to those shareholders having made advances to the Company on the amounts so advanced, such interest to be calculated from the date the said advances were made."

It should not be overlooked, however, that this rather belated decision was arrived at nearly seven years after the initial advance, of July 28, 1954, and more than six years after the last loan, on February 23, 1955.

Did the departmental re-assessments, dated July 28, 1960, spur a failing intention, or possibly suggest a previously forgotten initiative? All such surmises may be entertained without, I trust, denoting an unduly skeptical mind.

A last link in this circumstantial chain seems no less intriguing. Exhibit A-2, the May 26, 1961, resolution authorizing eventual interest payment at a rate of six per cent, corresponds to a nicety with that due to the lending bank as Harry Topper readily admits. I quote from page 52 of the evidence, lines 9 to 28; Mr. Silver is cross-examining:

Q. Now, Mr. Polon had said that the interest was to be at the bank rate?

A Yes.

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Q. Would it be fair to say, Mr. Topper, that . . . the reason you set the rate of 6% was because you were merely trying to recover or recoup the interest you had paid to the bank?

A. This is about the case. I had paid around 6% to the bank.

And six lines below this witness agrees he was not particularly trying to make a profit "on the interest".

No better justification than the appellant's own acquiescence is required to waive aside the first of the appeal's two submissions, and hold that earning of interest on loans was not a prompting motive.

But, had it been a proven incentive, the appellant's claim would not derive therefrom any firmer support.

The Supreme Court of Canada dealt with a problem of this kind *in re: Canada Safeway Ltd. v. M.N.R.*[1]. One of the issues concerned the deductibility of interest accruing from bonds issued by the appellant for the taking over from the holding company of a subsidiary enterprise. Speaking for the majority of the Court, Honourable Mr. Justice Rand expressed himself as follows:

> It is important to remember that in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense. If a company has not the money capital to commence business, why should it be allowed to deduct the interest on borrowed money? The company setting up with its own contributed capital would, on such a principle, be entitled to interest on its capital before taxable income was reached, but the income statutes give no countenance to such a deduction . . . *What is aimed at by the section is an employment of the borrowed funds immediately within the company's business and not one that effects its purpose in such an indirect and remote manner.* (emphasis added).

The mere substitution of an individual, namely, Harry Topper, to the company in the precedent above, renders it fully applicable here.

Very few lines need be written to dispose of Harry Toppers' alternate submission (equally true in the case of Victor Topper) that the borrowed funds served the purpose of earning income in the form of dividends, periodically produced by company shares.

Once more, unrebutted facts run counter to this contention.

When the loans were extended to Forest Hill Building Ltd., the ultimate date being February 23, 1955, Harry Topper did not own one share of that company's capital

[1] [1957] S.C.R. 717 at 727.

stock, and neither he nor his son, Victor, became shareholders until their allotment, of 33 shares each, on June 17, 1956 (cf. ex. R-2, R-3, R-4).

Next, none of the two enterprises, neither Forest Hill Building nor 124 Richmond West Ltd., had, as yet, paid a dollar in dividend when Harry Topper gave evidence before this court, September 17, 1964, as appears in the transcript (page 53, lines 27 to 33):

> Q. (By Mr. Silver) You never received a dividend from either Forest Hill Building Limited or 124 Richmond?
>
> A. Not yet. The company isn't in a position to do it yet.

If an urge for dividends really prompted this deal, the taxpayer's patience must have been sorely tried after close to a decade of negative results. Such financial forebearance might appear more consonant with an outright participation, through borrowed funds, *in the furtherance* of two real estate projects.

At all events, a pertinent section, possibly more so than 11(1)(*c*), is, I believe, section 12, s-s (1)(*a*) prescribing that:

> 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.* (italics not in text).

The enabling condition for availing oneself of the exception is that the "outlay or expense" be invested directly in the taxpayer's personal trade, business or calling, and not fused with the funds or working capital of a distinct legal body.

It is, I know, poor taste to presume quoting one's decisions; yet, since the parties at bar referred to a pronouncement of mine, I venture to take the liberty of so doing to emphasize the opinion just expressed.

In the matter of *Meyer Shuchat v. M.N.R.*[1] "the appellant borrowed money from the bank and reloaned it, interest free, to a company, S. & G. Furs, Inc., of which he was the controlling shareholder. He sought to deduct the interest paid to the bank in computing his personal income." (cf. Respondent's brief, page 14). The Court held that:

> S. & G. Furs, Inc, is a company duly endowed with its own legal entity, completely separate from that of the appellant, and, therefore, had

[1] [1963] C.T.C. 481 at 483.

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no financial connection whatever in law with Shuchat's personal income. If this assumption is exact, the money appellant borrowed from Canada Trust Company and subsequently passed on to S. & G. Furs, Inc, was not used for the purposes of earning his own personal income.

I can perceive of no significant differences between these two cases.

For these reasons, the appeal is dismissed with costs.

Judgment accordingly.