BETWEEN:

PALMER-McLELLAN (UNITED) LTD. ..APPELLANT;

AND

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

Ottawa 1968
Sept. 26
Oct. 11

Income tax—Interest on bonds—Deductibility—Amalgamated company—Bonds used by one predecessor to acquire capital stock of other predecessor—Income Tax Act, secs. 11(1)(c), 85i(2).

In December 1958 *O U* Co acquired all the issued capital stock of *S* Co for $110,000, which sum had been obtained from the sale of *O U* Co bonds, plus the delivery of other *O U* Co bonds to the value of $100,000. The *O U* Co and *S* Co were subsequently amalgamated as appellant under the New Brunswick *Companies Act*, *S* Co's capital stock becoming part of appellant's capital stock and appellant being substituted for *O U* Co with respect to the obligations of the latter's bonds.

Held, confirming a 1963 assessment, appellant was not entitled under s. 11(1)(*c*) of the *Income Tax Act* to deduct the interest paid on the bonds in computing its income.

1. Following the formation of appellant the *S* Co shares acquired by *O U* Co (the income from which would be exempt to *O U* Co) disappeared or became the property of *O U* Co shareholders, and the interest thereafter paid by appellant on *O U* Co bonds must continue to be characterized as interest on money used to acquire property the income from which would be exempt. *Canada Safeway Ltd. v. M.N.R.* [1957] S.C.R. 717 applied.

2. The provisions of s. 85i(2), that a corporate entity formed on amalgamation shall be deemed to be a new corporation, etc, do not affect the issue in this case.

3. Since *S* Co's shares disappeared or became the property of *O U* Co shareholders on the amalgamation it could not be said that such property was thereafter used in the amalgamated company's business so as to permit the claimed deduction.

4. Interest paid by appellant was not deductible as a current business expense apart from the provisions of s. 11(1)(*c*).

APPEAL from Tax Appeal Board.

John P. Palmer, Q.C. for appellant.

M. J. Bonner and *M. A. Mogan* for respondent.

THURLOW J.:—This is an appeal from a judgment of the Tax Appeal Board[1] which dismissed the appellant's appeal from an assessment of income tax for the year 1963. The

[1] [1967] Tax A.B.C. 458.

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issue raised is the right of the appellant, in computing its income, to deduct under section 11(1)(*c*) the interest paid by it on two issues of its bonds.

The facts are not in dispute and they were put before the court by an agreed statement signed by counsel for the parties.

The appellant is the corporation resulting from the amalgamation on or about December 31, 1959, under provisions of the New Brunswick *Companies Act*[2] of a company (herein referred to as Old United) of the same name as the appellant and another company named Palmer-McLellan Shoe Company Limited (herein referred to as the Shoe Company). At the time of amalgamation all the issued shares of the Shoe Company were owned by Old United which had acquired them on or about December 30, 1958, for $110,000, which had been raised by the sale of $110,000 of first mortgage bonds of Old United and paid in cash and $100,000 of general mortgage bonds of Old United which had been delivered to the vendors of the shares as part of the consideration therefor. It is agreed that these shares while held by Old United were property the income from which would be exempt within the meaning of sections 11(1)(*c*) and 12(1)(*c*) of the *Income Tax Act*. It would follow from this that the interest paid during the same period by Old United on the two issues of bonds referred to would not be deductible under section 11(1)(*c*) in computing its income.

The amalgamation of the Shoe Company and Old United was effected by an agreement between the companies dated November 23, 1959, which was confirmed under the provisions of the Act by letters patent dated December 22, 1959. Under these documents the capital stock of the appellant was established at the same amount and with the same division into two classes of shares as in the case of Old United and all such capital stock was declared to be issued as fully paid up and to be held by the persons who held shares of Old United, share for share. Both the agreement and the letters patent provided *inter alia* that on amalgamation all the property of the two almalgamating com-

[2] R.S.N.B. 1952, c. 33 as amended by Statutes of New Brunswick 1954, c. 28.

panies should be and become the property of the appellant, that the liabilities of both amalgamating companies should be and become liabilities of the appellant, that the unissued capital stock of the Shoe Company should cease to exist and that its issued capital stock should form part of the no par value common stock of the appellant.

Both documents provided as well that all charges and securities upon the assets of either or both of the amalgamating companies (other than the shares of the Shoe Company) should be unimpaired by the amalgamation and in particular that the securities constituted by the trust deeds given to secure the first mortgage and general mortgage bonds of Old United should continue in full force other than security upon the shares of the Shoe Company and that the amalgamated company should be bound to observe the contents of the said trust deeds and should succeed and be substituted for Old United under the said trust deeds with the same effect as if the appellant had been named therein as the party thereto.

Under section 30A of the *Companies Act* it is provided that upon the adoption of an amalgamation agreement in accordance with the provisions of the Act the amalgamating companies may apply to the Provincial Secretary Treasurer for letters patent confirming the agreement and amalgamating the companies so applying, and the statute goes on to declare that:

> ... on and from the date of the letters patent such companies are amalgamated and are continued as one company by the name in the letters patent provided, and the amalgamated company possesses all the property, rights, privileges and franchises and is subject to all liabilities, contracts, disabilities and debts of each of the amalgamating companies.

Following the amalgamation the appellant continued the business of both companies using therein the assets of both. In computing its income for the years 1960, 1961 and 1962 in all of which business losses were sustained, as well as for the year 1963, when a profit was realized, the appellant sought to deduct the interest on both issues of bonds of Old United but the Minister in making the assessment under appeal disallowed all such deductions.

With respect to the deductibility of interest on capital indebtedness in computing income for tax purposes Rand,

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J., in *Canada Safeway Ltd. v. Minister of National Revenue*[3] referring first to the *Income War Tax Act* and later to the *Income Tax Act* said at page 727:

> 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. To extend the statutory deduction in the converse case would add to the anomaly and open the way for borrowed capital to become involved in a complication of remote effects that cannot be considered as having been contemplated by Parliament. 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.

The claim made on the 1949 assessment results from the modification of provisions as they appear in the *Income Tax Act* which in that year superseded the *Income War Tax Act*. Section 11(1)(*c*)(i) and (ii), as re-enacted by 1950, c. 40, s. 5, are the pertinent paragraphs and they are as follows:

> 11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:
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> * * *
>
> (*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on
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> (i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or
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> (ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),
>
> or a reasonable amount in respect thereof, whichever is the lesser.

The language in (i) "used for the purpose of earning income from a business" corresponds with that of s. 5(1)(*b*) of the repealed Act and to what has been said on the latter there is nothing to be added: the business of the subsidiary is not that of the company.

The word "property" is introduced in paras. (i) and (ii) but I cannot see that it can help the appellant; the language

> borrowed money used for the purpose of earning income from ... property (other than property the income from which is exempt)

[3] [1957] S.C.R. 717.

in (i) means the income produced by the exploitation of the property itself. There is nothing in this language to extend the application to an acquisition of "power" annexed to stock, and to the indirect and remote effects upon the company of action taken in the course of business of the subsidiary.

In para. (ii), which contemplates an unpaid purchase price rather than a mortgage, where the "property" acquired is stock, so far as the income is the dividends received, the deduction is excluded by the last clause in brackets, and the effect of a collateral benefit has been dealt with. If the purpose is of gaining or producing income from a business, the language is limited to the business in which the property purchased is employed: beyond that, the question is the same as for the previous years.

The wording of section 11(1)(*c*) was amended by Statutes of Canada 1953-54, c. 57, section 21, to read:

> 11 (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:
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> . . .
>
> (*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property (other than *borrowed money used to acquire* property the income from which would be exempt), or
>
> (ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),
>
> or a reasonable amount in respect thereof, whichever is the lesser;

In seeking to apply section 11(1)(*c*) and the principles enunciated by Mr. Justice Rand to the present situation it is, I think, necessary to bear in mind that both the money borrowed by Old United on its first mortgage bonds and its general mortgage bonds themselves had been used to acquire property, that is to say, shares of the capital stock of the Shoe Company, and that Old United had held those shares, presumably for the purpose of gaining income therefrom, up to the time of the amalgamation. The conditions of section 11(1)(*c*) for deduction of the interest on the bonds would thus have been present had it not been for the fact that the shares were property the income from which would have been exempt and thus fell within the exception.

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But while this was the situation up to the moment of the amalgamation and though the precise effect of the amalgamation on the capital stock of the amalgamating companies, and in particular that of the Shoe Company, is not as clear as it might be, it is I think apparent that from the moment of the amalgamation the appellant, while saddled with liability for payment of both issues of the bonds of Old United, had no asset representing the capital stock of the Shoe Company. This appears to me to be so either because the capital stock of the Shoe Company had disappeared in the amalgamation or because it had in fact, as the amalgamation agreement and the letters patent provided, become part of the Class B stock of the appellant and had been treated as issued to the shareholders of Old United, share for share, and on a fully paid up basis.

The appellant from the moment of the amalgamation did have the assets of the Shoe Company but these assets were not what the money borrowed by Old United on its first mortgage bonds and its general mortgage bonds had been used to purchase and I do not see any way in which these assets can even be regarded as having been acquired in exchange for the shares. The shares went, if anywhere, to the shareholders of Old United. The assets of the Shoe Company went nowhere. They simply became part of the property of the amalgamated company of which the Shoe Company itself was a continuing element just as Old United as well was a continuing element.

Nor, on reflection, do I think the assets of the Shoe Company can be regarded as representing the capital stock of that company formerly held by Old United. Those assets, as I view the matter, became property of the appellant by virtue of the amalgamation procedure and not, in any legal sense, by reason of Old United's ownership of or its giving up of the shares.

It appears to me to follow from this that on the basis of the nature of the amalgamated company as a continuation as one company of both amalgamating companies, as contemplated by the *Companies Act*, there is no basis for the deduction under section 11(1)(*c*) of the interest paid by the appellant on the bonds issued by Old United, not, as I see it, because the property acquired through their issue, that is to say, the shares of the Shoe Company were prop-

erty the income from which would, while they were held by Old United, be exempt or because such shares were not acquired for the purpose of gaining income from such property but because the amalgamated company from the time of its inception never held such shares or anything representing them from which to gain or produce income, whether exempt or not exempt, and from the point of view of the appellant in any subsequent taxation year there is thus nothing upon which to characterize the use to which the borrowed money and bonds were put as anything but what it was originally, that is to say, use to acquire property the income from which would be exempt.

The appellant's case, however, was not founded solely on section 11(1)(*c*) and the application of it to the actual facts. Its counsel relied as well for the application of section 11(1)(*c*) on section 85I(2)(*a*) and the inference of a fictitious acquisition by the appellant of property upon condition that the appellant discharge liabilities secured thereby. Such an inference, in his submission, was necessarily to be implied from the provision of section 85I(2)(*a*)[4] that the appellant be deemed, for the purposes of the Act, to be a new corporation. He went on to contend, that the appellant's liability for the payment of interest on the two series of bonds issued by Old United was thus distinct from the liability of Old United therefor (which was a liability incurred to acquire shares of the Shoe Company) and was a liability incurred by the appellant to acquire the property by which the bonds were secured and therefore fell within section 11(1)(*c*)(ii) as an "amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from (the appellant's) business" . . .

In the view I take it is unnecessary to reach a conclusion as to what would follow from the inference of a fictitious

[4] Sec. 85I(2) Where there has been an amalgamation of two or more corporations the following rules apply:

(*a*) for the purposes of this Act, the corporate entity formed as a result of the amalgamation shall be deemed to be a new corporation the first taxation year of which shall be deemed to have commenced at the time of the amalgamation, and a taxation year of a predecessor corporation that would otherwise have ended after the amalgamation shall be deemed to have ended immediately before the amalgamation;

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acquisition by the appellant of assets subject to payment of liabilities secured thereby since I do not find in section 851 any sufficient warrant or basis for the suggested inference.

Accepting that the statute requires that the appellant be treated as a new corporation for the purposes of the *Income Tax Act* such purposes, so far as relevant, are, as I see it, the measuring of its income for prescribed periods of time, including the determination of deductions to which it may be entitled, and the computation of its liability for tax. These purposes do not seem to me to require any inference to be made as to how the new corporation came into possession of whatever assets it had at the commencement of its fictitious existence. It is to be treated as a new corporation for the purposes I have mentioned but, as I see it, it is not to be treated as a new corporation for any other purposes and I see in section 851 no basis for treating the assets of such a corporation as having been acquired in any other manner than that in which they were in fact acquired, that is to say, the manner in which they were acquired by the amalgamating corporations.

The new company contemplated by section 851 simply starts off with certain assets and certain liabilities, that is to say, the assets and liabilities of the amalgamating companies. With respect to such assets and liabilities nothing further is, as I see it, required for the purposes of the *Income Tax Act*; and if for the purpose of characterizing some items of assets or of liability it becomes necessary to know its history that history, as I see it, is nought but its actual history. There is no need to take the further step of assuming some fictitious transaction or event conferring the asset on the fictitious new company or visiting it with the liability.

If, for example, one of the amalgamating companies had used borrowed money or given bonds to acquire a mine, the income from which was exempt for the first three years of operation, I should not have thought it necessary to infer either an acquisition of the mine or an undertaking of liability for the borrowed money or bonds to render the interest therein deductible by the amalgamated company after the expiry of the period of exemption.

Nor do I find in paragraphs (*b*) to (*n*) of section 851(2), which prescribes rules relating to a variety of subjects

bearing on the computation of the income of an amalgamated corporation, anything which appears to me to conflict with this interpretation of section 85I(2)(*a*) or to render it necessary to draw the suggested inference. Indeed the fact that the legislature specifically provided for certain fictitious assumptions to be made tends to confirm that others not provided for are not to be made.

As an alternative submission the appellant also contended, also on the basis of the appellant being a new corporation distinct from the two amalgamating corporations, that for the purpose of determining deductibility of interest under section 11(1)(*c*) regard must be had to the use made of the borrowed money in the taxation year under consideration, that in the years under review the money represented by the bond issues of Old United was not invested in property the income from which would be exempt but was invested in the business of the appellant and the interest was therefore deductible.

With respect to the first mortgage bonds there is, as I see it, no basis for saying the money borrowed by Old United was used in the appellant's business or to gain income from its property during the years under review. It had in fact been used to purchase shares, which in the amalgamation either disappeared or became the property of the shareholders of Old United. And though the shareholders, as I see it, were no richer as a result, I do not see by what route it can be said to follow that the borrowed money which had been so used was in the years under review used to earn income from the appellant's business or property.

The situation is similar with respect to the interest on the general mortgage bonds of Old United. These bonds were given to acquire the same property (i.e., shares of Old United) which, in the amalgamation, either disappeared or became the property of the shareholders of Old United. One therefore is left to wonder what property used by the appellant to earn income from its business or property in the years under review was acquired for the amount owed on the bonds and again I can see no way in which any property which it had during those years can be regarded as having been acquired either for the amount due on the bonds or for anything acquired by Old United therefor.

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The submission in my opinion therefore fails.

Finally it was urged that since there is no definition of "profit" in the *Income Tax Act* and profits are thus left to be computed "on the basis of generally accepted accounting practice and long-established principles", the interest on the indebtedness here in question—being an annual recurring payment for the use of money invested in the appellant's business—was not a payment on account of capital within the prohibition of section 12(1)(*b*) and was within the exception of section 12(1)(*a*) since the payment of the interest was necessary to forestall foreclosure by the bondholders and consequent termination of the business and was deductible in computing profit on accepted commercial principles.

This argument was admittedly in conflict with the opening sentences which I have quoted from the judgment of Rand J., in *Canada Safeway Ltd. v. Minister of National Revenue (supra)* the correctness of which I have not heretofore known to be challenged and it is, I think, contrary as well to the concept expressed in section 4 of the Act which defines income from a business or property as being, subject to the other provisions of Part 1 of the Act, the profit (not of the taxpayer) but of the business or property for the year. The profit from the business or property initially is thus the same whether the capital invested in it is borrowed capital, on which interest is payable, or not. The right to deduct interest on borrowed capital invested in the business or property when computing income for income tax purposes therefore depends on the deduction falling within the precise limits defined by section 11(1)(*c*).

The appeal will be dismissed with costs.