1947
Apr. 10
Aug. 18

BETWEEN:

BENNETT AND WHITE CONSTRUCTION CO. LTD. .... APPELLANT;

AND

MINISTER OF NATIONAL REVENUE RESPONDENT.

Revenue—Income—Income Tax—Income War Tax Act R.S.C. 1927, c. 97, s. 6(1)(a)—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" —Commissions paid to guarantors of appellant for loans from bank not deductible when company engaged in construction business—Capital or income—Appellant's loans are borrowed capital used in same way as its own capital—Commissions are expenditures incurred in relation to the financing of the business—Commissions are paid in order to borrow additional capital and so are part of financial arrangements of appellant.

Appellant company is engaged in the construction business. From time to time appellant obtained loans from its bank in order to carry on its business operations. The bank required that such loans be guaranteed by directors of appellant. Appellant paid interest to the bank on the advances obtained and also paid to the guarantors by way of commission a sum equal to the interest payments. Appellant sought to deduct from income for the years 1941 and 1942 the amounts paid as commissions. The respondent refused to allow such deductions and appellant appealed to this Court.

Held: That the money borrowed by appellant is not temporary accommodation but is borrowed capital used in the same way as appellant's capital and the commissions are expenditures incurred in relation to the financing of appellant's business and the financial arrangements are quite distinct from the activities by which appellant earns its income and, therefore, are not expenditures incurred in earning the income within s. 6(1)(*a*) of the Act, and consequently are not deductible expenses.

APPEAL under the provisions of the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice O'Connor at Vancouver, B.C.

J. L. Lawrence and *A. W. Mercer* for appellant.

L. St. M. Dumoulin and *W. J. Hulbig* for respondent.

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

O'CONNOR J. now (August 18, 1947) delivered the following judgment:

This is an appeal from the assessments for income and excess profits tax for the taxation years 1941 and 1942.

The Company is engaged in the construction business. In 1935 the Company's bank refused to make advances to it unless one of the directors guaranteed the repayment of such advances. One of the directors then gave the bank the guarantee demanded and the Company paid him for so doing a commission equal to the interest paid by the Company to the bank in the Company's fiscal year.

From 1935 to 1942 the bank refused to make any advances to the Company without a guarantee of one or more of the directors of the Company and the Company adopted that method of financing its business and continued it during the whole of that period. The shareholders of the Company approved this course each year as shown by the Minutes of the annual meetings. The guarantee is on the usual bank form, and provides that it can be terminated at any time but is to remain in full force and effect until terminated. When an amount above the amount of the existing guarantee was required, the existing guarantee was withdrawn and a new guarantee for the larger amount was given.

Since the incorporation of the Company the paid-up capital of the Company was increased and it was also reduced. Preference shares were issued and redeemed and new Preference shares issued.

The Company's business was greatly increased by war contracts in 1941 and 1942 and the borrowings from the bank were substantial. The indebtedness of the Company to the bank fluctuated from day to day. The fluctuations would sometimes be as much as $100,000 to $200,000 either way.

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In 1941 Mrs. Mabel Bennett, J. G. Bennett and A. G. Bennett guaranteed to the bank that they would pay all sums advanced to the Company up to $370,000 with interest at 6 per cent. During that year the Company paid the bank interest in the sum of $20,813 and paid a similar amount to the guarantors. In 1942 the Company paid the same guarantors the sum of $23,455.07 for such guarantee.

The evidence showed that if the Company had been limited to its own capital and had not borrowed from the bank, that it would have only been able to do 25 per cent of the work that was done in each of the years in question. By borrowing the money from the bank it was able to greatly increase the work done each year. The additional work increased the income of the Company. The money borrowed was used in the same way as the capital of the Company was used, i.e., to meet pay rolls and to purchase materials and equipment for the works.

These commissions paid the guarantors were charged as expenses against income in the years 1935 and 1940 and were allowed by the respondent.

The commissions paid the guarantors were charged as expenses against income in the years 1941 and 1942 and were disallowed by the respondent on the grounds that (1) such amounts were not disbursements or expenses wholly necessarily and exclusively laid out or expended for the purpose of earning the income within the meaning of Section 6(1)(*a*) of the Income War Tax Act, and by an amendment at the trial on the further grounds that (2) the amounts paid were outlays or payments on account of capital within the meaning of Section 6(1)(*b*) of the said Act.

So far as relevant to the present purpose Section 6 reads as follows:

> 6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;
>
> (*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence except as otherwise provided in this Act.

The authorities cited by counsel have been referred to and discussed by Romer L.J., p. 16 and by Findlay J.,

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at p. 11 in the case of *European Investment Trust Company Limited* and *Jackson* (1), and by Duff C.J., in *Montreal Light, Heat and Power Consolidated* v. *Minister of National Revenue* (2), and by Lawrence J., in *Ascot Gas Water Heater Limited* v. *Duff* (3).

The effect of all these decisions is that the question in each case is a question of fact.

In addition the decisions clearly differentiate between those companies engaged in financial operations and all others.

In the *Ascot Gas Water Heater case* (*supra*), Lawrence J., held, after reviewing the authorities, that the only true principle was that laid down by Findlay J., in the *European Investment Trust case* (*supra*) at p. 11:

> Now, here it seems to me that the principle may be stated in this way: if you get a company dealing with money, buying or selling stocks or shares, Treasury bills, bonds, all sorts of things, and if you get that company getting, as such companies constantly do get, temporary loans from their bank—accommodation, I suppose, for sometimes twenty-four hours, or even less, sometimes for a good deal longer—if you get that sort of thing, then the interest on that money, the hire, so to speak, paid for that money, may properly be regarded as an expenditure of the business, an outgoing to earn the profits. On the other hand, if the truth of the thing is that by the payment of the interest the Company does not obtain mere temporary accommodation, day to day accommodation of that sort, but does in truth, add to its capital and get sums which are used as capital and nothing else, then I think that in that case all the authorities show that that deduction cannot properly be made.

Lawrence J. points out that in the Court of Appeal nothing appears to have been said about the principle applicable.

The difficulty of drawing a line between capital and revenue expenditures and the reason that no precise rule has been formulated are set out in *Atherton* v. *British Insulated and Helsby Cables Limited* (4), Scrutton L.J.:

> Obviously a case which may result in a definition by this Court of the line between capital and revenue expenditure must require very careful consideration by this Court, and the first thing that it must do is to bear in mind the warning of Lord Macnaghten in *Dovey* v. *Cory,* (1901) A.C. 477, at page 488: "I do not think it desirable for any tribunal to do that which Parliament has abstained from doing—that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances; and, speaking for myself, I rather doubt the wisdom of attempting to do more."

(1) (1932) 18 T.C. 1.
(2) (1942) S.C.R. 89 at 92
(3) (1940-42) 24 T.C. 171.
(4) (1924-26) 10 T.C. 155 at 185.

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In *Montreal Coke and Manufacturing Company* v. *Minister of National Revenue* and *Montreal Light, Heat and Power Consolidated* v. *Minister of National Revenue* (1), the same authorities were cited (page 131) including *Scottish North American Trust Company Limited* v. *Farmer* (2), and in the judgment there is this statement, p. 135:

> Reference was made in the course of the argument for the appellants to a number of reported cases, chiefly on the analogous provisions of English, Dominion and Indian revenue statutes. In some of these cases attempts were made to formulate principles of discrimination among different kinds of expenditure, permissible or prohibited as deductions. They illustrate the diversity of the problems which may arise. Their Lordships do not on the present occasion find it necessary to discuss these authorities as, in their opinion, the particular expenditure with which they have to deal falls clearly within the statutory prohibition against deduction.

Lord MacMillan said at p. 133:

> Expenditure to be deductible must be directly related to the earning of income. The earnings of a trader are the product of the trading operations which he conducts. These operations involve outgoings as well as receipts and the net profit or gain which the trader earns is the balance of his trade receipts over his trade outgoings. It is not the business of either of the appellants to engage in financial operations. The nature of their businesses is sufficiently indicated by their titles. It is to those businesses that they look for their earnings. Of course, like other business people, they must have capital to enable them to conduct their enterprises, but their financial arrangements are quite distinct from the activities by which they earn their income. No doubt, the way in which they finance their businesses will, or may, reflect itself favourably or unfavourably in their annual accounts, but expenditure incurred in relation to the financing of their businesses is not, in their Lordships' opinion, expenditure incurred in the earning of their income within the statutory meaning. The statute in section 5 (b) above quoted significantly employs the expression "capital used in the business to earn the income", differentiating between the provision of capital and the process of earning profits.

In this case the Company is not engaged in financial operations but is engaged in the construction business.

The method as outlined was adopted by the Company to finance its business, and it has continued to operate on that basis ever since.

In view of that, the borrowings cannot be termed "temporary accommodation" but are obviously borrowed capital used in the same way as its own capital. The interest paid to the bank each year on these borrowings has been claimed by the appellant and allowed by the respondent under

(1) (1944) A.C. 126. (2) (1911) 5 T.C. 693.

Section 5(*b*) as "interest on borrowed capital used in the business to earn the income". That being the only section under which it could be allowed. In statement (2) attached to the Auditors' Report for the year 1941 interest in exchange of $43,998.96 is shown and for 1942, $49,706.88. The evidence showed that these items included both the interest paid to the bank on the borrowings and the commissions paid to the guarantors, and were lumped together for convenience. And as Lord MacMillan pointed out, Section 5(*b*) significantly employs the expression "capital used in the business to earn the income", thus differentiating between the provisions of capital and the process of earning profits.

It was contended that, as the borrowings could not be obtained without the guarantee and the guarantee could only be given if the commissions were paid, the commissions were necessarily laid out to earn the increased income. But the commissions were paid in order to borrow this additional capital and are therefore part of the "financial arrangements" of the Company. The increase in income resulted from increase in capital.

The commissions were expenditures incurred in relation to the financing of the business, and in the language of Lord MacMillan "their financial arrangements are quite distinct from the activities by which they earn their income".

These commissions were not, in my opinion, expenditures incurred in the earning of the income within Section 6(1)(*a*).

For these reasons I am of the opinion that the assessments in question were properly made.

The appeal must be dismissed with costs.

Judgment accordingly.