Montreal
1967
Apr. 12
May 11

BETWEEN:

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

DUNCAN JOSEPH DESBARATS ..... RESPONDENT.

AND

BETWEEN:

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

EDWARD WILLIAM DESBARATS ..... RESPONDENT.

Income tax—Partnership business—Bank loan to meet operating deficit—Sale of collateral by bank—Whether amount deductible in computing partnership profits—Income Tax Act, s. 12(1)(b).

On the dissolution of respondents' partnership on March 31st 1961 they owed $184,000 to a bank on loans made to meet operating losses of

the firm during several years. The bank realized $78,000 on the sale of bonds which the partners had put up as collateral for the loans. In reporting their incomes for 1961 the partners claimed deduction of the $78,000 received by the bank on the sale of the bonds.

Held, respondents were not entitled to the deduction. Not only had the deduction claimed been previously allowed them as operating losses in computing the partnership's income each year, but moreover respondents' loss on the sale of the bonds resulted from the supply of capital to the partnership business and not from the operations of the business and the deduction of such loss was therefore prohibited by s. 12(1)(*b*) of the *Income Tax Act. Bennett and White Construction Co. Ltd. v. M.N.R.* [1949] S.C.R. 287; *Watney & Co. v. Musgrave* (1880) 5 Ex. D. 241; and *Montreal Coke and Mfg. Co. v. M.N.R.* [1944] A.C. 126, applied.

Income Tax appeals.

A. Garon and *P. H. Guilbault* for appellant.

E. Colas for respondents.

NOËL J.:—These are appeals from the decision of the Tax Appeal Board[1] dated January 14, 1965, allowing the appeals of the respondents from assessments resulting in additional taxes for the year 1961 in the amount of $5,084.01 for Duncan Joseph Desbarats and in the amount of $4,303.37 for Edward William Desbarats.

The above amounts were added to the tax indebtedness of both the respondents when the Minister refused to allow Duncan Joseph Desbarats to deduct a loss of $32,998.24 and Edward William Desbarats to deduct a loss of $45,257.62 from their respective revenues which, in the case of Duncan Joseph Desbarats, resulted in a taxable income of $18,711.65 (instead of a declared net loss of $22,866.59) and in the case of Edward William Desbarats resulted in a taxable income of $16,717.67 (instead of a declared net loss of $45,939.95).

The parties, through counsel, agreed that the evidence adduced herein, verbal as well as documentary, would apply to both appeals.

The above losses of $32,998.24 and $45,257.62, totalling $78,255.86 arose in the following circumstances. Both of the respondents carried on business in partnership under the name of Desbarats Advertising Agency till March 31, 1961. Over a number of years, during which the partnership operated, the partners would guarantee bank loans made to

[1] 38 T.A.B.C. 25 and 38.

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the partnership and the financial statements of the advertising business show a liability to the Banque Canadienne Nationale for each year. The Desbarats Advertising Agency in its statement of profit and loss for the year ended December 31, 1960, showed a loss of $68,287.62. The partnership operated only three months in 1961 at a net profit of $39,712.97 and on March 31, its assets and liabilities were sold to a limited corporation called "Desbarats Rayment Advertising Ltd." as of March 31, 1961, and the partnership was dissolved. At the above date, the partnership owed to the Banque Canadienne Nationale the sum of $184,924.01 which the partners had guaranteed personally by endorsement and also by depositing a number of bonds owned by them. The partners were called upon by the bank to pay the loans they had guaranteed and the bonds were sold by the bank. A sum of $78,355.86 was realized therefrom and this amount was applied in satisfaction of the personal guarantee assumed by the partners and reduced the partnership debt to the bank from $184,924.01 to $106,568.15. Edward William Desbarats' share was $45,257.62 and that of his brother Duncan was $32,998.24. Desbarats Rayment Advertising Ltd. assumed payment of the balance owing to the bank of $106,568.15 and the Desbarats brothers remained liable for this amount under their endorsement to the bank. The business of the company was disastrous for both respondents when the company later went into bankruptcy and were unable to obtain reimbursement for their losses.

The partners claimed the above amounts of $45,257.62 and $32,998.24 as expenses or losses applicable against the income of the partnership for its three months of operations in 1961 and, as already mentioned, the Minister refused to allow such deductions on the basis that the sum of $78,255.86, which the partners were called upon to pay in 1961, was in satisfaction of a debt assumed by the partners and was a non-deductible capital expense within the meaning of subparagraph (*b*) of paragraph (1) of section 12 of the Act.

The position taken by the respondents is that the above amounts of $45,257.62 and $32,998.24 are really expenses applicable against the income of the respondents for the

year 1961, having served to pay for losses which occurred in the running day to day business of the partnership. The respondents further submitted that the appeals should be vacated for the additional reason that in the year 1961 the respondents had no income but a loss which they allege was in the amount of $36,509.91. This loss, however, is arrived at by taking an operating loss of $78,222.58 (which the respondents were, however, unable to substantiate at the hearing of these appeals) deducting therefrom an amount of $39,712.67 of profits for the first three months of the year 1961, and thus obtaining the above mentioned sum of $38,509.91 (and not $36,509.61 as alleged by the respondents).

The statement of profit and loss of the partnership for the year ended December 31, 1960, however, shows a net loss for the year of $68,287.62 and not $78,222.58, as submitted by the respondents. Furthermore, the above statement also discloses that drawings of the partners in a total amount of $51,271.06 for the year were deducted as operating expenses and if these amounts cannot be so deducted and must be re-added to the revenue for the year, the loss here would be $17,016.56 and not $68,287.62.

The respondents, therefore, would be entitled, under section 27(1)(*e*) of the Act, to offset their share of partnership loss of $17,016.56 against other business, investment, rental and salary income of the same year, i.e., 1960, and the balance would then remain available for carry over to other years. The respondents, however, cannot deduct such share as they have already done so. The documentary evidence discloses that Edward William Desbarats, in respect of his share of the partnership loss of $6,843.97, in computing his income for 1960, deducted $1,508.19 and for 1959 deducted the balance of this loss, $5,004.33. Duncan Joseph Desbarats in respect of his share of the partnership loss of $9,156.58 in computing his income for 1960, deducted $1,508.19 and for 1959 deducted the balance of this loss, $7,648.39.

The above deductions had not been established before the Tax Appeal Board where the sole issue was as to whether the respondents were entitled to deduct as an operating loss their share of the value of the bonds sold to

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reduce the amount of indebtedness of the partnership to the bank. The argument that the respondents had no income for the year 1961 as a result of the losses sustained in the partnership in 1960 had not been raised. It was on the basis of the loss appearing on the partnership's profit and loss statement for the year 1960 that Mr. Boisvert, without dealing with the question as to whether the loss sustained by the partners as a result of the bank realizing on the sale of their bonds was deductible as a loss or not, suggested that the assessments be returned and amended to take into account the business losses of the partnership and that if this was done, the respondents would end up with a loss of $36,509.91 (which, as already mentioned, should be $38,509.91) instead of a profit of $39,712.67 for the first three months of the year 1961.

He, therefore, did not deal with the question as to whether the loss sustained through the sale of the respondents' bonds was a capital loss or not and this appears from his statement at p. 36 of his decision:

> It seems to me that, in determining the profits and losses, these rules were followed. Under the circumstances I do not believe it necessary to discuss whether or not the payment, made to the bank by the appellant, represented a capital loss.

Having thus established that the respondents have exhausted the deductions they were entitled to under section 27(1)(*e*) of the Act in the event the partnership's loss is $17,016.56 and not $68,287.62, the sole matter now remaining is whether (1) the profit of the partnership was properly established by adding the drawings of the partners to the revenue of the partnership and not allowing them as operating expenses and (2) whether the respondents would be entitled to a further deduction for the loss sustained as a result of the sale of their bonds.

That the drawings of the partners in a partnership cannot be deducted as an operational expense cannot, in my view, be contested. This, indeed, follows from a reading of sections 6(1)(*c*) and 15(1) of the Act. Under section 6(1)(*c*) the profits of a partnership must all be included in the partners' income for a taxation year whether or not actually withdrawn or even capable of being withdrawn in the year as all the earnings of the partnership business are business income of the individual partners and not of the partner-

ship. The entire income of partners is then taxed in the hands of the partners as part of their income for the calendar year in which the fiscal period of the partnership ends according to their respective interests.

It therefore follows that the only loss in the year 1960 that can be offset against the respondents' income is $17,016.56 and not $68,287.62 and as such a deduction has already been effected, the respondents can obtain no further relief in this respect.

The only matter now remaining is whether the amounts of $45,257.62 and $32,998.24, the respective values of the bonds owned by the parties and deposited at the bank as collateral for the loans made to the partnership, which the partners lost as a result of their sale when called upon to make good the guarantee given to the bank, was a deductible loss within the meaning of subparagraphs (*a*) or (*b*) of paragraph (1) of section 12 of the Act.

In order to properly resolve the question, it is helpful to examine the manner in which the indebtedness of the partners to the bank arose. During the years 1958, 1959, 1960 and 1961 the partnership, and from March 31, 1961, the corporation Desbarats Rayment Advertising Limited, sustained an operating loss of $140,000 due to a number of factors which the respondents list as paragraphs 9 and 10 of their respective "Answer to notice of appeal of appellant" as follows:

> 9. ...due mainly to the fact that the gross billings were only half of what they had expected, that the overhead was increased by 100%, that nearly $110,000 of salaries were paid to the various gentlemen that were brought in at the time A. Colin Rayment joined the original partnership, and that there were delinquent receivable accounts in the amount of $125,000.00;
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> 10. ...in order to meet this continually increasing deficit, which was occurring in the day to day running business of the partnership, the Respondent and his brother, Duncan Joseph Desbarats, obtained a loan from the Banque Canadienne Nationale, totalling $140,000.00 on December 31st, 1960, and guaranteed by endorsement of the Desbarats brothers and an additional guarantee of bonds held on deposit which were the personal property of the Respondent and his brother;

On April 1st, 1961, however, three months later, the guaranteed debt of the partnership to the bank had reached the sum of $184,924.01 and it was then that the Desbarats

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brothers had to consent to the sale of their bonds and the amount of their sale, e.g., $78,355.86 was then deducted from the debt of the partnership to the bank.

It therefore appears that the loans made by the bank to the partnership, which eventually added up to $184,924.01 were used by the partnership in its day to day business and was, over the years, charged off as operating expenses in arriving at the partners' income each year. It is clear that should the amounts of $45,267.62 and $32,998.24 now be allowed to be charged off, the respondents would be charging off the same expense twice and, of course, this they cannot do.

It however appears that even if they were not charging the expenses twice, the loss sustained by the sale of the bonds could not be charged off as an expense either under section 12(1)(*a*) or 12(1)(*b*) as the value of these bonds was lost in the process of supplying capital funds to the partnership business which was the means of carrying on the business of the partnership and such means must not be confused with the activities of the business itself. These bonds were indeed part of the capital structure of the partnership business and as stated by Rand J. in *Bennett and White Construction Company Limited v. M.N.R.*[2] at p. 293 when referring to premiums paid by the taxpayer, a construction company, to an individual guarantor of the company's bank loans for the purpose of obtaining necessary working capital (and referring to *Watney & Co. v. Musgrave*[3]):

> ...They (the premiums) furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business.

In *Montreal Coke and Manufacturing Company v. M.N.R.*[4] an expenditure incurred in effecting conversion of bonds into new bonds issued at a lower rate was refused as non-deductible. It was held therein:

> ...that expenditure, to be deductible, must be directly related to the earning of income from the trade or business conducted; that the businesses of the appellants were not to engage in financial operations and expenditure incurred in relation to the financing of their businesses was not laid out for the purpose of earning income in their businesses within the statutory meaning and, accordingly, that under s. 6(*a*) of

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[2] [1949] S.C.R. 287.

[3] (1880) 5 Ex. D. 241.

[4] [1944] A.C. 126.

the Income War Tax Act, 1927, that expenditure was not an allowable deduction. View of the courts below that the deductions claimed also fell to be disallowed as being payments "on account of capital" within s. 6(*b*) of the Act not dissented from.

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The losses sustained in the present case are, in my view, clearly of a capital nature and their deduction is prohibited by section 12(1)(*b*) of the Act.

I would, therefore, allow the appeals with costs and restore the assessments appealed from.