

Toronto
1965
Sept. 20
Ottawa
Sept. 30

BETWEEN:

GUNNAR MINING LTD. APPELLANT;

AND

THE MINISTER OF NATIONAL }
REVENUE } RESPONDENT.

Income Tax—Federal—Income Tax Act, R.S.C. 1952, c. 148, ss. 11(1)(c), 12(1)(c), 83(5)—Income Tax Regulations—Section 1201(2), (4)(d)—Whether interest paid on debentures wholly attributable to income derived from the operation of a mine during exempt period or attributable in whole or part to interest income derived from short-term investment of surplus funds—Depletion—Whether interest paid wholly deductible from profits reasonably attributable to the production of minerals or imputable in part to short-term investment income.

The appellant is a company incorporated under the laws of the Province of Ontario. It established a business in Saskatchewan consisting of mining and milling uranium ores from mineral claims, producing uranium concentrates and selling the same.

The appellant had borrowed \$19,500,000 by way of a debenture issue and had used the money to bring into operation its uranium mining and milling activities.

Under section 83(5) the income derived from the operation of its mine for the 36 months period ending February 28, 1959 was not included in computing the appellant's income for tax purposes.

The matter in issue was whether the debenture interest paid should be considered a deduction in computing the exempt income or, as claimed by the appellant, a deduction in whole or in part as a cost in computing its non-exempt income, namely, interest earned from the short-term investment of surplus funds prior to the retirement of the debentures.

Held: That none of the interest paid on the debenture debt was a cost of earning the interest income from the short-term investments.

- 2. That none of the statutory provisions relied on by the appellant was relevant.
- 3. That the appeal be dismissed.

APPEAL from a decision of the Tax Appeal Board.

R.M. Sedgwick, Q.C., and J.M. Shoemaker for appellant.

T. Z. Boles and D. G. H. Bowman for respondent.

GIBSON J.:—This is an appeal from the decision of the Tax Appeal Board dated September 24, 1963 in respect of assessments for income tax made against the Appellant in the sum

of \$1,753,200.07 being respectively a tax in the sum of \$171,271.01 levied in respect of income for the taxation year 1958, a tax in the sum of \$222,252.93 levied in respect of income for the taxation year 1959 and a tax in the sum of \$1,359,676.13 levied in respect of income for the taxation year 1960.

The Appellant is a company incorporated under the laws of the Province of Ontario.

The Appellant established a business in the Beaverlodge Area of Saskatchewan consisting of mining and milling uranium ores from mineral claims, producing uranium concentrates and selling the same to Eldorado Mining and Refining Limited. For the 36 month period ending February 28, 1959 the Appellant was not required to include in computing its income the "income derived from the operation of (its) mine" by reason of the provisions of s. 83 (5) of the *Income Tax Act*.

In order to bring into operation its uranium mining and milling activities, the Appellant raised \$19,500,000. by way of sale to the public of debentures bearing interest at 5%. The evidence discloses that the Appellant expended all these monies prior to any relevant taxation year in respect of which this appeal is concerned.

Subsequently, namely after March 1, 1956 and during the relevant taxation years, the Appellant in its mining and milling operations earned very substantial sums of money and accumulated large profits, but instead of using these accumulated profits to pay off and extinguish all of its liabilities in respect to its debenture debt, the Appellant invested certain of the surplus funds derived from these profits in short term investments such as Dominion of Canada bonds and provincial government bonds. On balance, these short term investments did not earn 5%. The Appellant, in its interest accounting, netted the debenture interest payable on its debentures outstanding and the interest received from these short term investments. By co-relating the interest paid out and the interest received, because the interest paid out in all cases was 5% and the interest received was less than 5% it was inevitable that the net interest account was less than it otherwise would have been.

The schedule attached to this Judgment illustrates this.

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The Appellant founded its appeal substantially on the evidence of its expert witness Mr. R. M. Parkinson, a chartered accountant of some 36 years experience.

The evidence of Mr. Parkinson in brief was that it was proper from a commercial and business point of view for the Appellant, or indeed for any business, to differentiate in its statement of income and expenditures between what he refers to as "operating items" and "non-operating items".

The figure obtained by considering only operating items, this witness said, results in arriving at a figure of "operating income". This is done by first obtaining the figure of gross sales less returns, allowances etc., and subtracting from that sum the cost of sales to arrive at a figure for gross profit. From this figure is then deducted selling expenses and general and administrative expenses from which the figure of operating income is obtained.

Then this witness said it is proper to consider the non-operating items in the business.

These non-operating items the witness said are categorized as "other income", and include interest and dividends and miscellaneous items on the receipt side and also on the disbursement side; and from which there is computed the figure of income before federal and other taxes. Then the witness said that it is proper to make a computation of federal and other taxes and subtract the figure so found from the figure of income above referred to, in order to obtain the figure of "net income" of the business for the fiscal year.

It is the submission of the Appellant that if the provisions of the *Income Tax Act* are considered in relation to this approach to the statement of income and expenditure, that the deductions from its income hereinafter referred are legally proper.

It is convenient to consider this appeal from the point of view of two periods of time, because different provisions of the *Income Tax Act* are relevant to each.

The first period may be referred to as the exempt period, that is the 36 month period ending February 28, 1959. This is the period during which the Appellant's income from the operation of its mine was exempt from taxation by reason of s. 83 (5) of the *Income Tax Act*.

The second period may be referred to as the non-exempt period by which is meant the period after the 36 month interval referred to in s. 83 (5) of the *Income Tax Act* had expired.

In respect to the first period, it is the submission of the Appellant that the income that the company received from its investments in short term securities is correctly categorized as non-exempt income and that the remaining income of the company namely, "that derived from the operation of (its) mine" was the exempt income.

The submission of the Appellant is that by reason of s. 11(1)(c) the Appellant was entitled to deduct interest for the purpose of computing its income from all sources and that this subsection did not require or permit the Appellant to relate separate portions of the permissible interest deduction to its various sources of income; and that the only interest deduction permitted to the Appellant during the exempt period by s. 11(1)(c) was to the extent that interest expense for that year "may reasonably be regarded as having been made or incurred for the purpose of gaining or producing *exempt income*" within the meaning of s. 12(1)(c).

The Appellant therefore submits that a determination of fact must be made as to what part of the debenture interest may reasonably be considered a cost of earning this non-exempt income; and such interest expense so found, the Appellant submits, is a permissible deduction under s. 11(1)(c) and is not taken away by s. 12(1)(c). Any method of computing the quantum of this sum, the Appellant says, is legally correct so long as it is reasonable; and it submits that netting the interest account as it did is a reasonable method. That is the submission in so far as the first period is concerned.

The second period is the non-exempt period.

The matter of trying to allocate any expense of debenture interest under s. 12(1)(c) is not in issue during this period because the deduction of debenture interest was allowed in full under s. 11(1)(c).

What is in issue during this second period is the quantum of the depletion allowance authorized by Regulation 1201(2). This regulation provides for a depletion allowance of 33 $\frac{1}{3}$ % of "the aggregate of... profits for the taxation

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year reasonably attributable to the production of... industrial minerals... minus the aggregate amount of deduction provided by..." Regulation 1201(4)(d). This latter regulation is the deduction permitted under s. 11(1)(c) "in respect of (i) borrowed money used in connection with, or used for the purpose of acquiring property used in connection with, or (ii) an amount payable for property used in connection with... production of... industrial minerals...".

It is the submission of the Appellant that in calculating the depletion allowance under Regulation 1201(2) there must be deducted from the operating profits "reasonably attributable to the production of... industrial minerals..." only such part of the Appellant's interest expense on its debentures incurred during the taxation year as is attributable to its mining operations and not the portion of such debenture interest as is attributable to earning income on its short term investments. In other words, the Appellant submits that the historical approach to the purpose for which the original debenture debt was incurred is not the proper approach but instead the approach should be on the basis of an annual inquiry of the use any borrowed monies are being put in any taxation year and that such is a question of fact. If such borrowed monies are used to earn income from more than one source, it is the submission of the Appellant that any reasonable method of calculating the portion of interest charges applicable to each separate source of income is legally correct. The Appellant submits that netting the interest costs and interest expenses is such a reasonable method. The Appellant further says that the fact that it employed surplus monies in earning income on short term investments rather than in paying off its debenture debt or rather than leaving the money in the bank without earning interest does not destroy *pro tanto* its right to make such a deduction from the interest on its debentures from its income.

I accept Mr. Parkinson's evidence in so far as it describes a method currently recommended as good practice and employed by many accountants in determining the profit or loss of a company from its business operations including miscellaneous revenues of investments of surplus cash. His method no doubt is not only good accounting practice but

is also acceptable as a method of determining the company's income for the purpose of the *Income Tax Act* for a fiscal year (When the company is taxable on its income from all sources) in that it is not contrary to any particular statutory direction.

In the matter under appeal, however, what is being considered is not income for the year from all sources but income from a source other than the company's mining business, namely, the income from its short term investments. Therefore it becomes necessary as a matter of accounting fact to consider solely the question as to what sources particular expenses are related to, and for the purposes of the *Income Tax Act* to consider the same in relation to its relevant provisions.

It is therefore necessary firstly to resolve a question of fact.

The sole question of fact is whether or not part of the interest paid on the debenture debt of the Appellant was a cost of earning the interest income on its short term investments. In my opinion on the evidence it was not. There was nothing adduced in evidence through Mr. Parkinson or any other witness to prove this; indeed no connection between these transactions was established at all.

In view of this finding, it follows, in respect to both of the said two periods, that none of the provisions of the *Income Tax Act*, by reason of which the Appellant submits that some deduction should be allowed in computing its income, are relevant.

The appeal therefore fails and is dismissed with costs.

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THIS IS THE SCHEDULE REFERRED TO IN THE JUDGMENT OF GUNNAR MINING LTD. *et al*

	5% Sinking Fund Debentures outstanding at commencement of Period	5% Sinking Fund Debentures outstanding at end of Period	\$ Amount of Short Term Investments at commencement of Period	\$ Amount of Short Term Investments at end of Period	Interest Expense on Debentures during Period	Interest Income on Short Term Investments during Period	Net Interest Expense* or Revenue
1958....	11,920,000	7,700,500	1,773,863	8,048,076	485,878	231,198	254,680*
First 2 Months of 1959. . .	7,700,500	3,289,000	8,048,076	15,159,485	60,151.90	68,922.28	8,770.38
Last 10 Months of 1959.... .	—	—	—	—	175,940	343,930	167,990
1960....	3,289,000 (By 1 Oct 60 Completely redeemed).	0	15,159,485	20,371,805	114,603	504,764	390,161