Toronto 1968 Feb. 27-29 — Ottawa May 3

BETWEEN:

SHERRITT GORDON MINES, LIMITED .... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Income tax—Money borrowed to finance mine—Commitment fee paid on unadvanced money—Whether part of capital cost—Capital cost allowances—Exploration and development expense—Allocation of expenses after expenditure on basis of judgment—Whether acceptable for tax purposes—Income Tax Act, s. 11(1)(a), (c), (cb), s. 83A (2) and (3).

During 1952, 1953 and 1954 appellant borrowed $24,000,000 dollars on first mortgage bonds to finance the development of a mine, power plant and refinery. In addition to payment of interest on the money so borrowed appellant was required to pay during those years a commitment fee of 1% to 1½% per annum on the unadvanced portion of the loans from January 1952. All of appellant's funds, whether from the loans or other sources, were co-mingled and payments of interest and commitment fee were not identified as to source or object until some time after completion of the project at the end of July 1954, and expenditures were then allocated to the three properties and to exploration and development on the basis of total monthly investment during the construction period. The sum of $240,567 in commitment fees was thus allocated to the capital cost of the three properties and $110,491 in commitment fees to exploration and development expense In assessing appellant for income tax for 1958 and 1959 (appellant's first profitable years after the project was completed) the Minister allowed a deduction in respect of interest allocated as described but disallowed a deduction of commitment fees.

Held, allowing the appeal (1) the commitment fees paid in respect to the three properties during the construction period were part of the capital cost of those properties within the meaning of s. 11(1)(*a*) of the *Income Tax Act* and therefore subject to capital cost allowances, and (2) the commitment fees allocated to exploration and development expense were deductible under s. 83A(2) and (3) except such portion as was attributable to the refinery.

Held also, in the circumstances of appellant's business the allocation of interest and commitment fees retroactively on the basis of judgment and appellant's records, though not completely accurate, was fair and reasonable and acceptable for income tax purposes.

M.N.R. v. Anaconda American Brass Ltd. [1956] A.C 85; *Can. Gen. Elec. Co. v. M.N.R.* [1962] S C.R. 3; *B.C. Elec. Ry Co. v M N.R.* [1958] S.C R. 133; *Chancery Lane Safe Deposit and Office Co. v. C.I.R.* (1965) 43 Tax Cas. 83; *Hinds v. Buenos*

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Ayres Grand National Tramways Co. [1906] 2 Ch. 654; *Fraser v. C.I.R.*, 25 F (2d) 653; *Georgia Cypress Co. v. South Carolina Tax Comm'n.* 22 S.E. 2d 419, considered.

INCOME TAX APPEALS.

J. F. Howard, Q.C. and *J. B. Tinker* for appellant.

D. G. H. Bowman and *Gordon Anderson* for respondent.

KERR J.:—These appeals under Part I of the *Income Tax Act* from re-assessments of the income tax of the appellant (hereinafter referred to as Sherritt) for its 1958 and 1959 taxation years were heard together in Toronto. They relate to disallowances by the Minister of National Revenue in respect of amounts that it had paid in the years 1952, 1953 and 1954 as a "commitment fee" pursuant to financing agreements with J. P. Morgan and Co. Incorporated and certain other companies, whereby Sherritt obtained $24,000,000 (United States funds) from sale of first mortgage bonds and agreed to pay, in addition to interest on the bonds, a commitment fee at the rate of 1% per annum in respect of Series A and Series B bonds and 1½% per annum in respect of Series C bonds, on the daily average unadvanced portion of the total amount that the lenders were obligated to lend under the provisions of the agreements, as set forth in paragraph 9 of the agreement dated June 13, 1952 (Exhibit 2) and paragraph 5 of the agreement dated April 12, 1954 (Exhibit 8).

Sherritt acquired a nickel-copper-cobalt property at Lynn Lake, Manitoba, in 1945 and by the end of 1951 had done considerable work in proving the ore body and in developing the mine project, which eventually included a power plant at Laurie River (about thirty-five miles from the mine) and a refinery at Fort Saskatchewan, near Edmonton, for production of metal from ore concentrates from the mine. The company planned a program of work to complete the entire project and in that work, in the years 1952, 1953 and 1954, expended the proceeds from the bonds and also money from other sources. The company made payments of bond interest and payments of commitment fee in those years, and subsequently attributed and allocated the amounts of such payments in its accounts to (a) exploration and development expenses (b) the cost of depreciable assets required and (c) operating expenses. I will refer later to the source and use of all funds and the allocation of interest and commitment fee payments.

In computing its taxable income from its 1958 and 1959 taxation years Sherritt deducted, as exploration and development expense, the portions of the bond interest and commitment fee payments in the years 1952, 1953 and 1954 that it had allocated to that expense; and claimed capital cost allowance in respect of the portions of the bond interest and commitment fee payments that it had allocated to the capital cost of depreciable assets acquired. The Minister allowed deductions claimed in respect of the payments of bond interest but disallowed the deductions claimed in respect of the payments of commitment fee.

In the Notice confirming the assessment of income tax for the 1958 and 1959 taxation years the Minister stated:

> . . . that the amount of $110,491 84 paid by the taxpayer in the taxation years 1952, 1953 and 1954 as commitment fees is not an exploration, prospecting or development expense and accordingly is not an allowable deduction under the provisions of section 83A of the Act in determining the income of the taxpayer for the 1958 and 1959 taxation years; that the amount of $240,567.19 paid by the taxpayer in the taxation years 1952, 1953 and 1954 as a commitment fee is not a part of the capital cost of the depreciable property owned by the taxpayer in the 1958 and 1959 taxation years.

In the Reply to the Notice of Appeal with respect to Sherritt's 1958 taxation year the Minister stated:

> 9. The Respondent says that of the amount of $3,163,410 70 claimed by the Appellant in the taxation year 1958 as development and exploration expenses, a portion thereof amounting to $110,491.84 represents a portion of an amount paid as commitment fees by the Appellant in the taxation years 1952, 1953 and 1954, pursuant to the agreement dated June 13th, 1952, referred to in paragraph 3 of the Notice of Appeal and is not properly deductible in computing the Appellant's income for the 1958 taxation year under section 83A of the *Income Tax Act* because the said commitment fees are not exploration, prospecting or development expenses within the meaning of section 83A of the *Income Tax Act.*
>
> 10. The Respondent says that no part of the commitment fees paid by the Appellant pursuant to the agreement dated June 13th, 1952, referred to in paragraph 3 of the Notice of Appeal, formed

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part of the capital cost to the Appellant of any property of the Appellant described in any of the Classes of Schedule B to the Regulations made pursuant to the *Income Tax Act*.

11. The Respondent says that if the commitment fees are interest on borrowed money, they were deductible under the provisions of paragraph (*c*) of subsection (1) of section 11 of the *Income Tax Act* in computing the Appellant's income for its 1952, 1953 and 1954 taxation years, and hence no portion was deductible under subsections (2) and (3) of section 83A of the *Income Tax Act* and no portion may be included in the capital cost to the Appellant of any property owned by it in the 1958 taxation year.

The Minister took a similar position in disallowing capital cost allowance claimed by Sherritt for its 1959 taxation year in respect of amounts paid as commitment fee in 1952, 1953 and 1954.

The years 1952, 1953 and 1954 are of particular significance, for they were a period of construction and development of Sherritt's Lynn Lake project, i.e., the mine at Lynn Lake, the power plant at Laurie River and the refinery at Fort Saskatchewan, in which Sherritt expended the proceeds from the bonds, and it was payments of bond interest and commitment fee "during construction" in those years that Sherritt capitalized.

It will be useful, I think, to outline the circumstances that led to the borrowing of money by Sherritt, the use of the borrowed money together with other funds of the company, the payment of bond interest and commitment fee and the allocation and treatment of the interest and commitment fee by the company, and I will endeavour to give the substance of the portions of the evidence, as I understand it, that I consider to be the more important and useful in determining the issues that are before the court for decision in these appeals.

Sherritt was incorporated in 1927 and from that time until 1951 was a relatively small mining company. It operated a copper and zinc mine at Sherridon, Manitoba, but suspended operation of that mine in September, 1951, following exhaustion of the ore body. In the years 1952, 1953 and 1954 the company's only business, other than shutting down the Sherridon mine and doing a minor amount of exploration, was its Lynn Lake project.

In 1951 the company prepared a study and a booklet setting forth plans for its Lynn Lake project, the estimated costs and the total capital expenditures involved. The estimated total costs were $42,810,000. Of that total the amount to be expended after June 30, 1951, was $32,812,000. The company planned at that time to raise $19,760,000 through sale of first mortgage bonds. This study and booklet formed the basis of discussions between Sherritt and J. P. Morgan and Co. and other lending companies, and led to the subsequent financing agreements and sale of bonds. The companies with which Sherritt entered into the financing arrangements were the Morgan Co., Bankers Trust Company, Newmont Mining Corporation, Metropolitan Life Insurance Company and other companies.

Mr. David D. Thomas, President of Sherritt, testified that the financing arrangements started in the fall of 1951 and that an oral agreement was reached that the lenders were committed to lend the agreed amount of money at 4% per annum on Series A bonds and at $4\frac{3}{4}$% on Series B bonds as of January 1, 1952, although the first written agreement (Exhibit 2) was not signed until June 13, 1952; also that payment of a commitment fee was a matter of discussion from the first time the parties talked and there was oral agreement that the commitment fee would commence on January 1, 1952. The agreement (Exhibit 2) provided for payment of the commitment fee to commence from that date. Mr. Thomas also stated that other possible sources of funds had been investigated and the company felt that they were less attractive to the shareholders than the arrangements made with Morgan and Co. and that the only way Sherritt could obtain money from the lenders was on the basis of the conditions set forth in the Mortgage Indenture that was entered into by the parties.

The first agreement provided for the authorization by Sherritt of $4,400,000 of first mortgage bonds Series A, and an issue of $17,600,000 of first mortgage bonds Series B, to be secured by a mortgage. The Mortgage Indenture, dated as of November 1, 1952, provides for payments to Sherritt by Morgan and Co., as trustee for the bond holders, from

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the money proceeds of the bonds upon certain conditions, one of which was that the money would be advanced against "bondable expenditures" certified by Sherritt as having been spent on property, plant and equipment and on deferred development of the Lynn Lake project. The definition of "bondable expenditures" on page 5 of the Mortgage Indenture (Exhibit 3) is in part as follows:

> The term "Bondable Expenditures" shall mean expenditures charged or properly chargeable to the capital accounts of the Company entitled "Property, Plant and Equipment" and "deferred Development Expenditures—Lynn Lake Project" or similar titles, in accordance with the accounting practices followed by the Company in the preparation of its balance sheet dated December 31, 1951, or charged or properly chargeable to other capital accounts of the Company in accordance with generally accepted accounting principles, made in connection with the acquisition or construction by the Company or by Laurie of property as part of the Company's Program . . .

Supplemental Indentures reduced the aggregate amount of the Series A and B bonds to $21,000,000 and added $6,000,000 Series C bonds. The procedure for taking down money upon proof of bondable expenditures was the same for the Series C bonds as for the A and B bonds. The commitment fee in respect of Series C bonds was 1½% per annum as from March 15, 1954.

Mr. W. A. Johnson, an underwriter with A. E. Ames and Company Limited, with responsibilities to advise and aid companies in securing financing, testified as an expert witness that it is general practice for institutional lenders to ask for a commitment fee on mortgage financing for a natural resource development and large construction purposes; that the majority of lenders look upon the commitment fee as additional yield on the loan, that it is paid on an amount that has not been advanced and is payable to the lender for the period from the time the lender commits to make the loan until the loan is actually made; and that the commitment fee accrues over equal periods of time like interest.

The issuance of bonds and the amounts received therefrom by Sherritt are shown in Exhibit 6 set forth next.

SHERRITT GORDON MINES LIMITED
SCHEDULE OF FIRST MORTGAGE BONDS ISSUED
YEARS 1952-1954 INCLUSIVE

	Series A	Series B	Series C	Total
Bonds issued U.S. funds				
December 23, 1952	$ 1,000,000 00	$ 4,000,000.00		$ 5,000,000.00
June 29, 1953	1,400,000.00	5,600,000.00		7,000,000.00
October 30, 1953	1,400,000.00	5,600,000.00		7,000,000.00
March 25, 1954	300,000.00	1,700,000.00		2,000,000.00
May 15, 1954			$ 3,000,000.00	3,000,000.00
	$ 4,100,000.00	$16,900,000.00	$ 3,000,000.00	$24,000,000.00
Money received from trustee U.S. funds				
December 26, 1952	$ 795,000 00	$ 3,180,000.00	$	$ 3,975,000.00
March 30, 1953	205,000 00	820,000 00		1,025,000.00
June 30, 1953	1,320,000.00	5,280,000.00		6,600,000.00
October 30, 1953	1,160,000.00	4,640,000.00		5,800,000.00
December 31, 1953	320,000.00	1,280,000.00		1,600,000.00
March 29, 1954	300,000.00	1,700,000.00		2,000,000.00
May 17, 1954			3,000,000.00	3,000,000.00
	$ 4,100,000.00	$16,900,000.00	$ 3,000,000.00	$24,000,000.00
Proceeds from money received Canadian funds Bonds issued				
December 23, 1952	$ 977,061.20	$ 3,908,244.81	$	$ 4,885,306.01
June 29, 1953	1,380,724.50	5,522,897.98		6,903,622.48
October 30, 1953	1,359,922.43	5,439,689.72		6,799,612.15
March 25, 1954	294,466 87	1,668,994.74		1,963,461.61
May 15, 1954			2,951,847.55	2,951,847.55
	$ 4,012,175.00	$16,539,827.25	$ 2,951,847.55	$23,503,849.80

The money spent by Sherritt in its Lynn Lake project came partly from the proceeds from the bonds and partly from other sources. Exhibit 7, set forth next, is a statement of the source and use of funds for the period January 1, 1952, to December 31, 1954:

SHERRITT GORDON MINES LIMITED
STATEMENT OF SOURCE AND USE OF FUNDS
FOR THE PERIOD JANUARY 1, 1952 TO DECEMBER 31, 1954

	U.S. Funds	Canadian Funds	
Funds were obtained from			
Net cash profit for the years 1952–1954 inclusive			$ 2,142,859.48
First mortgage bonds issued			
Series A	$ 4,100,000.00	$ 4,012,175.00	
Series B	16,900,000.00	16,539,827.25	
Series C	3,000,000.00	2,951,847.55	
	24,000,000.00	23,503,849.80	
Less Series A due in 1955	2,343,000.00	2,292,811.23	
	21,657,000.00		21,211,038.57
Convertible debentures issued			8,000,000.00
Advances from the United States Government	4,345,671.33	4,221,731.65	
Less minimum repayment due in 1955	217,283.57	211,086.58	
	4,128,387.76		4,010,645.07
			35,364,543.12
Decrease in working capital			3,783,219.05
			$39,147,762.17

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Funds were used for		
Expenditures on property, plant & equipment		
Lynn Lake mine plant .	$ 7,168,848 37	
Laurie River power plant	1,746,324 81	
Fort Saskatchewan chemical metallurgical plant	24,045,721 11	
	32,960,894 29	
Less construction materials on hand January 1, 1952	591,481.61	32,369,412.68
Deferred development expenditures—Lynn Lake project		4,314,424.45
Housing loans advanced to employees .		329,943 79
Inventory of nickel concentrates in storage as security for advances from U.S. Government repayable after 1955		2,056,937.26
Other deferred expenditures and sundry investments		77,043.99
		39,147,762.17
Working Capital		
As at December 31, 1951		4,983,207 25
Decrease during the period		3,783,219.05
As at December 31, 1954		1,199,988 20

Exhibit 7 shows funds from all sources in the years 1952, 1953 and 1954, total capital expenditures in those years on the Lynn Lake mine plant, Laurie River power plant and Fort Saskatchewan refinery, and deferred development expenditures on the project. (There also were expenditures prior to 1952 but they are not included in the exhibit.) These deferred development expenditures were said by Mr. Thomas to be the pre-production expenses involved in bringing the mining facility into production and included the sinking of the mine shafts, underground exploration, test milling programs to find out whether the ore could be put into the form of a concentrate, metallurgical research work done in developing a refining process, housing loans advanced to employees, and general administration expenses.

Mr. Thomas said that all the money received from the bonds was used in the development of the Lynn Lake project and was applicable to the property, plant and equipment account and to deferred development expenditures. Sherritt's accounts were kept on an accrual basis of accounting which showed the total cumulative monthly investments in the property accounts, the fixed assets of the Lynn Lake project at its three locations, plus deferred development expenditures, spent or accrued from January 1, 1952, through to December 31, 1954, regardless of the source of the funds used.

Exhibit 10, next, is a statement of net interest and commitment fee expenditures in the years 1952, 1953 and 1954.

SHERRITT GORDON MINES LIMITED
SCHEDULE OF NET INTEREST EXPENDITURES
YEARS 1952-1954 INCLUSIVE

	Commitment fee	Bond interest	Interest on G.S.A. advances	Interest income	Net interest expense
1952 .	213,467 09	4,960.96		121,784.80	96,643.25
1953 .	120,474 62	439,304.81		115,508.34	444,271.09
	333,941.71	444,265.77		237,293.14	540,914.34
1954 .	48,634.35	1,068,767 98	96,717.12	26,550 21	1,187,569 24
	382,576 06	1,513,033.75	96,717.12	263,843.35	1,728,483.58
Less 1954 direct charges to operating account	18,267.73	487,174 31	96,717.12	6,758 67	595,400.49
Amount allocated	364,308 33	1,025,859 44	—	257,084 68	1,133,083.09

The interest figures in Exhibit 10 include interest paid on certain advances received by Sherritt from General Services Administration, a Department of the United States Government. Interest income in the exhibit is interest earned by Sherritt from the investment of surplus funds, including interest from short term investment and money received from Morgan and Co. The exhibit does not show what interest income was from investment of money received from Morgan as opposed to interest on other money.

The net interest (including commitment fee) expenditures in Exhibit 10 amount to $1,728,483.58. During the entire period from January 1, 1952, to December 31, 1954, net interest was allocated by Sherritt to deferred development expenditures. Then, in January 1955, by which time the accounts for the three years were said to be finalized, the company allocated the net interest amount to the individual property, plant and equipment accounts for the Lynn Lake mine, the Laurie River power plant and the Fort Saskatchewan refinery, and also allocated a portion to deferred development expenditures. The allocation was made to the various capital asset accounts on the basis of total monthly investment in the fixed assets accounts during those years, excluding investment prior to January

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1952. The company made no distinction between interest and commitment fee in this allocation, the amount allocated being the net aggregate amount of interest and commitment fee.

Exhibit 11, set forth next, shows the distribution of interest and commitment fee made by Sherritt in January 1955, and the interest as distributed by type.

(NOTE. This is the left half of Exhibit 11)

Sherritt Gordon Mines Limited
Summary—Net Interest Expense Distribution
Years 1952–1954 inclusive

	Total 1952–1954	Interest distributed by year 1952	1953	1954
Property, plant and equipment				
(a) Lynn Lake	153,358.72	27,323.39	114,985.93	11,049.40
(b) Laurie River power plant .	19,893.88	18,460.60		1,433 28
(c) Fort Saskatchewan chemical metallurgical plant . .	585,472.53	16,164.28	211,656 56	357,651.69
	758,725.13	61,948.27	326,642.49	370,134.37
(d) Deferred development expenditures.	200,165.36	34,694.98	117,628.60	47,841.78
(e) Operating expense. .	174,192.60			174,192.60
(f) Total interest distributed....	1,133,083.09	96,643.25	444,271.09	592,168 75
(g) Interest charged directly to operating . .	595,400.49			595,400.49
	$1,728,483.58	$ 96,643.25	$ 444,271.09	$1,187,569.24

(NOTE: This is the right half of Exhibit 11)

Interest distributed by type

	Commitment fee	Bond interest	Interest on G.S.A. advances	Interest income (credit) 1953–54 capitalized for tax purposes	1952 to income for tax purposes	Total 1952–54 excluding 1952 interest income
(a)	91,985.97	126,073.37		30,269.11	34,431.51	187,790.23
(b)	40,834.76	2,370.63		48.42	23,263.09	43,156.97
(c)	107,746.46	565,208.74		67,113.28	20,369.39	605,841.92
	240,567.19	693,652.74		97,430.81	78,063.99	836,789.12
(d)	110,491.84	165,593.58		32,199.25	43,720.81	243,886.17
(e)	13,249.30	166,613.12		5,669.82		174,192.60
(f)	364,308.33	1,025,859.44		135,299.88	121,784.80	1,254,867.89
(g)	18,267.73	487,174.31	96,717.12	6,758.67		595,400.49
	$382,576.06	$1,513,033.75	$96,717.12	$142,058.55	$121,784.80	$1,850,268.38

The top half of the exhibit shows the total interest, including commitment fee, and its distribution by year to property, plant and equipment, deferred development and operating expense. Mr. Thomas explained that in the case of the Laurie River power plant, for example, it was completed in September 1952, and the net interest, including commitment fee, was attributed to the cumulative monthly investment, i.e., to the capital cost of the plant to that date, but that from the end of September 1952, to the end of 1953 the plant was used to supply operating or development power to the mine and therefore the interest attributable to the power plant was charged against deferred development expense at the mine as a cost of development power, and when at the end of 1953 the mine began to produce concentrate the interest was thereafter charged to operating account.

In the case of the mine, all the interest, including commitment fee, attributable to it was capitalized and until the end of 1953 was charged against property, plant and equipment or to deferred development expense, but at the end of 1953 the mine was operating and thereafter the interest attributable to that asset was charged against operating.

In the case of the refinery, interest was charged against it until it was completed and ready for operation at the end of July 1954, and thereafter was charged against the operations of the company.

The refinery was ready for operation, as stated, at the end of July 1954, and after that date all the interest was charged against the operations of the company.

The bottom half of Exhibit 11 shows the interest and commitment fee distribution by type. This analysis was not made until 1958, following a communication from the Department of National Revenue that payments of commitment fee would not be allowed as a taxable expense for income tax purposes. At that time the company broke down the interest expense in the years 1952, 1953 and 1954 into commitment fee, bond interest, interest on G.S.A. advances and interest earned, and separated them between its

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Lynn Lake plant, Laurie River plant, Fort Saskatchewan plant, deferred development expense and operating expense. The result was an attribution of commitment fee as follows: $240,567.19 to property, plant and equipment at the three locations; $110,491.84 to deferred development expenditures; and $31,517.03 to operating expense. (It was the deductions claimed by Sherritt in respect of the first two amounts that the Minister disallowed).

Mr. Thomson gave evidence to the effect that Sherritt's funds from all sources were co-mingled in the company's bank account or accounts and no record was kept as the money was being spent as to the particular source of the money; when a payment of interest or commitment fee was made it was not at that time allocated to or identified with any particular project or particular asset; the company decided to charge all interest and commitment fee to deferred development as a suspense account until the construction period was completed and would then make an allocation project by project or asset by asset; the allocation made in January 1955, was for accounting purposes. but later there was a greater breakdown by classes of assets; the allocation was not made on the basis of tracing a particular asset expenditure to a particular source of money, and in allocating the bond interest and commitment fee no differentiation was made between them.

Exhibit 15 shows the company's allocation to capital cost classes for income tax purposes of the net interest expense that was capitalized in the years 1952, 1953 and 1954. In the case of Lynn Lake and Laurie River the expense was totally allocated to Class 10, the only tax class; at Fort Saskatchewan it was allocated to the appropriate tax class on the basis of the final construction value at the end of 1954. The commitment fee was allocated in the same proportion as the interest, and the allocation was based upon the total money invested from the funds of the company from all sources.

Mr. Thomson also indicated that although the attribution of interest to property and to deferred development expense was made in January 1955, an issue with the

Department of National Revenue did not arise in respect of it until 1958, because in the years 1952 to 1957, inclusive, Sherritt had nil income tax assessments, and it was not until 1958 that the company had an assessment from which it could make an appeal.

Two chartered accountants, Mr. John R. Barker and Mr. Stephen Elliott, were called by counsel for Sherritt as experts in accounting. Mr. Barker expressed his opinion that Sherritt's treatment of payments of commitment fee and the company's capitalization and allocation of the payments of interest and commitment fee between depreciable assets and development expense was in accordance with generally accepted accounting principles and practice. He said that it is generally accepted accounting practice to add commitment fee and interest expended during a construction period to the cost of the construction, and that in a mining enterprise a similar treatment would be appropriate in the case of development expenses. He also said that to undertake a capital construction of the magnitude that Sherritt did, requires the bringing together of three factors, labour, materials and capital; capital had to be raised to complete the construction, and the interest and commitment fee incurred during the construction period is just as real a cost of that construction as the bricks and mortar; and capitalizing or adding the interest and commitment fee to the cost of construction establishes a base for depreciation in which the total capital cost is charged to the operations of the company over the useful life of the plant, thereby bringing about a proper matching of expenses with revenues during the operating life of the company; also that if interest during construction is not capitalized it must be charged to operations and thereby create a loss during construction, with the result that the company is operating at a loss before it has begun active operation, which not only does not represent proper matching of the total cost of the project over its useful life, i.e., the adequate matching of costs with revenues, because the period during which the money is expended does not coincide with the periods during which the benefit of that expense is going to be

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realized, but is also unfair to present shareholders in that for them there would be an expense and a loss whereas for future shareholders there would be a benefit because they would not have to bear that expense.

Mr. Barker also agreed that there are a number of factors and variables to be considered in deciding whether or not to capitalize interest during construction and these factors include income from other operations of a company, the significance and size of the interest expense, the co-mingling of funds and their segregation, the source of the funds and the purpose for which they are used, and the length of the period of construction. He agreed also that there is some difference of opinion as to whether interest during construction should be capitalized and there is also a view held that interest is a money cost or a financing cost and should either not be capitalized at all or, if capitalized, should not be charged to a particular asset but to an intangible account and written off over a period of time; also that it is difficult to find anything specific on commitment fee as such, and his opinion in respect of such fee expense is related to his experience with interest and other types of expense incidental to a particular project construction.

In Mr. Barker's opinion it would have been improper for Sherritt to isolate the interest during construction, take it out of development expenses and charge it as an operating loss.

Mr. Elliott gave his opinion that interest paid during the construction period with respect to funds borrowed for construction, and commitment fees paid for the availability of those funds, are properly capitalizable as part of the cost of the particular project for which the funds were expended; that it is accepted and proper accounting to attribute this expense to the cost of physical assets constructed; and that the commitment fee is paid only so long as the funds are not borrowed, only so long as the project is incomplete, and it is inherently a part of the cost of construction. He said that the generally accepted accounting principle, described as matching costs with revenue, is that in order to measure the income of a period the revenue of the period should be charged with the costs applicable to that period; if the cost of a service that will be derived from a capital asset in the future is charged off against income during a current period the income of the current period would be under-stated and, conversely, the income of the future period would be overstated by reason of the fact that there would be no charge against the revenue of the future period for the costs of the service rendered by that capital asset in that future period; and that a determinative factor in deciding at what time the capitalization of interest should cease is that the property be in a condition to be utilized to earn revenue.

Mr. Elliott also gave his opinion that in Sherritt's case the funds were borrowed for the Lynn Lake project and the interest and commitment fee paid during the construction period were properly attributable to that project and were part of the cost or expense of the development work or the depreciable assets and should be attributed to these accounts; the commitment fee should as a matter of principle be allocated along with the interest and proportionately thereto and that it is fair and reasonable to allocate the interest and commitment fee to the investment in the particular projects for which the funds were borrowed.

Mr. Elliot also said that the practice of capitalizing interest during construction started with utilities but has carried over into other types of companies and is accepted and preferred accounting practice in industrial companies as well as in utilities.

Professor W. B. Coutts, a chartered accountant and Professor of Accounting at the School of Business in the University of Toronto, was called as an expert by counsel for the Minister. His opinion was that capitalization of interest during construction as part of the cost of the assets acquired is not preferable treatment, because it involves too great a departure from the usual accounting basis of valuing or attaching a dollar figure to fixed assets in the accounts, which normally is restricted to costs directly related to the assets; interest is usually regarded as a financing cost, part of the cost of capital treated as a cost in the

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period in which it is incurred; the capitalization of interest during construction leads to inconsistencies within and between companies, such as the fact that an asset acquired by borrowing will show a different cost from the cost of an asset acquired out of equity funds, and the fact that an asset acquired at a time when the company is not engaged in other activities might be capitalized more readily than in the case of a company engaged in other activities; and when interest is capitalized it produces a cost figure that is not really consistent or in conformity with the usual way of valuing fixed assets. As to commitment fees, his opinion was that they are even less justifiably included in the capital asset costs than interest is—such fees seem to be a cost of not using capital in the asset and it is difficult to find any logical relationship between the amount of the commitment fee and the amount of any subsequent investment in fixed assets. As to the allocation of commitment fee expenses to particular assets, he could see no direct relationship between the fee and the amount invested in the asset at a particular time. Counsel for Sherritt showed Professor Coutts excerpts from balance sheets of a number of companies (Exhibit 15) which indicate that interest during construction has been capitalized. Professor Coutts agreed that the practice is more prevalent now than it was ten years ago and also that since 1956 his work has been in the academic world and since that year he has not had any close connection with actual practice.

The three accounting experts were questioned at some length in exploration of their opinion and Professor Coutts commented on extracts from books on accounting to which his attention was drawn by counsel for Sherritt.

The evidence satisfies me that Sherritt found it necessary to borrow, and did borrow, through the bond financing described in the evidence, money that it needed to complete its Lynn Lake project, which consisted of its Lynn Lake mine, Laurie River power plant, Fort Saskatchewan refinery and related facilities, all of which were inter-related with the objective of mining ore from the mine and converting it into concentrates from which saleable metals would be produced; that the money was borrowed exclusively for that project and was expended on it in the years 1952, 1953 and 1954, that payment of the commitment fee, in addition to interest on the bonds, was a requirement of the borrowing and a condition upon which the money was lent; and that the payments of bond interest and commitment fee were made and allocated as reported by Sherritt.

In the Notice of Appeal Sherritt suggested that the commitment fee is interest on borrowed money within the meaning of section 11(1)(*c*) of the *Income Tax Act*. That suggestion was not made at the hearing by counsel for Sherritt, who put Sherritt's case on other grounds. My conclusion is that the commitment fee is not interest.

The submission of counsel for Sherritt was substantially as follows:

1. In the absence of definition in the *Income Tax Act* of "expense" or "cost", these words are to be construed in their normal and ordinary meaning in accordance with accepted commercial principles and practice.

2. It is a fundamental principle of income tax law that expenditures are required to be attributed to an appropriate period in order to compute accurately the income of each period.

3. So-called financial costs, including interest and commitment fee, expended in a construction period are, in accordance with generally accepted accounting principles and practice, properly attributed to the capital cost of the fixed assets constructed, where the borrowing was done for the purpose of the construction; this treatment is based on the necessity to defer such costs over the useful life of the assets in order to give a fair and accurate statement of the income of the taxpayer in each of the periods in which the assets are used to produce revenue.

4. The amounts of commitment fee attributed and allocated by Sherritt in respect of the construction period to the capital cost of depreciable assets are part of the capital cost of those assets within the meaning of section 11(1)(*a*) of the Act and Regulations.

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5. The amounts of commitment fee attributed and allocated by Sherritt to exploration and development expenses are prospecting, exploration and development expenses incurred by Sherritt in searching for minerals in Canada in the years 1952, 1953 and 1954 within the meaning of section 83A(2) and (3) of the Act.

6. The payment of commitment fee is, from the point of view of problems raised by this case, of the same character as a payment of interest and there is no ground for treating commitment fee expense differently from interest expense during the construction period.

7. The method of allocation of the commitment fee followed by Sherritt on the basis of the *pro rata* amount of capital investment in the assets is approved by accounting practice and is fair and reasonable.

8. Sections 11(1)(*a*) and 83A and Regulation 1100 permit the deductions claimed by Sherritt.

The main points of argument submitted by counsel for the Minister were as follows:

1. Sherritt has not established as a fact that the commitment fees are part of the capital cost to it of the assets to which it seeks to attribute them or that they are prospecting, exploration and development expenses in searching for minerals within the meaning of section 83A of the Act.

2. Neither interest nor commitment fees may, as a matter of law, be treated under the Act as part of the capital cost of assets or prospecting, exploration and development expenses within the meaning of section 83A.

3. Interest and commitment fees are costs related to the raising of capital but not a cost of the assets acquired. Commitment fees may perhaps now be deducted, in the year in which they are incurred, under section 11(1)(*cb*) which covers general expenses in connection with raising capital, but that section was not enacted until 1955 and was not in force or applicable to the years 1952, 1953 and 1954 in which the fees were paid. The deduction in those years of commitment fees was prohibited by section

12(1)(*b*) and they cannot be deducted through the indirect route of sections 11(1)(*a*) and 83A. If interest and commitment fees can be capitalized as part of the capital cost of assets and deducted under section 11(1)(*a*), then sections 11(1)(*c*) and 11(1)(*cb*) are superfluous.

4. The legally incorrect result of capitalizing interest on borrowed capital is that it is deducted indirectly through the capital cost allowance route of section 11(1)(*a*) or the route of section 83A; there is only one way of deducting interest and that is under section 11(1)(*c*) in the year in which it is paid or incurred.

5. Capital cost to a taxpayer of depreciable property is the price he pays for it, not the price he pays to obtain the funds; it is plain from an examination of section 20 of the Act that the Act does not contemplate inclusion of interest in the capital cost to the taxpayer.

6. Capitalizing interest during construction is not consistent with the scheme of Part XI of the Regulations, which sets out generally rules for deducting capital cost allowance.

7. The scheme of section 83A is inconsistent with the theory that costs related to the raising of capital should be treated as exploration and development expense.

8. The capitalization of interest paid or accrued during a construction period depends on a large number of variables, is illogical and inconsistent, results in unfairness as between taxpayers, and should be rejected as a sound basis for determining capital cost or exploration and development expenses. There is no legal or logical basis for treating interest incurred during a construction period as part of the capital cost of assets, and treating interest subsequent to the construction period as a current deduction.

9. Sherritt's monies from all sources went into a comingled fund and were paid out without identification as to source.

10. The unadvanced amounts in respect of which the commitment fee was paid were not earmarked or segregated for any particular purpose.

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11. When a payment of commitment fee was made, it was not identified with any particular asset or activity.

12. The percentage allocation made by Sherritt was notional, retroactive and hypothetical and based on total cumulative monthly investment from all sources and not on any particular attribution to source.

13. The allocation of commitment fee follows the allocation of interest, i.e., it is in the same proportion, and does not take into account the difference between interest and commitment fee, the former being based on the amount of capital borrowed and the latter on the amount that had not been borrowed.

Counsel for Sherritt referred to the following cases in support of his argument:

Whimster & Co. v. C.I.R. 12 T.C. 813;
Russell v. Town and County Bank Ltd, 13 App. Cas. 418;
Hinds v. Buenos Ayres Grand National Tramways Co. [1906] 2 Ch. 654;
Chancery Lane Safe Deposit and Office Co. v. C.I.R., 43 T.C. 83;
Bardwell v. Sheffield Waterworks Co., L.R. 14 Eq 517;
Lions Equipment Ltd. v. M.N.R. (1964) 18 D.T.C. 35;
Dominion Taxicab Ass'n v. M.N.R. [1954] S.C.R. 82;
Robert Addie & Sons' Collieries Ltd. v. C.I.R., 8 T.C. 671.

Counsel for the Minister referred to the following cases in support of his argument:

Gunnar Mining Ltd v. M.N.R. [1966] Ex. C.R. 310; [1965] C.T.C. 387; affirmed [1968] C.T.C. 22;
Imperial Oil Ltd v. M.N.R. [1947] C.T.C. 353;
Trapp v. M.N.R. [1946] Ex. C.R. 245; [1946] C.T.C. 30;
M.N.R. v. Anaconda American Brass Ltd [1956] A.C. 85;
Montreal Coke & Mfg Co. v. M.N.R. [1941] Ex. C.R. 21; [1942] S.C.R. 89; [1944] A.C. 126; [1942] C.T.C. 1; (affirmed) [1944] C.T.C. 94 (P.C.);
Madden v. Nelson and Fort Sheppard Ry Co. [1899] A.C. 626;
re Farm Security Act [1947] S.C.R. 394;
Riches v. Westminster Bank Ltd [1947] A.C. 390;
Halsbury, 3rd ed., vol. 27, p. 7;
A. G. Ont. v. Barfried Enterprises Ltd [1963] S C.R. 570; 42 D.L.R. (2d) 137;
Canada Safeway Ltd v. M.N.R. [1956] Ex. C.R. 209; [1957] S.C.R. 717; [1957] C.T.C. 335;
Cree Enterprises Ltd v. M.N.R. [1966] C.T.C. 166; 16 DTC 5158;
City of Birmingham v. Barnes [1935] A.C. 292;
Fraser v. C.I.R. (Circuit Court of Appeals, Second Circuit) 25 F. (2d) 653;
Hays v. Gauley Mountain Coal Co. 247 U.S. 189;
Georgia Cypress Co. v. South Carolina Tax Comm'n., 22 S.E. 2d 419.

The question of deductions claimed by Sherritt and allowed by the Minister in respect of bond interest payments during the construction period is not directly in issue for determination in these appeals, but Sherritt's claim for deduction of commitment fee payments during the construction period is based on the theory that inclusion of payments of interest during construction as part of the cost of the property acquired with the borrowed money is in accordance with generally accepted business and commercial principles and that such interest in Sherritt's case may be deducted under section 11(1)(*a*) as part of the capital cost to the taxpayer of depreciable property and under section 83A(2) and (3) as exploration and development expenses incurred by the taxpayer in searching for minerals in Canada. Consequently that theory must be considered.

However, even if it is found as a fact, as counsel for Sherritt submits it should be, that Sherritt's treatment of payments of bond interest and commitment fee during construction was in accordance with generally accepted accountancy principles and that the method followed was an appropriate method of accounting for Sherritt, that is not conclusive of the question the court has to decide, for the prescriptions of the *Income Tax Act* prevail.

The deductions that are permitted or prohibited, as the case may be, in sections 11, 12 and 83A are certain deductions made in computing income. The word income is defined in section 4 of the Act as follows:

> 4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

This leads to consideration of what is meant by profit for the year.

In *M.N.R. v. Anaconda American Brass Ltd.*[1] the Privy Council said at pages 100 and 101:

> . . . The income tax law of Canada, as of the United Kingdom, is built upon the foundations described by Lord Clyde in *Whimster & Co. v. Inland Revenue Commissioners* ((1925) 12 T.C. 813, 823) in a passage cited by the Chief Justice which may be here repeated. "In the first place, the profits of any particular year or accounting period

[1] [1956] A.C. 85.

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must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn *those receipts*. In the second place, the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the *Income Tax Act*, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes." . . .

In *Can. Gen. Elec. Co. v. M.N.R.*[2] Martland J. said at page 12:

In considering the validity of this conclusion, reference may first be made to some general principles which have been stated regarding the meaning of the word "profit" and the method of its determination.

Viscount Maugham, In *Lowry (Inspector of Taxes)* v. *Cons. African Selection Trust, Ltd.* ([1940] A.C. 648 at 661, 2 All E.R. 545) said:

"It is well settled that profits and gains must be ascertained on ordinary commercial principles, and this fact must not be forgotten."

In this Court, in *Dom. Taxicab Ass'n v. M.N.R.* ([1954] S.C.R. 82 at 85, 54 DTC 1020) Cartwright J. said:

"The expression 'profit' is not defined in the *Act*. It has not a technical meaning and whether or not the sum in question constitutes profit must be determined on ordinary commercial principles unless the provisions of the *Income Tax Act* require a departure from such principles."

In *B.C. Elec. Ry. Co. v. M.N.R.*[3] Abbott J. said at page 137:

Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of s. 12(1)(*a*) whether it be classified as an income expense or as a capital outlay.

Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay. The principle underlying such a distinction is, of course, that since for tax purposes income

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[2] [1962] S.C.R. 3.

[3] [1958] S.C.R. 133.

is determined on an annual basis, an income expense is one incurred to earn the income of the particular year in which it is made and should be allowed as a deduction from gross income in that year. Most capital outlays on the other hand may be amortized or written off over a period of years depending upon whether or not the asset in respect of which the outlay is made is one coming within the capital cost allowance regulations made under s. 11(1)(*a*) of *The Income Tax Act*.

I am satisfied that at least where the amount is significant in relation to the business of a company, it is in accordance with generally accepted business and commercial principles to charge, as a cost of construction, payments of interest in respect of the construction period on borrowed money expended by the company for such construction and to write such payments off over a period of years. The practice of doing so is not as common outside the public utility field as within that field but it has extended to companies outside that field.

Having reached this conclusion, it is necessary to ask whether interest expense of this character may be deducted for income tax purposes in those years in which it is written off. I think there is no doubt that the interest is a capital outlay, the deduction of which in computing income for a taxation year, is prohibited by section 12(1)(*b*) unless its deduction is expressly permitted by some other provision of the Act. Sherritt's case is put on the basis that sections 11(1)(*a*) and 83A(2) and (3) permit deductions of amounts in the computation of which interest is a factor.

This leads to consideration, firstly, whether such interest is part of the cost of the assets acquired by the taxpayer with borrowed capital and, secondly, whether it is part of a capital cost within section 11(1)(*a*). Counsel for Sherritt cited a decision of the House of Lords in 1965, *Chancery Lane Safe Deposit and Offices Co. v. C.I.R.*[4], from which the following extracts are quoted:

Lord Pearson, pp. 128 and 129:

My Lords, the Appellant Company carries on in the basement of its buildings in Chancery Lane a safe deposit business, and lets the upper parts of the building to tenants. Most of the upper parts

[4] 43 T.C. 83.

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were destroyed by enemy action in the years 1940 and 1941. Building operations for rebuilding the upper parts and effecting some new construction were carried out in the period from 1949 to 1958. For the purpose of financing the building operations the Company borrowed large sums on mortgage in the years 1954 to 1956 and repayment was made in the years 1958 to 1961. In the meantime interest was paid on the sums outstanding and secured by the mortgages. The Company consulted its auditors as to the proper treatment of the mortgage interest in its accounts. The auditors advised the Company that, in order to give a true and fair view of the Company's affairs and in particular to bring out the cost of the building operations, and in accordance with general accountancy practice, it was proper to charge to capital the cost of finance during the period of construction in cases where the outlay was substantial in relation to the size of the Company. This was found by the Special Commissioners to be a proper method for accounting purposes, and it was adopted by the Company. A calculation was made for each of the relevant years in order to arrive at the correct proportion of the mortgage interest to be charged to capital in the Company's accounts in that year.

Lord Morris, p. 111:

In the year 1954-55 the Company paid £3,260 in mortgage interest; in the year 1955-6 the amount they paid was £11,324; in the year 1956-57 it was £26,536; in the year 1957-58 it was £29,149; in the year 1958-59 it was £28,879. In the years to which I have referred the Company decided to charge part of those sums to capital. Their decision was deliberate and calculated. It was supported by the reasoning, the soundness of which has not been challenged, that during the period of construction, when the money being spent was substantial in relation to the size of the Company, it was proper to make the cost of finance a charge to capital. The proportion of the mortgage interest which was so to be charged to capital was carefully calculated on the basis of the proportion which actual rents received bore to the estimated amount of the rents that might be obtained when the buildings were completed. By so charging to capital it was considered that a true and fair view of the Company's affairs and of the capital cost of the rebuilding and of the erection of the new buildings would be given.

Lord Upjohn, p. 119:

My Lords, when the Appellants wanted to rebuild their safe deposits premises in Chancery Lane, which had been damaged in the war, they decided to do so by financing it on borrowed money. They had, of course, to pay interest on it, and they were advised by their accountants that it would be proper to treat part of that interest as attributable to capital expenditure. That was plainly right and is not in dispute; the cost of hiring money to rebuild a house is just as much a capital cost as the cost of hiring labour to do the rebuilding. So, in their company accounts issued to shareholders for the relevant years, they debited part of the interest on the borrowed money against their profit and loss account, in the usual way, and part to capital account. This meant, of course, that the profit and loss account was not as diminished as it would have been had the whole been so debited.

Counsel for Sherritt also cited the decision of Warrington J. in *Hinds v. Buenos Ayres Grand National Tramways Co.*[5] from which I quote:

The Buenos Ayres Grand National Tramways Company, Limited, have issued certain debentures the interest on which is payable out of the profits of each year and the profits only. The question which the Court has to determine is whether the company are bound by law to charge against the profits of the year interest on money which has been borrowed expressly for the purpose of what I may call construction. It is not literally construction—it is the conversion of their horse line into an electrical traction line, but for practical purposes it is the same thing as money borrowed for the purposes of construction. The directors propose, unless they are so bound, to charge during the period of construction as part of the expenses of constructing each mile of the new line not only the money actually expended in paying for that construction, but the interest—the proportionate part of the interest—on the money which they have borrowed. Is there anything that renders it incumbent upon the company to charge that interest to the revenue account? In the first place, it is not contended that there is anything in any of the Companies Acts which in terms compels the company so to charge this interest. Neither is there any contractual stipulation to that effect in the documents which regulate the constitution of this company. The question therefore is, Is there, independently of statute, or independently of contractual stipulations affecting this company, any general rule of law which compels a company to charge interest on money borrowed for the purposes of construction against revenue, and prohibits it from charging that interest, during construction, to capital account? That really is the question which I have to decide.

In my opinion there is no such principle of law. I think the authorities establish that the principle which regulates all these questions is that which is expressed by Lord Macnaghten in the case of *Jamaica Ry. Co. v. Attorney-General of Jamaica* ([1893] A.C. 127, 136). He says in reference to expenditure, which prima facie in that particular case was income expenditure: "Nor is every item of expenditure necessarily to be debited wholly against the income of the period in which it occurs. It may be fair and proper to spread some items over a longer time." . . .

. . . In considering the accounts of a company the only principle by which the Court can be guided—of course unless there are some express words, express provisions, or express stipulations on the subject—is the consideration what a commercial man, acting fairly and honestly in the conduct of his business, would consider the proper

[5] [1906] 2 Ch. 654.

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thing to do. Now, I think that that is illustrated also by that case of *Bloxam v. Metropolitan Ry. Co.* (L.R. 3 Ch. 337). In that case the question which I have to determine directly arose. Wood V.-C. thought that the interest on borrowed money ought clearly to be charged against revenue; but the matter came before the Appeal Court, and Lord Chelmsford L.C. expressed the gravest doubt without expressly dissenting as to whether there was any such stringent rule as the Vice-Chancellor had thought. It is impossible to read the judgment of Lord Chelmsford without seeing (although he carefully guarded himself against expressly dissenting) what his views were. In a subsequent case, *Bardwell v. Sheffield Waterworks Co.* (L R. 14 Eq. 517), Malins V.-C. allowed the interest on money borrowed for the purpose of capital expenditure during construction to be added to the amount expended and to be treated as a capital charge. That is how the authorities stand. Now, what is it that the company are really proposing to do? They are creating a capital asset by means of which they will hereafter earn, or they hope to earn, profits for the company. They are not simply employing contractors to find the money and do the work. They are finding the money themselves, and they find the money by borrowing it. What does each mile of line cost them under these circumstances—what is it that they expend in constructing each mile of line, taking the amount of the borrowed money expended on that line to be £10,000., that being the company's estimate? The money is borrowed for that particular purpose—the £10,000. They have to pay interest on that £10,000. during the period that construction is taking place. In my opinion that asset which they are so constructing costs them not only the £10,000., but the £10,000. plus the amount of interest during that period of construction; and that is what they are out of pocket during the construction of that mile of line. Now, it seems to me that the company are entitled—I do not say that they are bound to do it—if they think fit to charge in their accounts as the cost of that mile of line not only the £10,000., but the £10,000. and the interest on it during the period of construction.

Counsel for the Minister cited several decisions of courts in the United States to the effect that the cost of property is the price paid for it at the time of its acquisition and that interest upon the sum invested or borrowed is not part of such cost.

Fraser v. C.I.R.[6]. On the question whether interest on borrowed money could be treated as part of the cost of real property for the purposes of income tax the court said at p. 655:

Again, at least as to interest charges, we should have to include not only that actually paid upon borrowed money, but that calculated upon the amount invested. Otherwise the profit of a speculator would

[6] 25 F. (2d) 653.

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be less than that of an investor, a result contrary to common understanding. Certainly it can make no difference how the owner procures the purchase price, whether from funds in hand, or on his bare credit, or on security, or with the help of sureties. Hays v. Gauley Mountain Co., 247 U.S. 189, 38 S. Ct. 470, 62 L. Ed. 1061, decided that interest upon the amount invested was not part of the cost, and the principle there settled seems to us to involve interest on borrowed money as well.

Georgia Cypress Co. v. South Carolina Tax Commission[7] at page 422:

> In construing the word "cost" as employed in the Statute, this Court has said: "It distinctly provides that the basis of taxation and allowances for depreciation shall be the cost (not the value) of the property and additions. Now in the nature of things the cost of the property is the price paid for it at the time of its acquisition and the cost of any improvements and betterments at the time they were made." . . .

There are differing views as to whether interest during construction is part of the cost of assets acquired or constructed with the borrowed money. However, as stated, it is necessary to go further and consider whether such interest is part of the capital cost to the taxpayer of property within the meaning of section 11(1)(*a*). The subsection is 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:
>
> (*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;

There is no decision binding on this court on that question, so far as I am aware. In my view the question is fairly arguable, but I am disposed to think that interest during construction can be a part of the capital cost of property within section 11(1)(*a*) and that in Sherritt's case a portion of the payments of bond interest and commitment fee during construction was part of the capital cost to Sherritt of the depreciable property upon which the bond money was expended, within the meaning of that subsection. The commitment fee payments were necessarily made to obtain the bond money and were payments on

[7] 22 S.E. 2d 419.

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account of capital and, although there are differences between bond interest and commitment fee, I see no persuasive reason why Sherritt's payments of commitment fee during construction should not be treated as part of the capital cost of the property if the payments of bond interest during construction are to be so treated.

In the absence of any definition in the statute of the expression "capital cost to the taxpayer of property" and in the absence of any authoritative interpretation of those words as used in section 11(1)(*a*), insofar as they are being considered with reference to the acquisition of capital assets, I am of opinion that they should be interpreted as including outlays of the taxpayer as a business man that were the direct result of the method he adopted to acquire the assets. In the case of the purchase of an asset, this would certainly include the price paid for the asset. It would probably include the legal costs directly related to its acquisition. It might well include, I do not express any opinion on the matter, the cost of moving the asset to the place where it is to be used in the business. When, instead of buying property to be used in the business, the taxpayer has done what is necessary to create it, the capital cost to him of the property clearly includes all monies paid out for the site and to architects, engineers and contractors. It seems equally clear that it includes the cost to him during the construction period of borrowing the capital required for creating the property, whether the cost is called interest or commitment fee. Such cost is a capital cost that could not be deducted as an operating expense, without special authority. Possibly as good a way as any of testing the matter is to consider the possibility of a third person creating the required assets to the taxpayer's specifications to sell them to him when completed. All their financing costs would enter into the price that the taxpayer would have to pay for the assets and there would be no doubt that the price would be the capital cost of the property to him if he bought it ready to use. If that be so, why should those costs be classified otherwise when he creates the asset himself?

The inclusion of interest during construction as part of the capital cost of property within the meaning and for the purposes of section 11(1)(*a*) may present problems in some instances, but I do not think that an interpretation that includes such interest is inconsistent with the scheme of the Act or its capital cost allowance provisions. On the contrary, that treatment of interest during construction should, I think, help to accurately reflect the result of each taxation year's operations and the profit therefrom for that year for both business and income tax purposes, without unduly interfering with the smooth working of the Act.

Next there is the contention that section 11(1)(*c*), governing the deduction of interest, is a specific provision and that it permits deduction of interest only as a current expense in the year in which it is incurred or paid, and that a taxpayer has no option to deduct interest through section 11(1)(*a*). Section 11(1)(*c*) is 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:
>
> . . .
>
> (*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;

There is also the argument that if deduction of payments of commitment fee is permissible it is by virtue of section 11(1)(*cb*), which was not enacted until 1955 and is not applicable to the years 1952, 1953 and 1954 in which the payments here under consideration were made, and this

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subsection permits deduction of expenses only in the year in which they are incurred. Section 11(1)(*cb*) is 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:
>
> . . .
>
> (*cb*) an expense incurred in the year,
>
> (i) in the course of issuing or selling shares of the capital stock of the taxpayer, or
>
> (ii) in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property (other than money used by the taxpayer for the purpose of acquiring property the income from which would be exempt),
>
> but not including any amount in respect of
>
> (iii) a commission or bonus paid or payable to a person to whom the shares were issued or sold or from whom the money was borrowed, or for or on account of services rendered by a person as a salesman, agent or dealer in securities in the course of issuing or selling the shares or borrowing the money, or
>
> (iv) an amount paid or payable as or on account of the principal amount of the indebtedness incurred in the course of borrowiing the money, or as or on account of interest:

Apart from section 11(1)(*a*), (*c*) and (*cb*), interest on borrowed capital and the expenses covered by paragraph (*cb*) would not be deductible, because they are expenses in relation to capital and are not operating expenses.

As regards interest paid in a year or payable in respect of a year while the company was carrying on its business, section 11(1)(*c*) provides for its deduction in computing its income of that year. Similarly, insofar as an expense within section 11(1)(*cb*) is concerned, if it was incurred in a year while the company was carrying on its business, section 11(1)(*cb*) applies to permit its deduction in computing its income of that year.

Neither section 11(1)(*c*) nor section 11(1)(*cb*) has any application to interest, or to expenses covered by paragraph (*cb*), incurred in respect of a year in which the company is building its plant and before it starts to carry on its business. It cannot have a computation of income from a nonexistent business. (Note Section 11(1)(*c*)(i): "borrowed money used for the purpose of earning income from a business").

Section 11(1)(*a*) was designed to allow capital costs to be written off as such and clearly applies—as paragraphs (*c*) and (*cb*) do not—to the costs of a capital nature incurred before the business was commenced. There is, therefore, nothing inconsistent between applying paragraphs (*c*) and (*cb*) to expenses incurred during the operation of a business and allowing such costs incurred before the starting of the business as capital costs under section 11(1)(*a*).

I would apply the same reasoning, although it is a little more difficult, to a case where, while one business is being carried on, a substantially different one is being readied for launching.

Heretofore I have dealt with the general question whether interest during construction is deductible under section 11(1)(*a*). The circumstances in Sherritt's case add complexities to the problem. Its funds from all sources were co-mingled and were paid out without identification as to source, and when a payment of bond interest or commitment fee was made it was not identified with any particular asset or activity. It was argued by counsel for the Minister that for these among other reasons Sherritt has not established that a portion of the commitment fee paid by it is part of the capital cost of the particular assets to which Sherritt has attributed and allocated payment of such fee and in respect of which it claims deductions under section 11(1)(*a*). Counsel for Sherritt, on the other hand, says that the method of attribution and allocation followed by the company on the basis of the *pro rata* amounts involved was in accordance with accepted business and accountancy practice and was fair and reasonable.

Having regard to the mingling of funds and the method of Sherritt's bookkeeping, I have no doubt that Sherritt cannot establish exactly how much of the bond money was expended on the construction of a particular asset in respect of which it is claiming capital cost allowance. However, I think that it probably was impractical in a business sense

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for Sherritt to keep records showing the source of the funds and their application in the case of each item of expenditure. The President of the company said that it is an impossibility, or at least he had never heard of a normal business attempting to do it, to get moneys in from various sources and to pay them all into separate accounts and then to say out of this account we spent so much and so much. Expenditures were recorded on a monthly accrual basis and the total amount spent on each asset was known. The total amount of bond money spent on the project was known, as was the total amount spent from other funds. The amounts of bond interest and commitment fee payments were known. The dates of expenditures and of payments of interest and commitment fee were known. The attribution and allocation of bond money and of bond interest made by Sherritt was accepted by the Minister in respect of the deductions claimed by Sherritt and allowed by the Minister in connection with payments of bond interest during construction.

I think that in the circumstances of Sherritt's business it was proper for the company to make a retroactive attribution and allocation of bond interest and commitment fee payments on the basis of judgment and opinion and the records of the company, as Sherritt did, and although the fit may not be perfect the attribution and allocation so made was fair and reasonable and adequate and acceptable for income tax purposes (except, as stated later herein to such extent, if any, as bond interest or commitment fee was attributed to the refinery at Fort Saskatchewan as an exploration or development expense in searching for minerals).

There remains the matter of deductions of commitment fee payments claimed as exploration and development expenses under section 83A(2) and (3) which were disallowed by the Minister. They were claimed on the basis that a portion of the bond money was expended in exploration and development of the Lynn Lake mine in the years 1952, 1953 and 1954 and that an appropriate portion of the interest and commitment fee payments during the construction period in those years was attributable to exploration and development expenses and deductible as such under section 83A(2) and (3). As in the case of construction of depreciable assets, these expenses were paid out of a common fund from all sources and no record was kept that would show the particular source of the money used to pay a particular item of expense. An attribution and allocation was made on a *pro rata* basis (as already referred to in the case of depreciable property) and it was accepted by the Minister in allowing, as exploration and development expenses, bond interest attributed and allocated to such expenses.

The pertinent parts of section 83A(2) and (3) are:

83A. (2) A corporation whose principal business is mining or exploring for minerals may deduct, in computing its income under this Part for a taxation year, the lesser of

(*a*) the aggregate of such of the prospecting, exploration and development expenses incurred by it in searching for minerals in Canada as were incurred during the calendar year 1952, to the extent that they were not deductible in computing income for a previous taxation year, or

. . .

(3) A corporation whose principal business is

. . .

(*b*) mining or exploring for minerals,

may deduct, in computing its income under this Part for a taxation year, the lesser of

(*c*) the aggregate of such of

. . .

(ii) the prospecting, exploration and development expenses incurred by it in searching for minerals in Canada,

as were incurred after the calendar year 1952 and before the end of the taxation year, to the extent that they were not deductible in computing income for a previous taxation year, or

I think that the reasoning that in my view supports the inclusion of interest during construction as part of the capital cost of the depreciable property acquired or constructed through the expenditure of the borrowed bond money also supports the inclusion, as exploration and development expenses, of interest during the construction period on the borrowed bond money spent in exploration and development work in that period. Similarly in respect of commitment fee payments.

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It is not clear to me whether any portion of the payments of bond interest or commitment fee during the construction period was attributed and allocated to the refinery at Fort Saskatchewan as an exploration or development expense. I do not think that expenses paid in the development of that refinery can be said to be expenses in searching for minerals within the meaning of sections 83A(2) and (3).

The appeals are allowed and the assessments for the appellant's 1958 and 1959 taxation years are referred back to the respondent for re-assessment to allow deductions of the portions of the payments of commitment fee claimed by the appellant as exploration and development expenses and as capital cost allowance (which are referred to in the Notices of Appeal, particularly in paragraph 9 in each Notice), except insofar as such portions include an amount allocated by the appellant to its accounts concerning its refinery at Fort Saskatchewan as being exploration and development expenses deductible under section 83A of the *Income Tax Act*.

The respondent will pay to the appellant its costs of the appeals to be taxed.