Privy Council Appeal No. 51 of 1942

The Montreal Coke and Manufacturing Company – *Appellants*

v.

The Minister of National Revenue – – – – *Respondents*

The Montreal Light Heat and Power Consolidated – *Appellants*

v.

The Minister of National Revenue – – – – *Respondents*

Consolidated Appeals

FROM

THE SUPREME COURT OF CANADA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 3RD MAY, 1944

Present at the Hearing:

THE LORD CHANCELLOR (*Viscount Simon*)
LORD RUSSELL OF KILLOWEN
LORD MACMILLAN
LORD WRIGHT
LORD PORTER

[*Delivered by* LORD MACMILLAN]

The appellants in these consolidated appeals, hereinafter for brevity called "The Coke Company" and "The Light Company", carry on important undertakings in Canada which are financed in part by money borrowed from the public on interest-bearing bonds. At 1st January, 1935, the Coke Company had outstanding a series of 5½ per cent. bonds maturing in 1947 but redeemable prior to maturity at a premium. Principal and interest were payable at the bondholder's option in United States dollars. The Light Company at 1st January, 1936, had outstanding a series of 5 per cent. bonds maturing in 1951. Principal and interest were payable at the bondholder's option in gold at Montreal, Toronto, New York or London. Owing to the state of the exchange the options as to the mode of payment occasioned considerable expense to both companies. Market conditions being favourable, both companies decided, with a view to reducing their interest charges, to redeem their existing bonds before maturity and to reborrow at lower rates on less onerous conditions as to payment. The carrying through of these financial operations necessarily involved substantial outlays on the part of both companies. The question for decision by their Lordships is whether these outlays are permissible deductions under the Income War Tax Act, 1927, in the assessment of the appellants' taxable income.

In order to appreciate the nature of the expenditure incurred by the companies in the conversion of their bonds it is necessary to set out the items in some detail. In the case of the Coke Company the amount of their 5½ per cent. bonds outstanding was $3,457,000. Notice was given that the bonds would be redeemed at 1st December, 1935, the next date for the payment of interest. As this date anticipated the maturity of the bonds a premium of 2 per cent. was payable, amounting to $69,140. The bondholders being entitled at their option to payment in United States dollars this involved the disbursement of $36,744.81 on account of exchange

premium. Under the scheme the company paid off $57,000 of the bonds out of earnings and replaced the balance of $3,400,000 by the issue of two new series of bonds, one of $1,200,000 3½ per cent. bonds, the other of $2,200,000 4 per cent. bonds, principal and interest being payable in Canada. A commission or discount of ½ per cent. on the 3½ per cent. issue and of 1 per cent. on the 4 per cent. issue was paid to underwriters who took up the whole of both issues. This commission or discount amounted to $28,000. These three sums of $69,140, $36,744.81 and $28,000 amounting together to $133,884.81, the company decided to amortize by spreading them over twelve years, involving a charge of $10,535.16 annually against income.

Then as the old bonds were not repaid till 1st December, 1935 and the new bonds dated from 16th September, 1935, the company had to pay interest on both the old bonds and the new bonds for the overlapping period. This cost the company $23,207.54. And legal, printing and other incidental expenses were incurred to the amount of $12,484.92 in connection with the retiring of the old bonds and the issue of the new bonds. These two items the company charged wholly against the income of the year 1935 but was willing to amortize them on the same footing as the other items above mentioned.

The result of this "refinancing"—the word is the appellants'—was a reduction of the company's interest charges by $4,750 in 1935 and $55,716.66 in 1936. In contrast with the system obtaining in the United Kingdom the legislation of Canada permits in the computation of taxable income, the deduction of "such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow" (Income War Tax Act, 1927, s.5 (*b*)). Consequently, a diminution in deducted interest charges reflects itself, other things being equal, in increased taxable income.

The details in the case of the Light Company are on the same lines. The company had outstanding 5 per cent. bonds to the amount of $27,615,000. The premium paid on their retirement was 4 per cent., amounting to $1,104,600. The exchange premium cost $676,726. The old bonds were repaid out of the proceeds of the sale of investments to the extent of $12,615,000. The balance of $15,000,000 was reborrowed on two series of bonds with different periods of redemption, one of $5,000,000 at 2½ per cent. and one of $10,000,000 at 3½ per cent. principal and interest being payable in Canada. Discount at the rate of 1½ per cent. was paid on the 2½ per cent. issue and at the rate of 4 per cent. on the 3½ per cent. issue, amounting in all to $475,000. Expenses in connection with the operation accounted for $25,753.42. These four items, totalling $2,282,079.42, the company amortized by spreading them over twenty years, the amount debited to 1936 (for eleven months) being $104,596.04. In this case also there was overlapping interest to the amount of $79,166.64 and the whole of this, as well as an item of $29,134.75 representing excise tax and expenses paid on the transfer of certain securities, the company charged against 1936 without amortization. The result of the whole operation was a large saving in interest charges and exchange.

The Coke Company in making its return of income for the year 1935 deducted a sum of $46,227.62 made up of the amortization instalment of $10,535.16, the overlapping interest $23,207.54 and expenses $12,484.92, as above detailed. In its return for 1936 the company deducted the amortization instalment of $10,535.16.

The Light Company in making its return for the year 1936 deducted a sum of $212,897.43 made up of the amortization instalment of $104,596.04, the overlapping interest $79,166.64 and the excise tax $29,134.75.

The respondent the Minister of National Defence disallowed *in toto* the deductions claimed by the Coke Company. The company served a notice of appeal on the Minister. The Minister affirmed his assessment. Thereupon the Company sent to the Minister a notice of dissatisfaction to which the Minister replied adhering to his decision. Finally the Minister caused

the relevant documents to be transmitted to the Registrar of the Exchequer Court of Canada and the matter was then deemed to be an action in that Court ready for trial or hearing. The procedure in the case of the Light Company followed the same lines. It may be noted that the claim to deduct the item of $29,134.75 for excise tax was not pursued and disappears from the case.

The appeals of both parties were heard in the first instance by McLean, J., who affirmed the Minister's decision disallowing the deductions. Appeals to the Supreme Court were dismissed by a majority consisting of the Chief Justice (Sir Lyman Duff) and Davis and Kerwin, J.J.; Rinfret and Taschereau, JJ., dissenting. The reasoned judgments of the Court are given in the Light Company's appeal. Special leave to appeal to His Majesty in Council was granted on the advice of their Lordships.

The question at issue turns entirely upon the terms of the Income War Tax Act, 1927. Part II of the Act, which is headed " Exemptions and Deductions ", contains section 6 which has a sub-heading " Deductions from Income not allowed ". So far as relevant to the present purpose section 6 reads as follows:

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

By section 9 of the Act the tax is charged upon income and by section 3 income is defined to mean annual net profit or gain.

It is important to attend precisely to the language of section 6. If the expenditure sought to be deducted is not for the purpose of earning the income and wholly, exclusively and necessarily for that purpose then it is disallowed as a deduction. If the expenditure is a payment on account of capital it is also disallowed. The appellants say that the outlays in question were made wholly, exclusively and necessarily for the purpose of earning income and were not payments on account of capital. The respondent maintains the contrary.

The justification for upholding the deductions claimed could not be more attractively presented than it is in the judgment of Rinfret, J. (now Chief Justice of Canada) with which Taschereau, J., concurred. The learned judge says: " There are two ways of increasing the profits from a trade or commercial or other calling; either by increasing the earnings while the expenses remain the same or by decreasing the expenses while the earnings remain the same. Of course if the expenses diminish at the same time as the gross earnings are increased the profits will be correspondingly larger and the proposition just mentioned is only made more evident. . . . In order to pay a lower interest and to get rid of the exchange rates it was necessary to redeem the original bonds; and therefore the expenses required to achieve that result were wholly, exclusively and necessarily laid out or expended for the purpose of decreasing the fixed interest and exchange charges and accordingly ' for the purpose of earning the income '." Down to the last nine words quoted the statement of Mr. Justice Rinfret is unexceptionable, but their Lordships are unable to accompany him in leaping the last fence. If the statute permitted the deduction of expenditure incurred for the purpose of increasing income the appellants might well have prevailed. But such a criterion would have opened a very wide door. It is obvious that there can be many forms of expenditure designed to increase income which would not be appropriate deductions in ascertaining annual net profit or gain. The statutory criterion is a much narrower one. Expenditure to be deductible must be directly related to the earning of income. The earnings of a trader are the product of the trading operations which he conducts. These operations involve outgoings as well as receipts and the net profit or gain which the

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

A faint suggestion was made that the item for overlapping interest might be differentiated from the other items of expenditure in view of the fact that interest on borrowed money is a permissible deduction at such rate as the Minister may allow. But the overlapping interest was paid as part of the cost of the refunding operations and on money borrowed temporarily in excess of what was required for the purposes of the businesses during the overlapping period and was thus properly disallowed by the Minister.

It was conceded in the Courts in Canada, and in any event it is clear, that the expenses incurred by the appellants in originally borrowing the money represented by the bonds subsequently redeemed were properly chargeable to capital and so were not incurred in earning income. If the bonds had subsisted to maturity the premiums and expenses then payable on redemption would plainly also have been on capital account. Why then should the outlays in connection with the present transactions, compendiously described as " refunding operations ", not also fall within the same category? Their Lordships are unable to discern any tenable distinction. In the history of both companies the financial re-adjustment of their borrowed capital was an isolated episode, unconnected with the day to day conduct of their businesses, and the benefit which they derived was not " earned " by them in their businesses.

In the Courts in Canada the deductions claimed were held to be struck at both by para. (*a*) of section 6 as not being expenditure for the purpose of earning the income and by para. (*b*) as being payments on account of capital. It may well be that items of expenditure may be open to both objections. The first objection, which their Lordships uphold, is sufficient for the disposal of the cases but their Lordships in no way dissent from the view that the second objection also applies.

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

Their Lordships will accordingly humbly advise His Majesty that the consolidated appeals be dismissed, and the judgments of the Supreme Court of Canada be affirmed. The appellants will pay the respondent's costs of the present appeal.

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In the Privy Council

THE MONTREAL COKE AND MANUFACTURING COMPANY

v.

THE MINISTER OF NATIONAL REVENUE

THE MONTREAL LIGHT HEAT AND POWER CONSOLIDATED

v.

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DELIVERED BY LORD MACMILLAN

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