

TAXATION DECISIONS AND RULINGS

THE PROFITS OF CORPORATIONS AND FROM BUSINESS

"Income" in section 3 of the Act is defined to mean the annual net profit or gain or gratuity directly or indirectly received "from any profession or calling, or from any trade, manufacture or business". The method by which such net profits or gains are to be ascertained is nowhere indicated in the Act, except that in section 5 certain deductions are allowed, and in section 6 certain outlays are expressly prohibited. In the case of a corporation therefore, the net profits may roughly be defined as being the gross receipts, excluding items of a capital nature, less the expenses wholly, necessarily and exclusively expended in earning such profits and deducting therefrom certain specifically designated payments or allowances, and which are

- (1) depletion (section 5, ss. 1 (a))
- (2) interest on borrowed money (section 5, ss. 1 (b))
- (3) payments into employees' pension funds (section 5, ss. 1(ff))
- (4) donations to charitable organizations (section 5, ss. 1(jj))
- (5) business losses in preceding year (section 5, ss. 1 (p))
- (6) reserve for bad debts (section 6, ss. 1(d))
- (7) depreciation (section 6, ss. 1(n)).

Some difficulty will, under the circumstances, arise in determining the net amount from which the above noted deductions may be made. The question as to just what does constitute "profits" has been considered by the courts in England in numerous judgments. It was stated in an early case:¹

The profits in a proper trader's balance sheet are a very different thing from profits as these have been defined under the provisions of the statute.

In a later case² Lord Johnston of the Court of Session (Scotland) says:

It is fully recognized that the profits or gains of a trade in the sense of the Income Tax Acts are not the profits which reach the partners, or the net profits, but the profits which the business, regarded an entity, makes

¹ *Edinburgh Southern Cemetery Co. v. Kinmont*, 2 T.C. 516 at 529.

² *Scottish North American Tr. v. Farmer*, 5 T.C. 693 at 697.

In discussing the computation of trading profits, the Committee appointed by the British Government to draft a Bill to codify the law relating to Income Tax says in its report, at page 48:

It has often been the subject of judicial comment that the existing Acts contain no general direction as to the ascertainment of business profits. Such guidance as they give is confined to a statement that the amount to be assessed is 'the balance of the profits or gains' of the business, subject to a series of provisions prohibiting certain specific deductions—some of which, being in the form of limitations, are taken as authorizations of deductions within limits. It has been left to the Courts to lay down that 'the balance of profits or gains' must in the absence of express provision to the contrary, be arrived at in accordance with ordinary commercial principles, and to formulate the principle that a proper debit item in a trading or in a profit and loss account is, in general, a proper debit item in an income tax computation.

In the English taxing Act the liability is against the "balance of profits and gains", arising in the taxation period. As in the Canadian Act, there is nothing to indicate just what these may be, and in the result they are arrived at by the exclusion from the gross receipts of those expenses not expressly prohibited. The restrictions are greater in the Canadian Act, which in section 6, ss. 1, para. (a) prohibits the deduction of expenditures "not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income". The corresponding section of the English Act is in Rule 3 of the Rules Applicable to Cases I and II of Schedule D and which prohibits the deduction of

(a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade

The distinction between monies expended for the "purpose of earning the income" and for the "purposes of the trade" was discussed in the Supreme Court of Canada in *Riedle Brewery Limited v. Minister of National Revenue*.³ In that case the point at issue was the allowance of certain so-called "treating expenses" occasioned by employees of the brewery entering taverns and purchasing a glass of beer for persons on the premises. In a minority judgment, Davis J. said:

The expense may have been wisely undertaken and may properly find a place, either in the balance sheet or in the profit and loss account of the appellants, but this is not enough to take it out of the prohibition in section 6(1) (a) of the Act. For that purpose it must have been incurred for the direct purpose of producing profits.

³ [1939] 3 D.L.R. 436.

The majority judgment of the Court was delivered by Kerwin J. and concurred in by Duff C.J. and Crocket J. A broader interpretation of the restrictive provisions was given in the following words:

There remains the question as to whether the money was thus laid out for the purpose of earning the income, that is the income for the 1933 taxation period. In any consideration of this question a certain degree of latitude must, I think, be allowed. For instance in the case of a manufacturing company employing travellers to solicit business, meticulous examination of the latter's expense accounts might easily disclose that sums expended towards the end of one taxation period were not productive of orders or of the filling of the orders or of the payment for the goods supplied;—in the same period. That result should not prevent the company deducting such expenses in its return under the Act. The statutory provisions may be given a reasonable and workable interpretation by holding that, as long as the disbursements fulfil the requirements already discussed, the taxpayer expended them for the purpose, *i.e.* with the object and intent that they should earn the particular gross income reported for the period.

A proper understanding of what constitutes taxable profits necessitates a full consideration of what is or is not deductible, for it is only in this way that the correct amount can be determined. In its essence the profit from a business resolves itself into that portion of the gross receipts which remains after all expenditures have been made. For taxation purposes, the nature and amount of such expenditures is not left to the sole discretion of the operator of the business but is limited by express statutory prohibitions.

In giving evidence before the Royal Commission on the Income Tax in England, Mr. A. Hook, the Superintending Inspector of Taxes, stated at paragraph 9878:

A clear idea of the meaning of profit will enable us to distinguish between expenses which are actual costs in earning the profit (such as the cost of trading stock) and expenses which are not in themselves actual costs in earning the profit, but merely payments by individuals for the opportunity of earning the profit, but merely payments by individuals for the opportunity of earning the profits (such as payments for goodwill).

And at paragraph 9879:

In other words, profit is the amount by which the sale price of the product exceeds the capital expended and used up in the actual process of production, without regard to any sums paid for a share of, or an interest in, the profits arising from such process.

The witness was questioned by one of the commissioners on this definition, and one question and answer is interesting as illustrating the viewpoint of the taxing authorities.

Paragraph 10019:

You rather indicate that the definition of profit is narrower in the view of the Income Tax Acts than its ordinary business meaning. Should there not be some attempt to reconcile the two in any suggestions for the alteration of the law? — I quite agree that the Income Tax should take tax upon the net profits of production, and that if in any case it does not at present admit an expense which is a *bona fide* cost of production, in principle it should be altered to meet that hardship; but as regards every other expense I think the Income Tax directly is not concerned at all, and in any case any outlay of that sort should not diminish the amount of profit on which the Revenue is entitled to receive tax.

There is evidence to show that the conception of the true profits from a business have changed and that these changes will continue. The keeping of books and the compilation of the balance sheet and trading account is now done by highly trained and expert accountants. There is no reason to believe that these persons will not evolve methods and procedure by which the earnings of the complex modern businesses will be more exactly determined. In particular, expenses which in the past have not been recognized, will be considered as being necessary in the proper conduct of the business. An example of this is the provision for social and health benefits for employees, and which are being regarded as not only profitable but necessary in the conduct of the business.

It may be that the taxing authorities will be slow to admit such new forms of expenditures as being necessary. There is evidence, however, that the courts may take a more advanced view. In an early case, *Gresham Life Assurance Society v. Styles*,⁴ Halsbury L.C. said:

The thing to be taxed is the amount of profits and gains. The word "profits" I think is to be understood in its natural and proper sense — in a sense which no commercial man would understand.

A leading case on the determination of profits is *Ushers' Wiltshire Brewery Ltd. v. Bruce*,⁵ where Lord Loreburn says at p. 419:

The reasons given were that profits and gains must be estimated on ordinary principles of commercial trading by setting against the income earned the cost of earning it, subject to the limitations prescribed by the Act.

⁴ 3 T.C. 185 at p. 188;

⁵ 6 T.C. 399;

And at p. 425 Lord Atkinson says:

This rule, however, proceeds to enact that only those deductions which are thereafter allowed are to be made. Deductions which, on ordinary business practice, and principles, might be deducted, are thus restricted.

But in a later case⁶ Lord Loreburn says at p. 379:

An infinite number of illustrations might be given of instances in which part of a trader's income is or is not profit of his trade, and it will be time enough to decide each case when it actually arises. I know of no formula which can discriminate in all circumstances what are and what are not profits of a trade. Probably that is the reason why the Statute does not contain a closer definition.

From the foregoing it is evident that the courts do not regard any fixed rule or procedure as being binding in the determination of what is "profits". It is apparent, however, that the accepted practice of accountants will bulk large in making the determination and the matter was clearly expressed by the Lord President Clyde of the Scottish Court of Session in *Lothian Chemical Company Limited v. C.I.R.*, 11 T.C. 508 at page 520 in the following words:

My Lords, it has been said times without number — it has been said repeatedly in this Court — that in considering what is the true balance of profits and gains in the Income Tax Acts — and it is not less true of the Act of 1918 than of its predecessors — you deal in the main with ordinary principles of commercial accounting. They do expressly exclude a number of deductions and allowances, some of which according to the ordinary principles of commercial accounting might be allowable. But where these ordinary principles are not invaded by Statute they must be allowed to prevail. It is according to the legitimate principles of commercial practice to draw distinctions, and sharp distinctions, between capital and revenue expenditure, and it is no use criticising these, as it is easy to do, upon the ground that if you apply logic to them they become more or less indefensible. They are matters of practical convenience, but practical convenience which is undoubtedly embodied in the generally understood principles of commercial accounting.

An interesting example as to the determination of profits was the *Tebrau (Johore) Rubber Syndicate Limited*.⁷ In this case a company was created for the purpose of and did acquire two rubber estates and it was intended to cultivate and develop such properties. There being insufficient capital the estates were sold to a second company at a profit and it was held that such

⁶ 6 T.C. 327;

⁷ 5 T.C. 658:

profit was not income of the company but was in fact an appreciation of capital. The deciding factor in this case was the conclusion that the company was amply capitalized and had in fact intended to work the property to produce profits. In *California Copper Syndicate v. Harris*⁸ the company acquired a copper bearing field which was sold for shares of another company. In this case the Court found that the company's capital set-up was such that it was evident it never intended to work the field and that on these facts the difference between the purchase price and the value of the shares received for the property was taxable income to the company. It would follow from this, therefore, that the full facts in every case would be, given consideration in the determination as to whether a receipt did constitute income.

In the case of an isolated transaction by a corporation it has been generally held that the profits are taxable. In this some distinction is made as between corporations and individuals. Thus a coal company which made a purchase of waggons on their own account and which were subsequently disposed of at a profit was deemed to be taxable on such profit which was made in the operation of the company's business.⁹ A subsidy paid under a Government order to encourage the manufacture of sugar in Great Britain from beets was held to be a trading receipt of the Company and taxable in the year in which it was received, *Smart v. Lincolnshire Sugar Company Limited*.¹⁰ This judgment was founded on the terms of the legislation authorizing the subsidy, which was based on so much per unit of sugar manufactured and was for a period of years only. The company contended that the subsidy was in fact an advance, the provisions of the Act providing that under certain circumstances the advances by way of subsidy might be repayable although in the event that happened they were not repaid. At page 660 Lord Wright M.R. says:

I cannot myself see any ground for regarding these payments as other than payments made to the Respondent Company in the way of their trade. I think they are what are often called, not perhaps very satisfactorily, 'trading receipts'. They were made for the definite purpose of enabling the Company to surmount the difficulties in the carrying on of their trade to which they might otherwise have been exposed.

This case, however, should be distinguished from the *Seaham Harbour Dock Company v. Crook*,¹¹ in which a company received

⁸ 5 T.C. 159;

⁹ *T. Beynon and Company Limited v. Ogg*, 7 T.C. 125;

¹⁰ 20 T.C. 643;

grants for an extension of a dock. It was held that these were advances of a capital nature and that they were not sums received in respect of a trade or as a trading receipt and so were exempt.

The profits from an unlawful business are taxable,¹² although in an earlier case,¹³ Scrutton L.J. says:

I am inclined to think, though I do not wish finally to decide it, that the Income Tax Acts are to be confined to lawful businesses carried on in a lawful way.

This statement is not supported by the judgment of the Privy Council in *Smith v. Minister of Finance*.¹⁴

The forgiving of a debt does not constitute income to the debtor.¹⁵

When determining the profits from a profession or business, the same limitation as to deductions is applicable as in the case of corporations. In the case of professional men, rulings have been given by the tax department limiting the nature of expenses which may be claimed. Thus, where a motor car is used for both business and personally, as in the case of a doctor, the charge for operation is limited to a fixed amount per mile, subject to supporting evidence that it was used in business. Depreciation will be allowed only on the total cost of the car when such cost is not in excess of \$1,800.00, this being based on the assumption that a car at that price is sufficient for the purpose. This determination is under the powers given by section 6, subsection (2) of the Act and which permit the Minister to disallow any expense which he may determine to be in excess of what is reasonable or normal for the business carried on by the taxpayer. On the other hand, by a ruling published in 1926 depreciation was allowed to members of the legal profession on law libraries. This was directly contrary to the judgment in *Daphne v. Shaw*,¹⁶ where a claim for such an allowance was refused.

Where a partnership is determined either by death or dissolution, some problems after the computation of and allocation of profits may arise. In an English case, *Mackintosh v. C.I.R.*,¹⁷ after the share of a deceased partner had been valued and discharged, it was agreed that the widow should receive a quar-

¹² 16 T.C. 333;

¹³ *Southern v. A. B. Limited*, 18 T.C. 59;

¹⁴ *Alexander Von Glehn v. C.I.R.*, 12 T.C. 232;

¹⁵ [1927] A.C. 193;

¹⁶ *Br. Mexican Petroleum Co. Ltd. v. Jackson*, 16 T.C. 570;

¹⁷ 11 T.C. 256;

¹⁸ 14 T.C. 15;

terly payment for five years, in consideration, for which the remaining partners could continue the use of the firm's name, marks and goodwill, and thereafter without further payment. The point involved was whether the quarterly payments were instalments of purchase money, and exempt, or annual payments and taxable. In holding that the payments were taxable, Rowlatt J. said at page 20:

I think it is a payment in the nature of income for the use of the firm name, the goodwill and rights, a payment concurrent with the enjoyment of the thing for which the payment is made, running on year after year and therefore prolonging the interest of the deceased partner in the income, although it is merely securing an income for a period of five years. That is the best conclusion I can come to upon a question which I am bound to say is a very narrow one.

Another case,¹⁸ involved a partnership where unclaimed balances belonging to clients had accumulated in a suspense account. In accordance with the terms of the partnership agreement, upon the entrance of a new partner, the amount at the credit of this suspense account was allocated to the former partners according to their interest. Such unclaimed amounts were recognized as belonging to the clients, and the partners would be liable for their pro-rata share of any sum claimed. The Court of Appeal reversed the findings of the trial judge and held that by the transfer of the balances to the partners' accounts, they had not thereby been converted into trading receipts, and therefore did not attract tax.

J. S. FORSYTH.

Ottawa.

¹⁸ *Morley v. Tattersall*, [1938] 3 All E.R. 296;