TAXATION DECISIONS AND RULINGS

Deductions From Income

In determining income which is subject to taxation the problem as to what deductions may be allowed and more particularly, the question whether expenditures which are made in the course of the operations of business and which appear to be necessarily expended in connection therewith are deductible, is of great importance. The Act itself gives no guide as to whether certain types of expenditures may be allowed but restricts itself to the general prohibition contained in section 6, ss. 1, para. (a) of the Act which limits deductible items to such expenditures as are "wholly, exclusively and necessarily" expended for the purpose of earning the income. There have, however, been numerous cases before the courts for a decision as to whether particular types of expenses come within the provisions of the Act. It is proposed to review those cases which have arisen under the Income War Tax Act as giving an indication of the type of expense which has been claimed in the past and the attitude of the court in disposing of such claims.

The cases discussed below are in chronological order and may give some indication as to the development and treatment of expenses in connection with the carrying on of a business.

Dupuis Freres, Limited v. *Minister of Customs and Excise.*[1]

Judgment in this case was given on the 31st of May, 1927, in respect of an assessment for 1923.

The appellant company had outstanding certain redeemable preferred shares of stock carrying a dividend rate of 8 per cent. The company claimed as a deduction against profits the amount of the dividend paid on these shares on the ground that such shares represented borrowed capital. As such, they were entitled to deduct under section 5, ss. 1, para. (b) of the Act the amount which was paid by way of dividend as being in the nature of interest on borrowed capital. (In this connection it may be noted that prior to 1921 there was no provision by which interest on borrowed capital was allowed as a deduction. Section 5, ss. 1, para. (b) of the Act was originally enacted by section 2, chapter 52, Statutes of 1923, and made retroactive and applicable to the 1921 and subsequent taxation periods.)

[1] [1927] Ex. C.R. 267.

In his judgment, Audette J. found that as a matter of fact the preferred shares were not borrowed capital and that the mere existence of any feature which might make it resemble a bond or debenture was not sufficient to transform it into borrowed capital for the purpose of assessment. In holding that the dividend paid on such shares was not deductible he said:

> The dividend paid upon these preferred shares is clearly and distinctly from the earned profits. The dividend in question was actually paid out of the profits and for all purposes remains a dividend.

O'Reilly and Belanger, Limited v. *Minister of National Revenue.*[2]

The judgment in this case was delivered on the 28th of December, 1927 on an appeal against an assessment levied for the year 1925.

The appellants were retail coal merchants in the city of Ottawa and they claimed as an expense amounts paid out for subscriptions and charitable donations. The payments made ranged in amount from $100.00 to 25 cents, and were described as follows: "With respect to the larger amounts to public, social, charitable and ecclesiastical institutions the appellant testified they were paid at the request of friends of such institutions. Some of the small amounts were paid in the office to a casual visitor, child or grown-up person, for tickets of all kinds and description for some performance, lottery, etc. Some such payments were even made to non-residents of Ottawa. The appellant further testified that these payments were not made for charitable purposes." In holding that these expenses were not proper deductions in determining taxable income, the court quoted with approval the contention advanced on behalf of the respondent that the words "wholly, exclusively and necessarily" mean, in effect, that only items of expenditure without which the business could not be carried on would be admissible. In his judgment Audette J. said:

> These donations were absolutely voluntary, made at the choice and volition of the appellant, and if they are so voluntarily made, then they cannot be regarded as necessary.

And further,

> Moreover, the contention that these donations may be of particular service to and benefit the appellant is conjectural and unascertainable. Moreover, these donations have been paid out of ascertained profits and not for the purpose of earning the profits.

The last quotation above would not appear to be wholly justified by the actual facts. The payments were not paid out of

[2] [1928] Ex. C.R. 61.

ascertained profits but were, in fact, regarded as a recurring expense, something which the appellant decided was desirable in order to maintain the goodwill in the business and was undoubtedly in accordance with the general practice. It is to be observed that it was not contended that the payments were to charitable institutions although no doubt such were at least in part the recipient of the benefits. Insofar as donations to charitable organizations are concerned, these are now expressly permitted, but the legislation recognizing such deductions was not enacted until 1929. The case, however, is of interest as indicating that a practice which was generally followed by people in business did not thereby justify the allowance of these payments as an expense in earning the income.

C. W. Roenisch v. *Minister of National Revenue.*[3]

The judgment in this case was delivered on October 30th, 1930, in respect of an appeal taken against an assessment for the year 1927.

The appellant was a resident of the Province of Alberta and received certain income arising within the Province of British Columbia. Upon such income arising in British Columbia there was assessed tax under the provision of the Income Tax Act of that Province. The appellant claimed that the amount of such tax paid to the Province of British Columbia was deductible as an expense in earning the income, subject to tax under the Income War Tax Act.

Under the British Columbia Income Tax Act it was permitted to deduct from income the amount paid as income tax to the Dominion Government. There was no corresponding section in the Dominion act in respect of income tax paid to the provinces upon income taxable under the Dominion act. Audette J. held that the deduction was not permissible under any provision of the Income War Tax Act. In his judgment he quoted with approval the remarks of the Attorney General in *Last* v. *London Assurance Corporation*[4] as follows:

> The test is this—if there is an expenditure which would be made in any case, from which profits may accrue, the expenditure may be deducted; but an expenditure which will not be incurred unless there is a profit is not an expenditure in order to earn a profit.

And further,

> This provincial income tax is not an expenditure which was necessary to earn a profit. Profits must be shown before the tax is imposed. There is no tax if there is no assessable profit.

[3] [1931] Ex. C.R. 1.
[4] 10 Opp. Cas 438.

This judgment would appear to be well founded. It is, of course, applicable only in respect of income tax which is a tax upon income after it is earned. It was not intended and does not cover those taxes which are necessarily expended in the earning of the income and which arise in the course of the trade and which are payable irrespective of whether or not the profit is incurred. Thus, taxes upon property payable to a municipality or licences or other fees which are paid annually to the provinces by reason of carrying on business therein or of owning property which is necessary in the earning of the income would appear to be proper deductible expenses.

Western Vinegars Limited v. *Minister of National Revenue.*[5]

Judgment in this appeal was given on the 1st of October, 1937, in respect of an appeal arising against an assessment levied for the year 1931. In this case the appellants sold vinegars to their customers in containers which consisted of wooden barrels and kegs. These containers were purchased by the company and when the goods were shipped, the cost of the container plus a profit of 40 per cent thereon was charged to the customer with the understanding that if such containers were returned, a refund would be made at the price at which they were charged such customer. When returned and after the refund was made, the container went back into the stock of the company at the inventory price which was the original cost. Many of these containers were outstanding over the end of the fiscal period of the taxpayer and the company set up a reserve in the year of assessment of $4000 as being an estimate of the amount which would be required to be refunded to their customers to whom containers had been shipped. It was contended that the amount which had been received during the year in payment for the containers did not in fact, constitute income as it would ultimately be paid back to the customers when the containers were returned. On behalf of the respondent it was contended that the amount of $4000 was, in fact, a reserve for a contingency and was accordingly not permissible under the provisions of section 6 (1) (d) of the Income War Tax Act, which section prohibits the deduction of any amount transferred or credited to a reserve, contingent account or sinking fund, with the exception of such reserve for bad debts as the Minister may allow. In his judgment Angers J. held that the amount so set aside was not a reserve; that there was no contingency as regarding the refund and that in fact, such refund was a certainty,

[5] [1938] Ex. C.R. 39.

the only question being as to the amount which would be refunded. Therefore in maintaining the contention of the taxpayer he said:

> If no allowance were made, it would mean that the appellant would have to pay tax on profits which it has no reaped.

It was the practice of the income tax authorities to require that the amount representing the profit on the containers should be treated as income in the year in which received, but that any amounts paid out as a refund would be allowed as a deduction in the year in which paid back. The decision in this case was discussed by Thorson J. in a later case, *Kenneth B. Robertson* v. *Minister of National Revenue*,[6] and it was clearly indicated that he did not approve of the conclusion reached. The judgment, therefore, appears to have been effective only upon the actual facts of the particular case.

Riedle Brewery, Limited v. *Minister of National Revenue.*[7]

The judgment in the Exchequer Court in this case was given on the 12th April, 1938, on an appeal against as assessment for the year 1933. The appellant was a brewery company engaged in the manufacture and sale of beer in the Province of Manitoba. Under the provisions of the Manitoba Liquor Control Act it was not permitted to advertise or promote directly the sale or consumption of beer. In order, however, to encourage the sale, the appellant, in common with other brewing companies in the province, through its officers and employees incurred so-called "treating" expenses which expenses it claimed were incurred in the conduct of the business as a brewery and for the purpose of earning the income. The practice was well stated by Davis J. of the Supreme Court, as follows:

> The appellant adopted the practice of having its officers or employees from time to time purchase its own manufactured beer in different beer parlours and licensed clubs throughout the province for the purpose of then and there treating those who were at the time on the premises with the object of making the appellant's beer better known to the beer-drinking public and of creating and fostering a taste among beer drinkers for its particular beer.

The respondent contended that the expenses were not necessarily incurred in earning the income and that in any event the practice was illegal and accordingly, the cost thereof should not be recognized as a proper deduction in determining the taxable income.

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[6] [1944] Ex. C.R. 170.
[7] [1939] Ex. C.R. 314; [1939] S.C.R. 253.

In the Exchequer Court McLean J. dismissed the appeal and held that the expenditures were prohibited as a deduction by section 6 (1) (a) of the Income War Tax Act. In discussing the application of this section, the learned judge said:

> It was not the intention of the Legislature to lay down a general rule that whatever a subject liked to expend in his business, even if commercially avantageous, could be deducted as a business expense but only such sums are to be allowed to which the character could be assigned that they had been 'wholly, exclusively and necessarily' laid out for the purpose of earning the income. Expenditures may be wisely made, they may have been prudent but it must also be shown that they were wholly necessary for the purpose of earning the income. The character of the deduction claimed in any case must, therefore, be carefully examined particularly where they are of an unusual nature, as in this case.

An appeal was taken to the Supreme Court of Canada where a majority of the Court, Duff C.J., Crockett and Kerwin JJ., (Rinfret and Davis JJ., dissenting), allowed the appeal and reversed the decision in the Exchequer Court. In his dissenting judgment Davis J., (with which Rinfret J. concurred) said with reference to section 6 (1) (a) of the Income War Tax Act:

> 'Necessarily' in section 6 means, I am satisfied, necessarily in a commercial sense and if the practice of treating had become generally adopted in the province by most if not all of the brewers doing business in that province, it would be reasonable to regard such treating expenditures as necessarily incurred within the statutory provision. . . . but the real difficulty in this appeal which presents itself to me is the question whether or not the expenditures can be said to have been necessary even in a business sense where the system adopted was in contravention, if not of the exact letter of the law, certainly of the spirit of the law of the province.

In the judgment of Kerwin J. (with which Crockett J. concurred), he said:

> Now upon the evidence, it appears to me that the appellant company disbursed the sum in question for the purpose of earning income and not as a capital expenditure. As to the words 'wholly' and 'exclusively' it is not suggested that the appellant desired to give away its funds, or any part of them, nor is it contended that there was any fraud or bad faith, or that any part of the expenditures was fictitious. The learned President of the Exchequer Court held that the expenditures were not necessary, but with respect, I find it impossible to agree. As already mentioned, the practice followed by appellant is one adopted by the other brewers in Manitoba, and followed by all as something considered by them, not merely advisable, but as obligatory, to increase, or at least sustain, the volume of their sales. Being considered thus in a commercial sense, I think it should be similarly held for the purposes of the Act.

> 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 returns 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.

Duff C.J. delivered a judgment indicating his agreement with the conclusions reached by Kerwin J. He made particular reference to the contention advanced by the Minister that the expenditures should be disallowed as being in contravention of the Liquor Control Act. In discussing this he says:

> As to the point based upon the provisions of the Manitoba Liquor Control Act of 1928, I think it was incumbent upon the Crown to establish an actual violation of the Statute in respect of the payments which it contends should be disallowed. I do not see, however, in view of the judgment of the judicial committee in the *Minister of Finance* v. *Smith*, [1927] A.C. 193, how the Minister could enter into the investigation of such an issue.

This case is important as indicating that the Court is not necessarily too restrictive in its application of the words "wholly, exclusively and necessarily" as used in section 6 (1) (a) of the Act. The indication would be that the Court is inclined to regard expenditures made as a general practice in the trade and in meeting competition as being proper deductions provided, however, that such expenditures have a direct relation to the earning of the income. The expenses in question were perhaps peculiar to the particular industry and to the conditions under which it was required to operate. It would not be safe to conclude that all treating or entertainment expenses so-called are, therefore, a proper deduction. The matter would have to be considered in the light of the actual facts under which the expenditure arose.

The comments of Duff C.J. as to the legality of the expenditures are of interest. The case of the *Minister of Finance* v. *Smith* referred to by him, dealt with the taxation of profits earned by a bootlegger who sold liquor in contravention of the laws of the Province of Ontario, Such profits were illegal profits and in earning them expenditures were incurred which could be

said to be illegal expenditures, but as pointed out, if the Crown through the Minister is to impose a tax on illegal profits, it must only impose the tax upon the net income arising from the illegal transactions and must allow as a deduction expenditures incurred in the earning of such profits notwithstanding that the expenses incurred are in contravention of the law.

NOTE:—*Judgments in other Canadian cases will be discussed in a later article.*

AMENDMENTS TO THE EXCESS PROFITS TAX ACT—1944.

The Excess Profits Act has been amended by Chapter 38 Statutes of 1944 and assented to August 15th, 1944. Following is a brief summary of the changes made

Tax Rate Applicable to New Business.

Provision has been made to provide certain relief to persons who commence a new business after the 26th June, 1944. Such new business of the taxpayer either individual or corporation, must be "substantially different "from that carried on in the standard period; and the physical assets used must also be "substantially different" from those used in any previous business by the taxpayer. If so qualified, the profits of the first fiscal period are not charged at the 100% rate but in the case of individuals at 15% and corporations 22%. The purpose of the amendment is to encourage new business enterprises. (Section 3, s.s. 1)

Adjustment of Standard Profits.

Where a corporation or joint stock company has increased the capital employed in its business, without an accompanying increase in capital stock in excess of that employed

(a) at the commencement of the 1939 taxation period, or

(b) at the commencement of a subsequent period in which the Board of Referees has last determined standard profits,

such company may now increase its standard profits by an amount equivalent to 5% of the increase in the capital employed.

Where a corporation of joint stock company has at the beginning of its 1945 or subsequent fiscal period decreased its capital employed below that employed at the commencement of its 1944

fiscal period, the standard profit will be reduced by an amount equivalent to 5% of the decrease in such capital employed. (Section 4, para. (b) sub-paras. (iii) and (iv).)

Consolidated Returns.

The regulation issued on December 25th, 1943 and reported in 22 CAN. BAR REV. at p. 85 has been implemented by appropriate legislation. Briefly, it provides that where consolidated returns are filed, the standard profit of any company included in such consolidation after the 1st of January 1940 shall be $5000.00 Profits or losses may continue to be consolidated, but the standard profits are not thereby subject to be increased. (Section 4A, s.s. 1, 2, 3 and 4).

Determination of Standard Profits of "substantially" new Business.

When a taxpayer derives profits in 1944 from a business which was "substantially different" from that carried on during the standard period or the period preceding the year under consideration, the standard profits of such business may be ascertained by the Board of Referees. The Board is directed to determine such profits in accordance with section 4, s.s. 2 or 3 of the Act. This requires that such standard profits be determined as a rate on the capital employed equivalent to that earned in the standard period by similar businesses or upon such basis as the Board may think just, and with regard to the profits made by taxpayers in a similar business. This amendment is applicable to 1944 and subsequent periods. (Section 4, s.s 4 and 5).

Charitable Donations.

The limitation upon the relief given for charitable donations, referred to by the Minister of Finance last February and referred to in 22 Can. Bar Rev. at p. 264 has been confirmed by appropriate legislation. In addition, it is provided that the new deductions from income provided for in section 5, s.s. 1, paras. (p) (u) and (v) of the Income War Tax Act may also be allowed in determining income for the purposes of the Excess Profits Tax Act. (Section 6, s.s. 2 para. a.)

Allowances for Salary against Standard Profits

The practice of the Department, by which any amount allowed as salary to proprietors of a business is deducted from the Standard Profits of such taxpayer has been affirmed and clarified

by new legislation. The amendment is made applicable to 1940 and all subsequent periods, but excludes those taxpayers who had filed an appeal, and which appeal is at the time of the passing of the amendment, actually before the Court. (Section 6, s.s. 2, para. (b))

Credit for Taxes paid Foreign Countries.

The relief in respect of taxes paid in other countries has been extended and now includes, besides Great Britain, and the Dominions or dependencies, any foreign country, irrespective of whether such foreign country grants reciprocal relief. This is effective for 1944 and subsequent taxation periods. (Section 9, s.s. 1).

Assignment of refundable portion

A taxpayer may now assign by way of security, the refundable portion of the tax, and to which he is ultimately entitled to receive. Such assignment can be made only if the Governor in Council is satisfied that it will enable the taxpayer to make capital expenditures contributing to post war conversion and that it will provide substantial employment.

The Governor in Council is also empowered to make regulations determining persons to whom the refundable portion of the tax shall be paid in the event of bankruptcy liquidation, winding-up or dissolution of the taxpayer. (Section 18, s.s (4) and (5))

Changes in Capital employed during taxation period

The provisions in the Act providing for changes in capital during the taxing period are clarified. It is further provided that the reduction in capital employed by reason of the payment of dividends in cash is limited to an amount equivalent to one half of the amount by which such capital employed is less at the end of the period than it was at the beginning. This is applicable to 1944 and subsequent periods. (First Schedule, sec. 4).

AMENDMENTS TO THE DOMINION SUCCESSION DUTY ACT, 1944.

The Dominion Succession Duty Act was amended by Chapter 39, Statutes of 1944, and assented to August 15th, 1944. Three changes were made, all effective from the date of assent.

Definition of Child

The definition of child was enlarged to extend to include a person to whom the deceased stood in loco parentis. The words used are:

"child" means

"A person who, during his infancy for a period of not less than ten years, was in law or in fact in the custody and control of the deceased and was dependent upon the deceased for support."

The intention is apparently to bring into the class children who are maintained and under the control of the deceased for a period of at least ten years during infancy and who were never legally adopted. Section 2, para. (b).

Gifts with Reservation to the Donor

Where a gift is made during the lifetime of the deceased, with reservation, and actual and bona fide possession is taken by the donee at least three years prior to the death of the deceased, the value of such gift is not included as a succession passing on death. This amendment brings the treatment of such gifts in line with those given inter vivos during the lifetime of the deceased. Section 3, s.s. 1, para. (d).

Where General power of Appointment or Disposal is not Exercised.

Where a beneficial interest is acquired in a property, through the failure of a deceased person to exercise a general power of appointment or disposal, it is now provided that the taking of such beneficial interest will be deemed to be a succession. The person failing to exercise the powers in respect of the property will be deemed to be a "predecessor" and the beneficiary a "successor".

The amendment confirms the position hitherto taken by the revenue authorities as to the manner in which such property should be treated for the purposes of the Act.

J. S. FORSYTH.

Ottawa.