TAXATION DECISIONS AND RULINGS

DEDUCTIONS FROM INCOME

There have been three further cases in the Canadian courts involving decisions under the Income War Tax Act in respect of deductions in determining taxable income of corporations. Two of these cases may be of particular interest involving as they do the question as to the deductibility of legal expenses incurred. There have also been two cases dealing with deductions from income of individuals and as these are somewhat similar, they are discussed together in this issue.

Dominion Natural Gas Company Ltd.
v. *Minister of National Revenue.*[1]

In this appeal the judgment of the Exchequer Court was rendered on the 3rd of January 1940, in respect of an assessment for the year 1934. The dispute arose in connection with certain legal fees incurred by the appellant company under the following circumstances.

The appellant company held a franchise under which it sold gas for illumination and heating to the inhabitants of an area just outside the city of Hamilton. This area was subsequently absorbed into the city of Hamilton. A rival company, the United Gas and Fuel Company, had an exclusive franchise to supply gas to the inhabitants of the city of Hamilton. After the area served by the appellant company was incorporated with the city, the United Company instituted proceedings claiming an injunction against the appellant for the use of the streets and supplying gas, an order requiring them to remove their mains and other property, and damages. The action was ultimately resolved in favor of the Dominion Company which claimed as a deduction in determining its taxable income the net cost of the litigation amounting to $48,560.94.

The respondent held that the deduction should not be allowed as being in contravention of section 6, ss. 1, paragraph (a) or in the alternative paragraph (b). The two paragraphs prohibit the deduction of (a) "any disbursement or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income or (b) any outlay, loss or replacement of capital or any payment on account of capital."

[1] [1940] Ex. C.R. 9; [1941] S.C.R. 19.

In his judgment, holding that the expenses were admissible deductions, MacLean J. reviewed many English and American authorities cited on behalf of both parties. He says,

> The generally recognized rule as regards trade expenses is that a deduction is permissible which is justifiable on business and accountancy principles, but this principle is subject to certain specific statutory provisions, which prohibit the allowance of certain expenses as deductions in computing the net profit or gain to be assessed. To the extent that ordinary business and accountancy principles are not invaded by the statute they prevail. In computing the amount of the profits and gains to be assessed the Act does not sanction specific deductions, but by prohibiting certain deductions it impliedly allows other deductions. In order that a trade expense may be allowable as a deduction, the amount expended must be 'wholly, exclusively and necessarily' laid out for the purpose of 'earning the income' which means the "annual net profit or gain', but this must not be construed so as to preclude the deduction of those expenses as a result of which receipts of profits may accrue in the future.

And further,

> No distinction is to be drawn between legal expenses and other business expenses.The question always is whether the expense was a necessary one for the purpose of earning the annual net profit or gain of the taxpayer.

The learned Judge also stated that the expenditure in question was not, in the language of the Act, an outlay, loss or replacement of capital or any payment on account of capital.

> No advantage accrued to the capital of the Dominion Company by the success attending its defence of the action brought against it. The situation as to capital remained as it was.

An appeal was taken to the Supreme Court of Canada where the judgment of the Exchequer Court was reversed. The Court was unanimous, and felt that it was bound by the judgment of the Privy Council in *Tata Hydro Electric Agencies Ltd.* v. *Commissioner of Income Tax*,[2] wherein the dicta in *Lothian Chemical Co. Ltd.* v. *Rogers*,[3] was quoted with approval:

> What is money wholly and exclusively laid out for the purposes of the trade is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure and to ask oneself the question, Is it a part of the company's working expenses; is it expenditure laid out as part of the process of profit earning.

Leave to appeal to the Privy Council in this case was refused.

[2] [1937] A.C. 685.
[3] 11 T.C. 508.

Kellogg Company of Canada Ltd. v. *Minister of National Revenue.*[4]

Judgment in this case was given on 31st March 1942, in respect of assessments for the years 1936 and 1937.

The appellant in this case had incurred certain legal expenses in defending an action asking an injunction against the use of the words "shredded wheat" in describing one of its products sold to the public and damages or alternatively, profits. The action was ultimately dismissed on the grounds that the words were descriptive only and were in the public domain. The judgment of the Supreme Court of Canada in *Dominion Natural Gas Company Ltd.* v. *Minister of National Revenue* had been pronounced but was distinguished and the contention of the taxpayer maintained in the Exchequer Court. The learned Judge pointed out that the expenses here in question were not in respect of any asset nor had they brought an "enduring advantage". He said,

> I do not think it can be said that the expenditure in question here brought into existence any asset that could possibly appear as such in any balance sheet, or that it procured an enduring advantage for the taxpayer's trade which must presuppose that something was acquired which had no prior existence. No 'material' or 'positive' advantage or benefit resulted to the trade of Kellogg from the litigation except perhaps a judicial affirmation of an advantage already in existence and enjoyed by Kellogg.

And further,

> Again, this is not a case of a payment made once and for all in substitution of a 'recurring' annual payment, as no such payment was ever made by Kellogg, and equally true is it, I think, that the expenses here were not incurred for the purpose of earning future profits. . . . . The profits of Kellogg were made by the sale of certain cereal products in cartons. . . . . It was to maintain this trading and profit-making position that Kellogg was obliged to make the expenditure in question.

This judgment was in turn appealed to the Supreme Court of Canada which unanimously maintained the judgment of the Exchequer Court. In the judgment of the Court which was delivered by the Chief Justice he said,

> It was pointed out in *Minister of National Revenue* v. *Dominion Natural Gas Company* that in the ordinary course legal expenses are simply current expenditures and deductible as such. The expenditures in question here would appear to fall within this general rule.

[4] [1942] Ex. C.R. 33; [1943] S.C.R. 58.

Montreal Light, Heat and Power Company v. *Minister of National Revenue*[5]

These appeals dealt with the disallowance of certain expenses incurred in the refunding of outstanding bonds of the appellant companies. In the Exchequer Court the judgment was for the respondent maintaining that the expenses were not properly allowable and this was approved by a majority judgment of the Supreme Court. In the Privy Council the contention was further maintained on the ground that deduction of the expenses was prohibited by section 6 (1)(a) of the Income War Tax Act as not having been incurred in the earning of the income. It was also intimated that the Board did not dissent from the view that they were also inadmissible under section 6 (1)(b) of the Act. This case was discussed in the 22 CANADIAN BAR REVIEW, at page 635.

In Re Taxation of Lieutenant-Governor's Salary.[6]

This judgment was delivered on the 14th of February 1924, in respect of an appeal of an assessment for the year 1920. This case was heard in camera and it would appear that the appellant occupied the position of a Lieutenant-Governor of one of the provinces. The claim was for certain amounts to be deducted from the salary received by virtue of his office and for social entertainments. The contention of the appellant was disallowed and in doing so Audette J. found as a fact that there was no contractual obligation upon the part of the appellant to make the expenses in question. He said,

> The generous hospitality with which the present appellant entertains is of itself a commendable thing and reflects much lustre upon the office he holds; but I fail to find either within the spirit or language of the Act any ground for holding that it comes under the expression "disbursements or expenses wholly, exclusively and necessarily laid out or expended for the purpose of earning the income".

The learned Judge also went on to say,

> The disbursements that must be made to earn profit are those in connection with unascertained incomes unlike a case of salary where disbursements are made at the discretion and will of the taxpayer . . . . but it is otherwise in the case where a person received an annual salary from any office or employment, an amount which is duly ascertained and capable of computation and which constitutes a net income.

The above dicta have been the basis upon which the taxing authorities have refused to recognize any expenses against salary

[5] [1944] A.C. 126; [1941] Ex. C.R. 30; [1942] S.C.R. 106.
[6] [1931] Ex. C.R. 232.

income. The dicta are very sweeping and in their application may have caused some apparent hardships. They appear to be founded on the basis of the finding that there was no contractual relationship and it is reasonable to assume that had there been such relationship established, the result might have been different. These dicta were discussed and disapproved by the present President of the Exchequer Court in the case of *Samson* v. *Minister of National Revenue* referred to below.

Samson v. *Minister of National Revenue*[7]

The judgment in this case was delivered on the 27th of February, 1943, in respect of an assessment made upon the appellant for the year 1939. The appellant, who was a resident of the city of Quebec, was appointed Hides and Leather Administrator of the Wartime Prices and Trade Board and he was to receive an allowance of fifteen dollars per day for every day spent away from home in connection with the duties of this office. The authorities sought to tax him upon this allowance without any deduction for the expenses required in travelling from his home in Quebec to Ottawa and on other trips which it was necessary to take in the performance of the duties. The respondent relied upon the judgment in the Lieutenant-Governor's case but this did not commend itself to Thorson J. who held that under the definition of income in section 3 of the Act it was necessary to ascertain the "net" income and this could only be done after deducting those expenses which were necessarily incurred in the earning of it. He said,

> The test of taxability of an annual gain or profit or gratuity is not whether it is " ascertained " or " unascertained " but whether it is net.

With regard to the judgment in the *Lieutenant-Governor's* case, the learned judge said,

> The decision in *In Re Salary of Lieutenant-Governors* is not authority for the view that sums of money received by a taxpayer "as being wages, salary or other fixed amount" are necessarily "net" or taxable income. It may well be that sums of money received by a taxpayer as wages or salary, even although they are of a fixed nature may be subject to deductions other than those specifically admitted, such as charitable donations and the like, in order to determine the amount which is properly assessable for income tax purposes under the provisions of the Income War Tax Act.

[7] [1943] Ex. C.R. 17.

The learned Judge in deciding this case held that the per diem allowance was in fact not income even to the extent that the allowance received was in excess of the actual disbursements. With regard to this he said,

> I have come to the conclusion having regard to all the circumstances of the case that the per diem living allowances authorized by (the Order in Council) involved no element of remuneration or net gain or profit or gratuity to the appellant and did not result in any gain or profit to him. They were paid to him only as reimbursement of living expenses over and above ordinary and present living expenses up to the fixed amount per day. They were not in any sense "income" as defined by the Income War Tax Act and the appellant should not have been assessed for income tax purposes in respect of them.

The effect of this judgment in so far as it applied to per diem allowances was nullified by the subsequent enactment of section 3, ss. 4 of the Income War Tax Act which specifically created such payments as taxable income in the hands of the recipient. They have consequently been so treated and, notwithstanding the terms of the judgment, have been taxed in full on the basis of the dicta in the *Lieutenant-Governor's* case.

* * * *

In section 6 of the Income War Tax Act it is provided that in computing the amount of the profits or gains to be assessed a deduction shall not be allowed in respect of

> (n) Depreciation, except such amount as the Minister in his discretion may allow including
>
> (ii) depreciation at not more than double the rates normally allowed in respect of plant or equipment built or acquired in a period fixed by the Governor in Council for the purposes of this paragraph if the taxpayer is, in the opinion of the Minister, making a new investment by building or acquiring the plant or equipment.

Pursuant to the authority in the above mentioned section of the Act, the following Order in Council has been passed fixing the period as required therein.

Order in Council providing for depreciation at double the rates normally allowed in respect of plant or equipment built or acquired in the period set out.

P.C. 8640

AT THE GOVERNMENT HOUSE AT OTTAWA

FRIDAY, THE 10TH DAY OF NOVEMBER, 1944.

PRESENT:

HIS EXCELLENCY

THE GOVERNOR GENERAL IN COUNCIL:

WHEREAS under the Income War Tax Act, the Minister of National Revenue in his discretion may allow depreciation at not more than double the rates normally allowed in respect of plant or equipment built or acquired in a period to be fixed by the Governor in Council if the taxpayer is, in the opinion of the Minister, making a new investment by building or acquiring the plant or equipment;

AND WHEREAS it is deemed expedient and advisable to fix the period for the purposes of subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act to commence on November tenth, 1944, in order to enable such industries as can, because their activities are essential, secure necessary materials and labour at the present time to proceed immediately with such expansion as has both a war and post-war purpose and thus to qualify for depreciation allowances under the aforesaid subparagraph (ii) without awaiting the cessation of hostilities in Europe;

AND WHEREAS it is also deemed expedient and advisable for industries other than those mentioned in the next preceding paragraph that are planning post-war expansion, conversion or modernization to prepare their plans without delay so as to be ready to commence work on their plant and equipment as soon as materials and labour are available, and it is desirable that they should be enabled to commence such work as soon as is compatible with the efficient prosecution of the war and the effecting of an orderly transition from a wartime to a peacetime economy;

AND WHEREAS by reason of the war, it is therefore deemed necessary for the security, defence, peace, order and welfare of Canada that the order hereinafter set forth be made;

THEREFORE, His Excellency the Governor General in Council, on the recommendation of the Minister of Finance, the Minister of Munitions and Supply and the Minister of Reconstruction and the Minister of National Revenue and under and by virtue of subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act and the War Measures Act, is pleased to make and doth hereby make the following order:

1. (1) The period commencing on November tenth, nineteen hundred and forty-four and ending on the last day of the year nineteen hundred and forty-six or on the day two years from the day on which organized hostilities between Canada and Germany cease wholly or substantially, whichever is the earlier, is hereby fixed as the period mentioned in subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act.

(2) Organized hostilities between Canada and Germany shall be deemed for the purposes of this order to have ceased wholly or substantially on such day as the Governor in Council may fix for the purposes of this order as the end of the said hostilities.

2. (1) In computing the amount of the profits or gains to be assessed under the Income War Tax Act or the Excess Profits Tax Act, 1940, depreciation may be deducted at the option of the taxpayer in an amount computed at not more than double and not less than one-half the rates normally allowed if the amount is allowed by the Minister pursuant to subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act.

(2) No depreciation shall be allowed under the said subparagraph (ii), notwithstanding anything contained therein, after the aggregate of the allowances made thereunder equals eighty per centum of the cost of the plant or equipment.

(3) No depreciation shall be allowed pursuant to the said subparagraph (ii) in respect of any plant or equipment unless the the Minister of Reconstruction has certifiied that having regard to war or reconstruction needs, it is desirable in his opinion that depreciation be allowed in respect thereof under the said subparagraph.

3. In this order and in subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act "plant or equipment" means such property as the Minister of National Defence may, by regulation, prescribe but, notwithstanding any such regulation, does not include

(a) plant or equipment outside Canada,

(b) patents, goodwill, intangible rights or incorporael hereditaments,

(c) leasehold interests in land, buildings, machinery or equipment,

(d) office equipment or furnishings,

(e) buildings used as dwellings including apartment houses and equipment, furniture and furnishings therein or used in connection therewith,

(f) buildings used for commercial or financial purposes including stores, hotels, tourist accomodation and office buildings,

(g) automobiles, trucks and buses,

(h) rolling stock of a railway,

(i) a building that has been used by a person other than the taxpayer or a building that was built and in existence prior to November tenth, nineteen hundred and forty four unless

(A) the Minister of National Revenue is satisfied that the building has, since acquisition by the taxpayer, been used by him for a business substantially different from that carried on therein prior to acquisition by him, or

(B) the building was purchased by the taxpayer from War Assets Corporation,

(j) property built or acquired by a company entitled to exemption in the taxation year under section eighty-nine of the Income War Tax Act or paragraph (g) of section seven of the The Excess Profits Tax Act, 1940,

(k) property in respect of which special depreciation has been allowed under subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act or in respect of which provision has been made for special depreciation or allowances in lieu of depreciation under special authority.

4. Where plant or equipment is partly built in the period fixed by section one of this order, such part thereof as is built during the period shall be deemed to be plant or equipment built during the period for the purposes of subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act.

5. Notwithstanding this order or any provision in the Income War Tax Act, the decision of the Minister of National Revenue as to whether depreciation is allowable under subparagraph (ii) of paragraph (n) of subsection one of section six of the Income War Tax Act and as to the amount thereof if any is final and conclusive.

Exemption from Taxation of Post-Discharge Payments to Returned Soldiers

Below is the text of the Order in Council exempting from taxation payments received by discharged members of the Armed Forces who are receiving rehabilitation training.

"The Board had under consideration a memorandum from the Honourable the Minister of Veterans' Affairs, concurred in by the Honourable the Minister of National Revenue, reporting:

"That under and by virtue of Order in Council P.C. 5210 of the 13th July, 1944, known as The Post-Discharge Re-establishment Order, the Minister of Pensions and National Health is authorized to make payment of a grant, under conditions therein set forth, to a discharged person who is pursuing vocational or technical training or other educational training which has been approved by the Department of Pensions and National Health as training which will fit him or keep him fit for employment or re-employment, or will enable him to obtain better or more suitable employment;

And That the amounts of such grants have been determined on the basis that there should be no deduction therefrom by reason of taxation under the Income War Tax Act.

Now Therefore, the undersigned, with the concurrence of the Minister of National Revenue, has the honour to recommend that Your Excellency in Council, under the War Measures Act, be pleased to order that moneys granted to a discharged person under the provisions of paragraph 6, 8 and 9 of Order in Council P.C. 5210 of the 13th July, 1944, known as The Post-Discharge Re-establishment Order, shall not be liable to taxation under the Income War Tax Act."

The Board concur in the above report and recommendation, and submit the same for favourable consideration."

* * *

Text of Order in Council No. P.C. 8679 Appointing a Committee to Inquire into the Taxation of Annuities and the Surplus of Closely Held Corporations

The Committee of the Privy Council have had before them a report, dated 10th November, 1944, from the Minister of Finance, representing that there are various types of payment received by individuals regarding which there may be reasonable doubt as to whether they are payments of income or capital or a combination of income and capital; and that the present level of income tax rates greatly accentuates the necessity of determining whether such payments are income or capital or a combination of both and, if the latter, of clearly demarcating the income portion from the capital portion of the payments, in order to avoid inequitable tax treatment as between various types of income and as between various forms of savings and capital accumulation;

That under the various tax laws in force in Canada the combined effect of the taxes imposed on income which has been accumulated as earned surplus by a private corporation or a closely held corporation and on the assets of such corporation when they pass by succession or devise to the heirs or beneficiaries of a person owning a substantial proportion of the shares of such corporation, may in certain cases constitute so heavy a burden as to offend against all reasonable standards of equity, and that such tax burdens, if long continued, may have an adverse effect upon the national welfare by discouraging the initiation and expansion of new enterprises of a size appropriate to the resources of single individuals or of family groups.

The Committee, therefore, on the recommendation of the Minister of Finance, advise—

1. That Mr. William C. Ives, retired Chief Justice, Trial Division of the Supreme Court of Alberta, Dr. D. A. MacGibbon, of the City of Winnipeg, Man., and Mr. M. W. Mackenzie, of the City of Montreal, P.Q., be appointed Commissioners under Part I of the Inquiries Act,—

   (a) to investigate and report upon the present treatment under the Income War Tax Act of payments to individuals in the form of annuities or other annual or periodic payments received under the provisions of any contract, will or trust; payments to individuals in the form of pensions, superannuation or other periodic payments or single payments received following retirement from or cessation of employment with an employer; payments by individuals under an annuity, insurance endowment or other savings contract; and other payments of such a character that it is not obvious whether they are solely income or solely capital or partly the one and partly the other; and to consider whether any modification of that treatment is desirable and, if so, what alterations of the law are required for the purpose;

   (b) to investigate and report upon the taxes imposed under laws in force in Canada on income and successions or inheritances arising upon the death of a person owning a substantial proportion of the shares of a private corporation or a closely held corporation which has accumulated an earned surplus, and to consider whether under any circumstances there should be an abatement of the tax liability, and, if so, under what circumstances and to what extent there should be such abatement;

2. That Mr. William C. Ives, retired Chief Justice, Trial Division of the Supreme Court of Alberta, be Chairman of the said commissioners;

3. That the commissioners be authorized to engage the services of such technical advisers or other experts, clerks, reporters and assistants as they deem necessary and advisable and also the services of counsel to aid and assist the commissioners in the inquiry.

4. That the Commissioners be authorized to determine the places where the inquiry shall be conducted and the manner of conducting the proceedings in respect of the inquiry; and

5. That the commissioners be directed to report to the Minister of Finance.

TEXT OF ORDER IN COUNCIL P.C. 8725 APPOINTING A COMMISSION TO INQUIRE INTO THE TAXATION OF CO-OPERATIVES

The Committee of the Privy Council have had before them a report dated 10th November, 1944, from the Minister of Finance, representing that doubt has arisen as to the effect of the Income War Tax Act and The Excess Profits Tax Act, 1940 in the case of co-operative corporations, associations and societies both as regards the general principles intended by Parliament to be applied and the effect, in many matters of detail, of the said taxation statutes upon these co-operative organizations and their members;

That this doubt, both as to the general principles, intended to be applied and the effect of the aforesaid statutes, has created serious problems in connection with the administration of these taxation statutes and a considerable measure of uncertainty in the business operations of some of the co-operative organizations themselves; and

That a full public inquiry into the application of income and profits tax measures to organizations organized and operated on a co-operative or mutual basis and organizations claiming so to be organized (hereinafter referred to as co-operatives) and into the comparative position in relation to taxation under such measures of persons engaged in business in direct competition with co-operatives should be undertaken without delay;

The Committee, therefore, on the recommendation of the Minister of Finance, advise,

1. That the Honourable Errol M. W. McDougall, a Judge of the Court of King's Bench, Quebec; Mr. B. N. Arnason, Regina, Sask.; Mr. G. A. Elliott, Edmonton, Alta.; Mr. J. M. Nadeau, Montreal, P.Q., and Mr. J. J. Vaughan, Toronto, Ont., be appointed commissioners under Part I of the Inquiries Act to inquire into—

   (a) the present position of co-operatives in the matter of the application of the Income War Tax Act and The Excess Profits Tax Act, 1940, and

   (b) the organization and business methods and operations of the said co-operatives as well as any other matters relevant to the question of the application of income and profits tax measures thereto, and

   (c) the comparative position in relation to taxation under the said Acts of persons engaged in any line of business in direct competition with co-operatives,

   and report, in so far as the same can conveniently be done, all facts which appear to them to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the Income War Tax Act and The Excess Profits Tax Act, 1940 to co-operatives and to persons other than co-operatives in respect of methods of doing business analogous to co-operative methods, such as the making of payments commonly called patronage dividends and to make such recommendations for the amendment of existing laws as they consider to be justified in the public interest;

2. That the Honourable Mr. Justice McDougall, Court of King's Bench, Quebec, be chairman of the said commissioners;
3. That the commissioners be authorized to engage services of such technical advisers or other experts, clerks, reporters and assistants as they deem necessary or advisable and also the services of counsel to aid and assist the commissioners in the inquiry;
4. That the commissioners be authorized to determine the places where the inquiry shall be conducted and the manner of conducting the proceedings in respect of the inquiry;
5. That the commissioners be directed to report to the Governor in Council.

Ottawa. J. S. FORSYTH.