TAXATION DECISIONS AND RULINGS

The Income War Tax Act—Regulations Re Private Companies

The following regulations with respect to private companies were issued on August 31st last by the Minister of National Revenue and the Deputy Minister under Part XVIII of the Income War Tax Act:—

The Income War Tax Act provides by subsection (1) of section 96 of Part XVIII of the said Act that,—

> A Private Company may elect in such manner as may be prescribed by regulations,
> on or before the thirty-first day of December, 1947
> to be assessed and pay a tax, computed in the manner set out in subsection two of this section, on an amount equal to
> its undistributed income on hand at the end of its 1939 fiscal period or
> its undistributed income on hand at the end of the fiscal period that terminates nearest the time when it so elects,
> whichever is the lesser.

The following regulations are therefore made, namely:

1. A resolution authorizing the company to elect to pay the tax provided for in section 96, subsection (2) of the Income War Tax Act must be passed by a majority of the shareholders present and entitled to vote, at a properly constituted meeting of the shareholders of the company, called for that purpose.

2. The company shall file, in duplicate, the following documents with the Inspector of Income Tax in the District in which the company has been filing its income tax returns, or in which it resides, namely:

(a) Copies of the notice calling the meeting and of the resolution, each certified by a senior officer;

(b) Form P.C.1 (Private Companies) duly completed as required thereby;

(c) A covering letter appropriately worded.

These documents must be filed on or before the 31st December, 1947.

3. The effective date of election is when the action of notifying the Department of National Revenue, Taxation Division, has been taken, and shall be deemed to be the date on which the said documents were mailed, by registered post, to the Inspector of Income Tax, or the date on which they were delivered to and stamped by the Inspector of Income Tax.

4. In any instance where the form P.C.1 (Private Companies) requires information in respect to a fiscal period ending subsequent to 30th June, 1947, the filing of the said forms, in duplicate, completed in respect to all information except that pertaining to the said fiscal period shall be deemed to be an effective election, provided that the forms are completed, by the filing of the additional information by separate statement in duplicate, within six months after the end of the said fiscal period. If such forms are not so completed, the partly completed forms previously filed shall not be deemed to be an effective election.

5. The following paragraphs refer to three points in time:

(a) In determining "the respective portions of the amount on which the tax is payable" by the company, for purposes of applying the schedule in subsection 2 of section 96, only shareholders of record as at the 31st December, 1944, shall count, whether or not the shareholder of record was an agent, nominee, trustee or personal corporation, holding on behalf of others.

(b) For the purpose of determining the number of shareholders with a view to ascertaining whether the company qualifies as a "Private Company", the shareholders of record during the period from the 29th April, 1941 to the date of election will count, whether or not the shareholder of record was an agent, nominee, trustee or personal corporation, holding on behalf of others, unless in the opinion of the Minister persons other than shareholders of record should be counted.

(c) After election and after payment of the required tax, any dividend paid out of the accumulated undistributed income, as provided in Section 95, shall, in the hands of the following otherwise taxable recipients, be received by them without further liability for income tax—

(i) individual shareholders, including individuals who are principals of agents and nominees;

(ii) individual shareholders of a personal corporation through the medium of such personal corporation;

(iii) estates or trusts accumulating income for the benefit of unascertained persons or persons with contingent interests;

(iv) income beneficiaries of estates or trusts receiving their portion of the dividend through non-cumulating estates or trusts which do not accumulate for the benefit of unascertained persons or persons having a contingent interest.

6. As to dividends paid out after election and after payment of the required tax,—

(a) If the dividend is a single dividend equal to the undistributed income, it will be tax-free to the recipients, without regard to the earnings of the previous year or years; (A 'single dividend' will include all such dividends paid in a fiscal period).

(b) If the dividend is less than the said undistributed income, then the dividend shall be taxable in an amount equal to the income of the preceding year, less taxes paid thereon, and in the amount by which the balance exceeds the remaining undistributed income;

(c) If the dividend is greater than the said undistributed income, then the dividend shall be tax-free to the extent of the undistributed income, or the remaining portion not previously distributed, and taxable on the excess thereof.

The words 'undistributed income' as used above mean the accumulated undistributed income, less taxes paid thereon.

The word 'dividend' includes the plural.

7. (i) Dividends paid in respect of the said undistributed income, after election and after payment of the required tax, must be reported in detail by a separate statement, in duplicate showing:—

(a) The name in full of the recipient shareholder, together with the address, and the amount paid to each and in total, whether the recipient is a taxable or non-taxable person.

(b) The names will be listed under three headings—

Persons ordinarily taxable—

1. Persons ordinarily taxable on the receipt of dividends, putting the Canadian resident shareholders first, followed by the non-Canadian residents.

Special groups—

2. Estates and trusts, and personal corporations so far as known to the officers of the private company.

Companies and non-taxable entities—

3. Persons, such as companies which are non-taxable on dividends from another Canadian company, charitable organizations and other non-taxable entities.

(ii) In the case of any dividend paid which is partly taxable and partly non-taxable, the statement will segregate into two

columns the taxable and the non-taxable portions, opposite the respective names.

(iii) This statement must be filed within thirty days of the payment of the dividend as herein provided under covering letter which may contain such additional detail or explanation of special or unusual circumstances as may be required.

(v) Dividends shown on the special report as referred to above need not be reported on Form T.5.

8. The dividend may be distributed to common or preferred shareholders as the charter, by-laws or other powers of the company may permit, but if distribution is made to more than one class of shareholders, mention must be made of that fact, in the covering letter, referred to in 7 (iii) above, showing the basis of division as between them and the power authorizing it.

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Legal Costs In Taxation Appeals

The taxing authorities have held that the expenses of litigation pertaining to Income Tax, Excess Profits Tax or Succession Duty when actually before the courts, and including the necessary fees to counsel, are not an expense that may be charged against the profits in any year. This ruling is in accordance with the judgment of Finlay J. of the Kings Bench Division in England in the case of *Allen* v. *Farquharson Brothers & Co.*[1] This case involved a dispute as to whether the sum of £100 expended by the respondent, as legal costs including solicitor and counsel fees, in an appeal before the Special Commissioners was a deductible expense for the purposes of the Income Tax Act. The matter in dispute before the Special Commissioners had reference to assessments covering four years, 1927 to 1930 inclusive. In the result a substantial reduction in the profits to be assessed and in the tax payable by the respondents was obtained. The costs were paid and claimed in the year 1931, although the assessment for that year had not been in dispute in the matter under which such costs had been incurred.

In his judgment Finlay J. intimated that in his opinion the costs incurred were reasonable and proper. However, he points out that Income Tax is not a deduction before you arrive at the profits—the tax is a part of the profits and has in fact been called the Crown's share of the profits. The point to be decided was whether the expenditure was in the category of a disbursement or expense wholly and exclusively expended for

[1] (1932), 17 T.C. 59.

the purposes of the trade. He refers to the well-known case of *Strong* v. *Woodifield*[2] where it was said that not every expenditure that a prudent trader makes can be deducted. In particular, reference was made to the remarks of Lord Davey where he said:[3]

> It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits.

Accepting the principle laid down in the *Woodifield* case, Findlay J. concludes that the expenditure was not admissible. He said (at p. 66):

> The answer seems to me to be simple, that it was not an expenditure for the purpose of earning the profits and could not be. I cannot see that the profits were in the slightest degree altered, either decreased or diminished, as the result of this expenditure. I feel compelled, on these facts as they are set out in this case, to hold that this was an application—I should think, as far as I can judge, an exceedingly proper application—of profits after they have been earned and was not an expenditure necessary to earn the profits.

This judgment was rendered in 1932, and a careful search does not disclose any further litigation in respect of expenses incurred in tax litigation until recently. Legal expenses generally have been considered in Canada in the appeal of *Dominion Natural Gas Company Ltd.* v. *Minister of National Revenue*[4] and *Kellogg Co. of Canada Ltd.* v. *Minister of National Revenue.*[5] The expenses incurred, and which were involved in the dispute in these cases, were not in connection with the determination of tax liability.

The judgments of Atkinson J., also of the Kings Bench Division in England, in *Rushden Heel Company Ltd.* v. *C.I.R.*[6] and *Smiths Potato Estates Ltd.* v. *Boland,*[7] which were given on the 6th of June last, are of interest on this point.

In the *Rushden Heel* case the facts show that the company was engaged in, amongst other things, the manufacture of heels for boots and shoes. Of the capital of 2000 shares, 1971 were held by one man and the remainder by his children. In order to take advantage of a particular section of the English Excess Profits Tax Act the father transferred 100 of his shares to each

[2] 5 T.C. 215.
[3] *Ibid.*, p. 220.
[4] [1941] S.C.R. 19.
[5] [1943] S.C.R. 58.
[6] [1946] T.R. 273; [1946] 2 All E.R. 141.
[7] [1946] T.R. 283.

of his six children. As a result of this and in conformity with the legislation the company claimed that they were entitled to a substantially increased standard profit.

The Commissioners of Inland Revenue, acting under the section of the English Act that is the counterpart of section 15 of the Canadian Excess Profits Tax Act (and section 32A of the Income War Tax Act) claimed that the main purpose of the transfer was to avoid Excess Profits Tax. As stated in the judgment:

> In other words, the Commissioners made a charge of bad faith against these gentlemen, which reduced the standard profit to £1500 (from £4500).

The company appealed against an assessment levied upon them for 1941 upon the basis of the findings of the Commissioners of Inland Revenue. This was appealed to the Special Commissioners who allowed it and restored the standard profit to £4500. Expenses of the appeal, being for legal and accounting expenses and exceeding £141, were disallowed as an expense of the company in 1943, the year when they were paid.

In his judgment Atkinson J. points out the procedure required in present-day taxation matters for the ascertainment of profits. First, there is the commercial ascertainment, which in the case of companies must be carried out by qualified accountants. An expenditure such as is in question here would, without question, be treated by the company as a revenue expense.

The next ascertainment is that of arriving at the profits for the purpose of determining the Excess Profits Tax. The act requires that for this purpose the profits "should be separately computed and should be so computed on income tax principles. . . . ."[8]

The third ascertainment of profits is for income tax purposes. His Lordship says as to this:

> There again that is a different computation, because many of the rules, which are applicable when computing the profit for the purposes of E.P.T. do not apply to the computation for the purpose of arriving at the profits for the purposes of income tax.

His Lordship points out that the expenses of accountants and auditors whose services are employed in the determination of the profits are not and have not been questioned. This is the case notwithstanding that such expenses are incurred after

[8] Finance (No. 2) Act 1939, s. 14.

the close of the fiscal period and the profits have actually been earned. These expenses indeed were recognized as proper deductions in the *Farquharson Brothers* case (*supra*). If so, his Lordship argues, why is not the expense incurred in arguing an appeal concerning the same matters before the Special Commissioners? He says:

> The expense of arguing the matter in one room is allowed. The expense of arguing before the Special Commissioners in another room and saving between £2000 and £3000 for the business, it is said, must be disallowed. . . . It seems to me plain that the expense in dispute ought to be allowed and unless I am precluded by authority from so doing, I shall proceed so to hold.

His Lordship then discusses the reasons in the *Farquharson Brothers* case. He finds himself unable to follow the reasoning of Finlay J. when he says that the profits were not "in the slightest degree altered, either increased or diminished". In his view the result of the expenditure was a very considerable reduction in the amount of profits to be assessed. In the result he considers that there are two reasons why he should give effect to his own view. The first one is the fact that the present case concerned Excess Profits Tax whereas the *Farquharson* case dealt with Income Tax. The second and more important reason is that his view is consistent with the judgment of the Court of Appeal in *Worsley Brewery Company Ltd.* v. *C.I.R.*,[9] a judgment given in 1932 some three months after the judgment in the *Farquharson* case.

The facts in the *Worsley Brewery Company* case show that in 1925 the company engaged the services of a firm of accountants, other than the firm usually employed by them to investigate their accounts, for the period 1914 to 1920 inclusive, they having reason to believe that there had been an overpayment by them of Excess Profits Duty in those years severally. As a result the company was repaid a substantial amount. The fees to the accountants amounted to some £973, which was 15% of the amount actually repaid by the Revenue to the company.

The company sought to charge these fees against the assessments for the seven years 1914 to 1920. It was held, however, that the expense was properly chargeable only in the year in which it was actually expended. The decision in the *Farquharson* case was not discussed but it was stated that the expenses incurred in the ascertainment of profits are properly deductible. The question resolves itself therefore into the time when the profits are ascertained. Atkinson J. says:

[9] (1932), 17 T.C. 349.

> The profits were not ascertained when the Commissioners of Inland Revenue or the Inspector of Taxes made a charge of bad faith against the appellant and directed that the transaction in question should be disregarded. They were not ascertained until the appeal had been heard and a final decision given. None of the profits in any of the three senses to which I have referred were ascertainable until after the decision had been given. . . . .
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> In my judgment, the true principle, if I may repeat it once more, is that an expense, properly and reasonably incurred in the final ascertainment of profits may properly be considered an outlay in order to earn profits.

The last sentence of his Lordship quoted above is important. He does not tie up such an expenditure with the expenses of the trade, but rather considers it directly related to the earning of profits. He uses the word "profits" here as having the meaning given in *Vulcan Motor and Engineering Co.* v. *Hampson*,[10] where it was held that the profits earned by a company were "profits divisible among the shareholders, in other words 'net profits' ". The statement, if correct, would bring the expenditure into conformity with the Canadian statute, which limits deductible expenses to those "wholly, exclusively and necessarily expended" for the purpose of earning the income. "Income" is defined in section 3 of the act as meaning "annual net profit or gain".

In the *Smiths Potato Estates* case the facts show that the earnings of an employee of the company had been arbitrarily reduced by the taxing authorities from £6486 to £3500. This was done under a provision of the English Act (the counterpart of section 6, subsection 2, of the Canadian Income War Tax Act), which permits the authorities to disallow as a deduction any payment for services that is deemed to be in excess of what is considered reasonable for the services rendered. The company appealed the assessment, and the Special Commissioners adjusted the salary and allowed the company a deduction of £5800 out of the £6486 actually paid the employee.

The costs incurred in the appeal to the Commissioners were in excess of £600 and the present case was to decide whether such costs were a proper deduction in the year when they were paid. It was shown that the services of the employee were extremely valuable to the company and that if he were not properly remunerated he would leave the company at the first opportunity.

Atkinson J. held that the costs of the appeal were proper expenses to be deducted for the reason given in the *Rushden Heel*

[10] [1921] 3 K.B. 597.

Manufacturing Co. case (*supra*). However, he stated he would also allow it on the ground that it was an expenditure incurred for the purpose of retaining somebody whose services were vital to the company, an expenditure "which is, even on a narrow interpretation of the phrase, incurred for the purpose of gaining profits".

The expenses in dispute in these cases were all incurred in appeals before the Special Commissioners, a body that corresponds roughly to the Income Tax Appeal Board for which provision was made in the last amendment of the Income War Tax Act. It would seem reasonable, however, to assume that if the judgments of Atkinson J. are maintained the principle would extend to costs incurred in a court of law should it be necessary to proceed to such court to ascertain the profits. It is not questioned that legal and accounting fees incurred in discussing an assessment with the taxing authorities prior to appearance in court are a proper expense of the year in which they were paid.

These two cases are also of interest as indicating the manner in which administrative findings are dealt with under the English statutes. Recently several appeals against determinations made under section 6, subsection 2, of the Income Tax Act have been before the Exchequer Court. It has been held that the court has no jurisdiction to upset the findings or determination of the Minister under this section if his determination was made in a proper manner and upon correct legal principles. In England a right of appeal to the Special Commissioners against any such determination is given, and they apparently do upset the findings of the taxing authorities. In Canada a right of appeal is not given to the proposed Board of Tax Appeals, but to a proposed Advisory Board, which will advise the Minister on appeals. The Minister, however, is not bound to accept the decision of the Advisory Board and, in any event, the legal status of his finding is exactly the same as if the Advisory Board did not exist.

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