BETWEEN:

1960
Feb. 4
Sept. 22

HARRY SILVERMAN ....APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Revenue—Income—Income tax—Bonus paid by real estate dealer to obtain mortgage loans—Whether capital outlay or deductible expense —The Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 11(1)(cb), 12(1)(a) and (b).

Appellant was a member of a partnership which carried on the business of buying and selling real estate. In December 1954 a property was purchased for $9,000 and sold the following February for $12,500. Prior to the sale the partners mortgaged the property to secure repayment in five years of $4,200, and it was a term of the agreement of sale that the purchaser, in payment of $4,200 of the selling price, should assume the mortgage. Of the $4,200 the partners received $4,000, a $200 bonus being exacted by the mortgagee. The evidence did not disclose what the money was used for or why it was borrowed.

A second property was purchased in November 1954 for $12,200 and sold in February 1955 for $15,000. It too was mortgaged prior to sale to secure repayment in five years of $6,500, and the assumption of the

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mortgage by the purchaser represented $6,500 of the selling price. The proceeds of the loan were $6,000 after deduction by the mortgagee of a $500 bonus. The evidence was that the moneys received were applied in part payment of the balance of the purchase price by the partnership. In calculating its trading profit for 1955 the partnership deducted from its gross profit the bonuses of $700 as expenses incurred in arranging first mortgages. In making the assessment the Minister added back this amount on the ground that the bonuses were outlays made to secure working capital the deduction of which is prohibited by s. 12(1)(*b*) of the *Income Tax Act.*

The appellant appealed to this Court from a decision of the Income Tax Appeal Board dismissing his appeal from the assessment.

Held: That the loan secured by the property in respect of which a $500 bonus was paid while on its face not of a temporary nature could be so regarded since the partners did not expect to have the property for long and the assumption and retirement of the loan were in fact provided for in the transaction in which the property was sold. Further the borrowed money was directly used to pay part of the purchase price of a property acquired as a revenue asset and it did not add anything of a permanent nature to the assets employed as either fixed or circulating capital in the business.

2. That in the circumstances the money so borrowed was not used as capital in the business in the sense in which the word "capital" is used in s. 12(1)(*b*) of the *Income Tax Act.*

3. That the $500 bonus was not a payment or outlay on account of capital within the meaning of s. 12 (1)(*b*) and its deduction should be allowed.

4. That with respect to the mortgage on which a $200 bonus was paid the evidence did not show why the money was borrowed or what it was used for and the taxpayer not having met the onus placed upon him to satisfy the Court that the bonus was not incurred on account of capital failed to establish any right to its deduction.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Thurlow at Toronto.

Charles Drukarsh, Q.C. and *J. G. McDonald* for appellant.

F. J. Cross and *G. W. Ainslie* for respondent.

THURLOW J. now (September 22, 1960) delivered the following judgment:

This is an appeal from a judgment of the Income Tax Appeal Board dated September 28, 1955, dismissing an appeal by the appellant against an assessment of income tax for the year 1955. In making the assessment, the Minister added to the income of the appellant an amount of $233.33, representing the appellant's share of a sum of $700

which had been deducted by the appellant in his computation of the profit of a partnership known as Pearl Realty, in which he had a one-third interest, and the issue in the appeal is whether the appellant is liable to tax in respect of this amount.

The partnership was formed in November, 1954 and carried on the business of buying and selling real estate in Toronto until March 31, 1955, when it was dissolved. In that period, three properties were bought and sold, the transactions pertaining to two of such properties, namely 23 Cowan Avenue and 61 Beatrice Street, being in question in these proceedings. Twenty-three Cowan Avenue, was purchased for $9,000 on December 20, 1954, the date set for completion of the purchase being December 31, 1954. The property was sold on or about February 21, 1955 for $12,500. In the meantime, on or about January 30, it had been mortgaged by the partners to secure repayment in five years of $4,200 and interest at 6½ per cent, and it was a term of the agreement of sale that the purchaser, in payment of $4,200 of the selling price, should assume the mortgage. Of the $4,200 so secured, the partners had received $4,000, the remaining $200 being a bonus exacted by the mortgagee. As to this transaction, the evidence shows that on February 2, 1955 the solicitor for the partnership sent to it a cheque for $3,941.50, representing the proceeds of the loan, but there is no satisfactory evidence as to what this money was used for or why it was borrowed. In particular, the evidence leaves me unsatisfied that the money was used to pay for the property.

The property known as 61 Beatrice Street was purchased on November 22, 1954 for $12,200 and was sold on February 26, 1955 for $15,000. In the meantime, it, too, had been mortgaged to secure repayment in five years of $6,500 and interest at 6½ per cent, and the assumption of the mortgage by the purchaser represented $6,500 of the selling price. The proceeds of the loan were $6,000, the remaining $500 being a bonus exacted by the mortgagee. In this case the evidence shows that the moneys received, less some legal fees, were applied in part payment of the balance of the purchase price payable by Pearl Realty when the purchase was completed on or about February 7, 1955.

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The evidence also shows that the appellant put $6,000 or $7,000 into the partnership as his share of its capital and that the other partner was expected to put in somewhat more, but it is not clear how much he did in fact contribute.

In the trading account of the partnership for the period from January 1, 1955 to March 31, 1955, which accompanied the appellant's income tax return for 1955, the receipts from sales of the three properties were shown at $42,300, which included the $12,500 and the $15,000 for which 23 Cowan Avenue and 61 Beatrice Street, respectively, were sold, and from the gross profit calculated after deducting the cost of purchasing the properties and a sum for improvements and repairs, there was deducted under the heading "Expenses" an amount of $700 entitled "Bonus on arranging of First Mortgages." In making the assessment, the Minister added back this amount, and the issue is whether he was right in so doing.

The appellant put his case in two ways. He submitted first that the $700 was never received by the partnership and would never be received and that, although in the method of accounting used the $700 had been included in the receipts and then deducted, it would have been equally accurate and in accordance with the requirements of the *Income Tax Act* not to include it in the receipts and not deduct it. Secondly, he submitted that, if it was necessary in computing income to include in the receipts the full selling price of the properties, the $700 was properly deducted. The position taken by the Minister was that the full selling price of the properties must be brought into the computation and accounted for and that the bonuses were outlays made by the partners to secure working capital for their business and were thus payments or outlays on account of capital, the deduction of which in computing income for income tax purposes is prohibited by s. 12(1)(*b*) of the *Income Tax Act*.

By s. 3 of the *Income Tax Act*, R.S.C. 1952, c. 148, it is declared that, for the purposes of Part I of the Act, the income of a taxpayer for a taxation year is his income from all sources and includes income for the year from all businesses, and by s. 4 it is provided that, subject to the other

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provisions of Part I, income for a taxation year from a business is the profit therefrom for the year. Clauses (*a*) and (*b*) of s-s. (1) of s. 12 are as follows:

> 12. (1) In computing income, no deduction shall be made in respect of
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
> (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

In s. 11(1)(*c*) provision is, however, made that, notwithstanding paras. (*a*), (*b*) and (*h*) of s. 12(1), interest on borrowed money used for the purpose of earning income from a business may be deducted, and by s. 11(1)(*cb*) it is also provided that a taxpayer may deduct an expense incurred in the year in the course of borrowing money used by the taxpayer for the purpose of earning income from a business, but not including any amount in respect of a bonus paid or payable to a person from whom the money was borrowed.

It will be observed that the statute does not define what is to be taken as the profit from a business, nor does it prescribe how or by what method such profit is to be computed, though it does contain provisions to which, for income tax purposes, any method adopted is subject. However, since what is declared to be the income from a business is the profit therefrom for the year, the method adopted must be one which accurately reflects the result of the year's operations, and where two different methods, either of which may be acceptable for business purposes, differ in their results, for income tax purposes the appropriate method is that which most accurately shows the profit from the year's operations.

Thus in *Publishers Guild v. Minister of National Revenue*[1] Thorson P. said at p. 29:

> What is basically to be determined under the *Income War Tax Act* is the amount of "net profit or gain . . . received" by the taxpayer during the year. It was established by the House of Lords in *Sun Insurance Office v. Clark,* [1912] A.C. 443, that "the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business". Thus, what is to be determined here is, not whether the Department has accepted the accrual basis system of accounting and rejected the instalment system, but rather which system more nearly accurately reflects the taxpayer's income position.

[1] [1957] C.T.C. 1; 57 D.T C. 1017.

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See also *Minister of National Revenue v. Anaconda American Brass Ltd.*[1] and *Ken Steeves Sales Ltd. v. Minister of National Revenue*[2].

Turning now to the question whether the $700 must, in the first instance, be included in the computation as a receipt since it formed part of the nominal selling price of the two properties, there being but two transactions to consider, both of which were substantially completed in the accounting period, it would seem that the result ought to be the same whether the method of computation used is that employed in the appellant's income tax return or any other logical method. If, however, instead of the nominal selling price of the properties, one takes as the starting point of the computation what was actually received, it becomes necessary, in my opinion, to examine the transactions themselves, in which the properties were sold, to see what was in fact realized in them. It should here be noted that the transactions in which the properties were mortgaged do not, in my opinion, enter into the computation. The mortgaging of the properties cannot be regarded as a partial disposal of them, nor do the sums received from the mortgagees form part of the proceeds of their disposal or become revenue receipts of the partnership. In each case, however, when the property was sold, the partners were liable for the mortgage debt, which included the bonus granted by them and, when selling the property, the partners received a portion of the purchase price in cash and a second mortgage for another portion of it. There is no doubt that both the amount received and the value of the second mortgage must be brought into the computation. In addition, on each occasion the partners obtained the purchasers' undertaking to pay to the mortgagee the sum which they were obligated to pay to him. In my view, this undertaking was something of value to the partners since, without it, they would have been obliged sooner or later to find the money to discharge their obligation and the purchasers' undertaking relieved them of the obligation to do so. It seems to me, therefore, that the actual receipts at the time of sale in each case were made up of the cash and second mortgage received and a contractual obligation as well, which *prima facie* was worth

[1] [1955] C.T.C. 311; 55 D.T.C. 1220.

[2] [1955] Ex. C.R. 108.

to the partnership the amount outstanding on the first mortgage. Moreover, while the actual payment of the first mortgage by the purchaser would probably not be completed for some years, so far as the partners were concerned in the ordinary course of events there would be nothing more to be done by them in any subsequent year to earn or obtain this portion of the selling price of the property. This feature distinguishes the case on its facts from that of *Publishers Guild v. Minister of National Revenue* (*supra*). The amount of the bonuses assumed by the purchasers accordingly, in my opinion, forms part of the total amount to be accounted for by the partners as receipts from the sales of the properties, and it thus makes no difference for the purposes of this case whether what is taken as the starting point of the computation is the nominal selling price of the properties or what was actually received.

Having reached this conclusion, it becomes necessary to consider whether the bonuses or either of them may properly be deducted as expenses.

In *Royal Trust Company v. Minister of National Revenue*[1] Thorson P., in discussing the approach to the question of allowance of deductions under the *Income Tax Act*, said at p. 42:

> Consequently, if the correct approach to the question of whether a disbursement or expense was properly deductible in a case under the *Income War Tax Act* was the one which I have outlined, it follows, *a fortiori*, that it is the correct approach to the question of whether an outlay or expense is properly deductible in a case under the *Income Tax Act*. Thus, it may be stated categorically that in a case under the *Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of Section 12(1)(*a*) of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of Section 12(1)(*a*) and, therefore, within its prohibition.

In *B.C. Electric Railway Co. Ltd. v. Minister of National Revenue*[2] Abbott J., with whom the Chief Justice and Fauteux J. concurred, said at p. 137:

> Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of s. 12(1)(*a*) whether it be classified as an income expense or as a capital outlay.

[1] [1957] C.T.C. 32; 57 D.T.C. 1055.
[2] [1958] S.C.R. 133.

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Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay. The principle underlying such a distinction is, of course, that since for tax purposes income is determined on an annual basis, an income expense is one incurred to earn the income of the particular year in which it is made and should be allowed as a deduction from gross income in that year. Most capital outlays on the other hand may be amortized or written off over a period of years depending upon whether or not the asset in resepct of which the outlay is made is one coming within the capital cost allowance regulations made under s. 11(1)(*a*) of *The Income Tax Act*.

In *W. E. Bannerman v. Minister of National Revenue*[1] Kerwin C.J., in delivering the unanimous judgment of the Court, said at p. 564:

Under Section 12(1)(*a*) of the present Act it is sufficient that an outlay be made or expense incurred with the object or intention that it should earn income, but since in one sense it might be said that almost every outlay or expense was made or incurred for that purpose, a line must be drawn in the individual case depending upon the circumstances and bearing in mind the provisions of Section 12(1)(*b*).

See also *Evans v. Minister of National Revenue.*[2]

In the present case, it was not contended that the deduction of the expense attending either of the two mortgages was prohibited by s. 12(1)(*a*), and the matter falls to be determined on whether the bonuses were outlays on account of capital the deduction of which is prohibited by s. 12(1)(*b*). This question, in my opinion, turns on whether or not the borrowed moneys in respect of which the bonuses were incurred were in fact used as capital in the partnership business.

In *The European Investment Trust Co. v. Jackson*[3] Romer L.J., referring to the judgment of the House of Lords in *Scottish North American Trust Ltd. v. Farmer*[4], said at p. 16:

The House of Lords, affirming the decision of the Court of Session in Scotland, held that the moneys so borrowed were not sums employed as capital in the trade, within the meaning of what then, I think, corresponded to Rule 3, Sub-rule (*f*). In point of fact, the money which was held not to be capital—although it was capital, as I say, in the sense that it was not income—was, really, what is frequently referred to as circulating capital. But, again, it is impossible, I think, to treat the decision of the House of Lords as laying down that capital, which is used as circulating capital, is not capital within the meaning of Sub-rule (*f*).

[1] [1959] S.C.R. 562.
[2] [1960] S.C.R. 391.
[3] 18 T.C. 1.
[4] 5 T.C. 693.

To start with, they did not, in terms, draw any distinction between circulating capital and fixed capital and, in the next place, they did not overrule, although they commented upon, the decision in the *Anglo-Continental Guano Works v. Bell*, reported in 3 T.C. 239, where money that, so far as I can see, was borrowed and used as a circulating capital, was treated as capital within the meaning of Sub-rule (*f*). The only conclusion that I can draw from those cases, therefore, is this, that, in each case, it is a question of fact whether the capital money borrowed is or is not capital employed in the trade within the meaning of this sub-paragraph, and if the Commissioners have decided, as a question of fact, that it is, then this Court cannot interfere.

In the same case, Finlay J. had said at p. 11:

Now, here it seems to me that the principle may be stated in this way: if you get a company dealing with money, buying or selling stocks or shares, Treasury bills, bonds, all sorts of things, and if you get that company getting, as such companies constantly do get, temporary loans from their bank—accommodation, I suppose, for sometimes twenty-four hours, or even less, sometimes for a good deal longer—if you get that sort of thing, then the interest on that money, the hire, so to speak, paid for that money, may properly be regarded as an expenditure of the business, an outgoing to earn the profits. On the other hand, if the truth of the thing is that by the payment of the interest the company does not obtain mere temporary accommodation, day to day accommodation of that sort, but does, in truth, add to its capital and get sums which are used as capital and nothing else, then I think that in that case all the authorities show that that deduction cannot properly be made.

In *Ascot Gas Water Heaters Ltd. v. Duff*[1] Lawrence J. said at p. 176:

It appears, therefore, from those observations of Romer, L.J., that the matter cannot be concluded by considering simply whether the sum in respect of which the sum is sought to be deducted is fixed capital or circulating capital, and it appears to me that the only true principle must be the principle which is laid down by Finlay, J., and which is binding upon me, no other decision or criticism of his statement of the principle having been brought to my notice. The principle, therefore, which the Commissioners ought to have applied in each of these cases was whether the sums in respect of which the commission dealt with in these two cases was payable, were sums which, although capital, were temporary in their nature and might be regarded as an ordinary incident of carrying on the business of the Company.

In the case before Lawrence J., two sums were in issue, one of which was a payment made by the taxpayer to obtain a guarantee for indebtedness incurred for raw materials purchased in the course of trading and the other a payment made for a guarantee of a loan raised in order to provide credit and reserves necessary for the expansion of the business and the commissioners had held the first

[1] 24 T.C. 171

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sum so paid to be a proper deduction and the second to be not a proper deduction. With respect to the latter, Lawrence J. held that there was overwhelming evidence before the commissioners on which they might find, as they had, that the latter sum was not deductible, and he then proceeded as follows at p. 177:

> In the other case there is much more difficulty, but the Commissioners have in that case expressed their finding as a finding of fact that the money was wholly and exclusively laid out for the purposes of the business, and was a proper deduction. Having regard to the fact that the commission was payable in resepct of a sum of money which was raised in respect of the guarantee of the amount of an existing trade debt, and the fact that that trade debt was very largely reduced in the two years after the guarantee had been given, and the fact that the parties were, according to the evidence, anxious that this loan should be repaid as quickly as possible, I feel unable to say that there was no evidence upon which the Commissioners might come to the conclusion of fact which they did.

In *Ward v. Anglo-American Oil Co. Ltd.*[1] Singleton J. expressed the distinction thus at p. 108:

> It is unnecessary for me to deal further with the matter except to say that bearing in mind the words of Lord Sumner and Lord Parker in the case of *Usher's Wiltshire Brewery, Limited v. Bruce,* 6 T.C. 399, and that which was said by Lord Justice Warrington in *Atherton v. British Insulated & Helsby Cables,* 10 T.C. at page 182, I conceive the scheme of that part of the Act and of Schedule D, which deals with profits or gains from trade and deductions which can be made therefrom, to be this: that one must arrive at profits or gains in the ordinary commercial or business sense. Interest on ordinary bankers' overdrafts which has arisen for ordinary trading purposes is a legitimate deduction, because it is money wholly and exclusively laid out or expended for the purpose of trade. On the other hand, interest on an issue of notes, whether for one year or for a longer period, may fall, and in the circumstances of this case does fall, into an entirely different category. It seems to me to savour much more of a capital nature or of some fund employed or intended to be employed as capital, and I do not think the issue of notes on which interest accrued would be regarded by business men as of the same nature as facilities obtained for ordinary trading purposes.

In *Bennett and White Construction Co. Ltd. v. Minister of National Revenue*[2] the Supreme Court of Canada considered a case under the *Income War Tax Act* wherein the taxpayer had incurred expense in securing the guarantees of its principal shareholders for its indebtedness to a bank

[1] 19 T.C. 94
[2] [1949] S.C.R 287; C.T.C. 1; 49 D.T.C. 514.

and held that the expense in question was an outlay or payment on account of capital. Locke J., with whom Rinfret C.J. concurred, said at p. 292:

I am of the opinion that expenditures such as these made by reason of the necessity of obtaining working capital are payments of the same nature.

Rand J. said at pp. 292-293:

The case for the company is that the payments were "wholly, exclusively and necessarily" paid out to earn the income. In a remote sense that is so; but the same can be said for almost every outlay in the organization of the company. The conception of the statute however is an earning of income through the use of capital funds which in one form or another constitute the means and instruments by which the business is prosecuted; but that providing or organizing them must be clearly differentiated from the activities of the business itself has been lately reaffirmed by the Judicial Committee in *Montreal Coke and Manufacturing Company v. The Minister of National Revenue,* [1944] C.T.C. 94, [1944] A.C. 126.

The acquisition of capital may be by various methods including stock subscriptions, permanent borrowings through issues of securities, or term loans; and ordinarily it should make no difference in taxation whether a company carried on financially by one means or another. In the absence of statute, it seems to be settled that to bring interest paid on temporary financing within deductible expenses requires that the financing be an integral part of the business carried on. That is clearly exemplified where the transactions are those of daily buying and selling of securities: *Farmer v. Scottish Trust,* [1912] A.C. 118: or conversely lending money as part of a brewery business: *Reid's Brewery v. Mail,* [1891] 2 Q.B. 1.

Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (*b*). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue. The lender might insist on being furnished with premises near the scene of the works; it might exact any other accommodation as the price of its willingness to provide funds; but all that would be outside the circumference of the transactions from which the income arises. Within the meaning of the Act, the premiums create part of the capital structure and are a capital payment: *Watney v. Musgrove,* 5 Ex. D. 241. they furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business. That was the view of O'Connor, J. below and I agree with it.

Estey J. said at p. 296:

This was not a borrowing of money on a temporary or short-term basis such as is necessary and incidental to the ordinary and usual transactions in the course of the appellant's business.

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> The learned trial Judge held that the sums as borrowed were capital and the evidence fully supports his finding.

and at p. 299:

> The appellant upon obtaining this line of credit was enabled to complete its financial arrangements at the bank, which enabled it to undertake the larger volume of business. Sums borrowed under such circumstances are capital and the sums paid are not deductible under the provisions of 6(1)(*a*).

In the present case, while the loan secured by the partners by mortgaging 61 Beatrice Street was on its face not of a temporary nature I think it may in the circumstances be inferred that the partners expected to dispose quickly of the property in just such a transaction as subsequently occurred. From their point of view the borrowing can, I think, accordingly be regarded as temporary since they did not expect to have the property for long and the assumption and retirement of the loan were in fact provided for in the transaction in which the property was sold. Next it appears that the borrowed money was not simply deposited in the partnership bank account to be used as the day-to-day exigencies of the business might require but was directly used to pay a part of the purchase price of the property itself, a property which was undoubtedly acquired as a revenue asset of the business. And in the ordinary course neither this money nor anything representing it would again fall into the hands of the partners or be capable of use by them in their business. Though in being used to purchase a trading asset it was used as circulating capital is used, it would not be used again in the way that circulating capital is ordinarily used over and over again. Nor did this borrowing expand or add anything of a permanent nature to the assets employed as capital in the business. I am accordingly of the opinion that the money so borrowed was not used as capital in the business in the sense in which the word "capital" is used in s. 12(1)(*b*) and that the bonus of $500 was not a payment or outlay on account of capital within the meaning of that clause. It follows that the bonus was properly deductible in computing the profit from the partnership business. Nor, in my opinion, is this conclusion affected by s. 11(1)(*cb*), which operates to permit the deduction therein mentioned, whether it is prohibited or not by s. 12(1)(*a*), (*b*), and (*h*), but does not itself prohibit deduction of an amount the deduction of which is not prohibited by s. 12.

On the other hand, with respect to the mortgage on 23 Cowan Avenue the situation differs in that the evidence does not show why the money was borrowed or what it was used for, and the burden being on the taxpayer to satisfy the Court that the bonus which he seeks to deduct was not incurred on account of capital, even though the retirement of the loan was provided for in the same way as for the other loan, in the absence of satisfactory evidence that the borrowed money was not used to provide fixed or working capital for the partnership, I am of the opinion that the appellant has not established any right to deduct the bonus.

The appeal will be allowed with respect to the bonus on the mortgage on 61 Beatrice Street only, and the assessment will be referred back to the Minister to be revised accordingly. The appellant is entitled to the costs of the appeal.

Judgment accordingly.