

1945 }  
 Nov. 7 & 8 }  
 Dec. 29 }  
 BETWEEN: }  
 DOMINION TELEGRAPH SECURI- }  
 TIES LIMITED, ..... } APPELLANT;  
 AND  
 THE MINISTER OF NATIONAL }  
 REVENUE, ..... } RESPONDENT.

*Revenue—Income—Income War Tax Act R.S.C. 1927, c. 97, secs. 6 5(1) (b), 6(1) (a), 6(1) (d)—Rentals held to be income and not compensation for transfer of physical assets—Interest on funds held in sinking fund is income of appellant—Appeal dismissed.*

Appellant was incorporated for the purpose of distributing the assets of Dominion Telegraph Company among the shareholders of that company. These assets consisted of a cash payment of \$116,640 00 and an assignment of annual payments as rentals of the sum of \$62,500.00 each under an agreement entered into between the Great North West Telegraph Company and the Dominion Telegraph Company, such rentals representing the payment by the former company for the physical assets of the Dominion Telegraph Company. Pursuant to an agreement between the appellant and Dominion Telegraph Company the appellant issued bonds of the par value of \$1,000,000.00 under a mortgage and deed of trust entered into with the Royal Trust Company as trustee, and also issued 2000 certificates of interest under an agreement with the same trustee. Also pursuant to the agreement appellant purchased bonds of this issue to the amount of \$52,500 00 and delivered these to the trustee to be held by it to retire the certificates of interest; appellant also purchased bonds of the par value of \$56,500.00 and deposited these with the trustee as a sinking fund for the redemption of the entire bond issue. Appellant also assigned to the trustee the annual rentals of \$62,500.00 to pay the interest on the bonds. Except for these two lots of bonds all the certificates of interest and bonds were distributed among the shareholders of Dominion Telegraph Company as partial distribution of the assets of that company, appellant receiving in return all the share certificates of that company from its shareholders.

Appellant filed income tax returns for the years 1926 to 1929, both inclusive, showing the rentals as income and the interest paid on the bonds as expense.

Respondent allowed the interest paid on the bonds outstanding, other than those in the sinking fund as an expense but disallowed the interest on the bonds held in the sinking fund as an expense and assessed appellant for income tax purposes on such interest as income received by it. Appellant appealed to this Court.

*Held:* That the annual payments of \$62,500.00 are income of the appellant.

2. That the interest on the bonds in the sinking fund is not an expense which the appellant is entitled to charge against income in determining appellant's taxable income.

APPEAL under the provisions of the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice O'Connor, at Ottawa.

*L. A. Landriau, K.C.* for appellant.

*R. Forsyth, K.C.* and *A. A. McGrory* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

O'CONNOR J., now (January 14, 1946) delivered the following judgment:

The appellant appeals from assessments for income tax made by the respondent for the years, 1926 to 1929, both inclusive.

The appellant was incorporated for the purpose of distributing the assets of Dominion Telegraph Company among its shareholders, consisting of the cash payment of \$116,640.00, and an assignment of annual payments of \$62,500.00, under an agreement between the Great North West Telegraph Company and the Dominion Telegraph Company. The appellant then issued bonds of the par value of \$1,000,000.00 under a mortgage and deed of trust with the Royal Trust Company, and issued 2,000 certificates of interest under an agreement with the same trustee and distributed both the bonds and the certificates of interest among the shareholders of Dominion Telegraph Company, and received in return the share certificates of Dominion Telegraph Company from its shareholders.

Pursuant to the mortgage and the agreement, the appellant used \$109,000.00 of the cash payment of \$116,640.00 to acquire part of the bonds which it had issued, and placed these bonds with the trustee to create a sinking fund to retire all the bonds and the certificates of interest, and the appellant assigned sufficient of the annual payments to the trustee to secure the payment of the interest on the said issue of bonds.

The appellant in its income tax return, under The Income War Tax Act, being chapter 97 of the Revised Statutes of Canada, 1927, and amendments, filed in each of the years in question, charged the interest on the bonds in the sinking fund as an expense against income.

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The respondent disallowed the interest on the bonds in the sinking fund and charged them back to income and assessed the appellant in respect of these items in each of the years in question.

The appellant contends that the interest on these bonds in the sinking fund is not taxable owing to the fact that the same does not constitute sinking funds created in the ordinary way, but represents the distribution of a fund received as a repayment of capital exclusively.

The respondent contends that the interest on these bonds in the sinking fund gives rise to income by way of interest, and, although received by the trustee, is income of the appellant and taxable, and in the alternative the interest received in respect of the bonds held in the sinking fund is not an expense which the appellant is entitled to charge against income in determining taxable income under the act.

Dominion Telegraph Company was incorporated in 1871, and established and maintained throughout Canada a public telegraph system.

On the 12th June, 1879, by an indenture of lease, Dominion Telegraph Company, as lessor, leased to American Union Telegraph Company, as lessee, the entire telegraph system for a period of ninety-nine years from the 1st July, 1879, at a rental of \$52,500.00 per annum, payable quarterly, and the lessee covenanted to keep the telegraph system in good working order and on the termination of the lease, to surrender and yield up the property in good working order and repair, and to pay an increased rental of \$10,000.00 per year if the lessee made arrangements with any telegraph company in Canada for pooling receipts.

On the 11th July, 1881, American Union Telegraph Company assigned the lease to Western Union Telegraph Company and the rental was increased to \$62,500.00 by reason of the provision set out in the preceding paragraph.

On the 26th August, 1881, Western Union Telegraph Company assigned the lease to the Great North Western Telegraph Company in so far as the lease related to that portion of the system lying West of the Province of New Brunswick.

Counsel agreed that Canadian National Railways took over the Great North Western Telegraph Company.

The appellant alleges that the officers of Dominion Telegraph Company discovered that the telegraph system had been so interwoven with the telegraph lines of the Great North Western Telegraph Company as to be indistinguishable, and tendered certain evidence, which will be referred to later, as to the negotiations which took place over a period of years between the officers of the Dominion Telegraph Company and the officers of Canadian National Railway.

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As a result of these negotiations a settlement was effected. The appellant was incorporated for the purpose of distributing the payments received from the settlement among the shareholders of Dominion Telegraph Company.

The agreement containing the settlement was entered into between the Great North Western Telegraph Company and the Dominion Telegraph Company, and the appellant, and the intervening lessees are parties thereto.

The agreement is dated 15th January, 1925, and the Schedules "A", "B" and "C", which are attached to the agreement, are the original lease and the two assignments already referred to.

The agreement then provides:—

1. In consideration of the sum of One hundred and sixteen thousand six hundred and forty dollars (\$116,640.00) heretofore paid to the Dominion Company and for the sum of One dollar—(\$1.00) each in hand paid to the Dominion Company and the Securities Company upon the execution of this agreement, the receipt whereof is hereby acknowledged, the Dominion Company and the Securities Company hereby release the other parties hereto from all claims and demands, present and future, in respect of the following covenants in the Indenture hereunto annexed as Schedule "A" hereto which are to the following effect:—

*FIRSTLY*, that the lessee in the said Indenture of the 12th of June, 1879, should, during the demised term, keep the said telegraph lines, system and plant in good working order and should pay all costs of renewals thereof and all expenses of carrying on the same, and

*SECONDLY*, that on the last day of the said term, or on the sooner determination of the estate thereby granted, the lessee should peaceably and quietly leave, surrender and yield up unto the Dominion Company all and singular the said demised premises and property in good working order and repair with an adequate supply of instruments and plant of the most improved character then in use on telegraph lines in America.

2. Upon the expiration of the said lease on the 20th day of June 1978 or upon its earlier termination as therein provided for, the Dominion Company and the Securities Co., for the aforesaid sum of

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One hundred and sixteen thousand six hundred and forty dollars (\$116,640.00) hereby agree to sell, transfer, quit claim and assign unto the Great North Western all of the Dominion Company's and the Securities Company's right, title and interest in and to all of the lines, telegraph system and properties conveyed by the said lease existing and being West of the Province of New Brunswick in the Dominion of Canada and elsewhere West of the Province of New Brunswick and the Dominion Company and the Securities Company hereby agree to sell, transfer, quit claim and assign unto the Western Union all the Dominion Company's and the Securities Company's right, title and interest in and to all of the other lines, telegraph system and properties conveyed by the said lease; PROVIDED, HOWEVER, that the provision of the said lease with respect to the payment of rentals shall have been in all respects fully complied with.

3. The Indenture of Lease hereunto annexed as Schedule "A" hereto and all the covenants, provisos, conditions, powers, matters and things whatsoever contained therein shall enure to the benefit of and be binding upon the successors and assigns of each of the corporate parties hereto and shall continue in full force and effect save and except as hereby expressly amended.

4. All future rents payable during the whole of the currency of the said Indenture of Lease and amounting to the sum of Sixty-two thousand five hundred dollars (\$62,500.00) per annum payable quarterly on the 1st days of January, April, July and October in each and every year during the currency of the said lease, shall be paid to the Securities Company which has acquired by purchase all the assets and goodwill of the Dominion Company subject to the terms and conditions of this Agreement.

Then by an agreement dated 12th January, 1925, after reciting the original lease and assignment, Dominion Telegraph Company assigned the lease and the rent payable thereunder to the appellant. The agreement recites all the provisions of the agreement between the two telegraph companies and appellant and Dominion Telegraph Company covenants and agrees with the appellant that the rent of \$62,500.00 per annum will continue to be paid quarter-yearly until the expiration of the lease.

Then by another agreement between Dominion Telegraph Company, as vendor, and the appellant, as purchaser, also dated 12th January, 1925, it was provided:—

1. The Vendor hereby agrees to sell and the Purchaser hereby agrees to purchase the entire assets of the Vendor subject to all liabilities, if any, of the Vendor which shall be assumed and paid by the Purchaser.

2. The Purchaser covenants, promises and agrees to execute a Mortgage and Deed of Trust in favour of The Royal Trust Company (hereinafter called "the Trust Company") to secure an issue of 5½ per cent Fifty-three Year Mortgage Bonds bearing date the Second day of

February 1925, of a total par value of One million dollars (\$1,000,000.) and consisting of bonds of the denominations of One hundred dollars (\$100 00), Five hundred dollars (\$500 00), One thousand dollars (\$1,000.00) and Fifty thousand dollars (\$50,000.00) respectively and to deposit with the Trust Company bonds of the said issue to an amount sufficient to create a sinking fund which will retire all of the said bonds at or before maturity by reason of provisions being inserted in the said Mortgage and Deed of Trust to provide that bonds of said issue shall at all times be available for purchase for the sinking fund on interest dates by drawings by lot. The interest on the said issue of bonds shall be fully secured by an assignment by the Purchaser to the Trust Company of a sufficient part of the rentals payable under a certain Indenture of Lease bearing date the Twelfth day of June, 1879, made between the Vendor, as Lessor, and The American Union Telegraph Company, as Lessee.

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3. The Purchaser further covenants, promises and agrees to and with the Vendor to enter into an agreement with the Trust Company to deliver to it additional bonds of the said issue of the par value of Fifty-two thousand five hundred dollars (\$52,500.00) to be invested and kept invested by the Trust Company in bonds of the Purchaser until such time as the said bonds may be required for the sinking fund in connection with the bond issue hereinbefore referred to and thereafter any monies not so invested shall by the terms of the said agreement with the Trust Company be expended in the redemption of Certificates of Interest (hereinafter referred to) at the then ascertained value thereof by drawings by lot or by purchases from the Company or in the open market. By the terms of this agreement the Trust Company shall be bound to issue Two thousand (2,000) "Certificates of Interest" in the said fund which will entitle the holders thereof to a pro rata division of the said fund on the date of the final maturity of the said issue of bonds.

4. As the consideration for the assets (subject to liabilities) hereby agreed to be sold by the Vendor to the Purchaser, the Purchaser shall deliver the entire issue of such bonds and the entire number of certificates of interest hereinbefore referred to pro rata to the individual shareholders of the Vendor, as its nominees, upon surrender to the Purchaser of stock certificates with power of attorney thereon duly endorsed representing the shares held by the shareholders in the Vendor. Such certificates, however, shall be only used by the Purchaser for surrender and cancellation to the Vendor in connection with the voluntary liquidation of the Vendor which shall be undertaken by the Purchaser. As the lowest denomination of the bonds to be issued by the Purchaser will be One hundred dollars (\$100 00) and the Vendor's shares are of the par value of Fifty dollars (\$50.00), the holders of only one share and the holders of shares which would call for a fractional interest in a bond shall be paid the sum of Fifty dollars (\$50.00) in money for such one share.

Clause 5 is a covenant for further assurance and Clause 6 provides that the agreement shall enure to the benefit of and be binding upon the successors and assigns of each of the parties thereto.

Pursuant to the last agreement dated 12th January, 1925, the appellant entered into a deed of trust and mortgage with the Royal Trust Company and an agreement

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with the Trust Company under which it carried out the provisions of paragraphs 2, 3 and 4 of this last mentioned agreement and out of the sum of \$116,640.00 which the appellant had received, the appellant purchased bonds of the par value of \$52,500.00 of the issue and delivered these to the Royal Trust Company to be held by it to retire the certificates of interest of the par value of \$100.00 each. The appellant in addition purchased bonds, having a par value of \$56,500.00, and deposited these with the Royal Trust Company as a sinking fund for the redemption of the entire bond issue. The certificates of interest and all the bonds, with the exception of these two blocks, were distributed among the shareholders of Dominion Telegraph by way of partial distribution of assets of Dominion Telegraph.

Dominion Telegraph Securities, Limited, reserved the sum of \$7,000.00 annually out of the annual payment of \$62,500.00 in order to maintain an office, keep the books and for other expenses.

The Dominion Telegraph Company was then liquidated, and its assets distributed among its shareholders.

The appellant filed returns for the years 1926 to 1929, both inclusive, and on July 28, 1931, the respondent made and delivered to the appellant, assessments for those years.

In each return for the years in question in this appeal, the appellant, in the profit and loss account, set out the rentals as income, and set out as an expense, the interest paid on the bonds. One of the witnesses for the appellant explained that this was done merely to show the complete transaction.

The respondent accepted the rentals as income and allowed the interest on the bonds outstanding, other than those held in the sinking fund, as an expense, but disallowed the interest on the bonds held in the sinking fund as an expense against income, and charged them back to income and assessed the appellant accordingly.

On the appeal the appellant contended that:

1. At the time of the settlement the telegraph system had been completely destroyed and that it did not exist and could not therefore be leased.

2. The payment of \$116,640.00 and the annual payment of \$62,500.00 were compensation for the loss of a capital asset viz; the telegraph system and were therefore capital in character and not income.

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3. The \$1,000,000.00 is capital because the settlement was not \$116,640.00 but that sum was only a basis which represented \$1,000,000.00 that is a sum calculated on a 4 per cent interest compounded annually basis to produce \$1,000,000.00 in 1978.

4. The sinking fund was not set up out of profits, nor was it to meet some certain contingency and differed materially from the ordinary sinking fund in which when the bonds are redeemed or paid off, the appellant would not get back its properties and the interest on the bonds in the sinking fund was a distribution of capital. Therefore section 6 (1) (d) does not apply.

6 (1). In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(d) amounts transferred or credited to a reserve, contingent account or sinking fund, except such an amount for bad debts as the Minister may allow and except as otherwise provided in this Act.

5. Without varying the written agreement, the true character of the original transaction can be ascertained and that this discloses that all the payments are capital in character.

The respondent contends that:

1. The interest on the bonds in the sinking fund gives rise to income by way of interest and, although received by the Trustee, is income of the appellant, held and reinvested by the Trustee to create sinking funds of the appellant to meet its capital obligations to its bondholders and holders of certificates of interest, and that such interest income is taxable in the appellant's hands, and, in the alternative, the interest received in respect of the bonds held in the sinking fund, is not an expense which the appellant is entitled to charge against income in determining taxable income under the Act.

2. The whole sum of \$55,000.00 could have been disallowed because it was not interest on borrowed capital used in the business which would be deductible under 5 (1) (b) nor was it a disbursement laid out to earn the income which would be deductible under 6 (1) (a).



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3. Under the agreement between the appellant and the Royal Trust Company the money was transferred to the Royal Trust Company for the purpose of creating a sinking fund and that this money was income and that 6 (1) (d) (ante) prohibited any deduction in respect thereto.

The appellant tendered the evidence of Mr. A. W. Hodgetts, who has been the Secretary-Treasurer of the appellant company since May, 1928, and the evidence of Mr. A. W. Holmsted, the solicitor for Dominion Telegraph Company, at the time of the negotiations with the Canadian National Railway. The evidence, in part, of both these witnesses consisted of statements made by the late Mr. Macrae as to conversations he had had with Mr. Ruel, General Counsel for the Canadian National Railways, during the negotiations.

I understood that counsel for the respondent consented to the evidence being admitted. After going over the transcript of the evidence I was unable to find any passage in which this was set out; and at the end of the evidence it appeared that Mr. Ruel was available as a witness. I was informed that counsel for the respondent had not agreed to the admission of the evidence and had objected to it. In view of the misunderstanding I requested counsel for both parties to appear and argue the admissibility of this evidence, and I gave to counsel for the appellant, the right to call evidence to establish the admissibility of this evidence or any further evidence so that the appellant would not be prejudiced by the misunderstanding.

Counsel for the appellant submitted that the evidence as to these conversations with the late Mr. Macrae was admissible as declarations made by a deceased person in the ordinary course of duty, or was admissible to show the circumstances which the parties had in mind at the time the settlement was made. In support of his contention, Mr. Hodgetts and Mr. Holmsted gave further evidence and I reserved the question of the admissibility of the evidence which they had given at the trial.

After considering the matter I reach the conclusion that the evidence of these witnesses as to their conversations with the late Mr. Macrae is not admissible. The evidence

did not establish that Mr. Macrae's statements were made in the ordinary course of duty. I reject those portions of the evidence of both of these witnesses, based on conversations with Mr. Macrae.

Counsel for the appellant tendered in evidence the Minute Book of Dominion Telegraph Company in respect of the minutes of a special general meeting of the shareholders held April 2, 1924. Counsel for the respondent stated that he had no objection to this and the minute in question was accepted in evidence.

Under the agreement between the telegraph companies and appellant the sum of \$116,640.00 is the consideration for a release of the covenants and a transfer of the telegraph system in 1978.

It also provides that the lease is to remain in full force and effect until 1978 and that the rental of \$62,500.00 is to be paid annually to the appellant.

In view of this express provision, it would require evidence of the clearest and most cogent character that these annual payments were not rentals but part of the compensation for the destruction of the system.

There is no evidence of that character before me.

The minutes of the meeting of April 2, 1924, do not support the contention of the appellant. Mr. Macrae reported the position of the directors to the meeting as:

The directors were not satisfied with our position under the lease of June 12, 1879. We had nothing behind our stock to maintain its value except the covenants in the lease and we did not know if the leasehold property was in good repair or could be kept in good repair, or what could be done with it when we got it back, or if we could want it back, or what damages we could get if it was not restored to us.

The President and Secretary then went to New York to ascertain the position of the system. They saw the officials of the Western Union; and the Secretary reported the information received to the meeting of the shareholders.

They told us our lines were being absorbed into their own system \* \* \* They said 99 years is a long time and they could not be expected to keep this Company's whole system just as they got it for such a long period. It would not be practicable for them to do so, nor would the law require it, the poles and wires were on the highways: all modern companies have private rights of way, therefore, the big Companies have gradually rebuilt the whole lines into their own

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systems on their own rights of way and they have become merged into those systems. *As they were gradually taking in the whole system in this way*, it would not be possible for them to restore it as an operating unit to the Dominion Telegraph Company at the end of the lease \* \* \*

While the system could not be restored at the end of the lease it could not be said that there was nothing left to lease.

The explanation of the sum of \$1,000,000.00 is given in Mr. Macrae's description of the negotiation:

Negotiations followed—they lasted about 18 months. We were first offered \$65,000.00 to be paid in cash now, as a sum which at 5 per cent would net us \$1,000,000.00 in 55 years. The sum of \$1,000,000.00 *was the goal* because it was the value of the property when the lease was made and was also the amount of our stock. We declined this offer of \$65,000.00 as we could not be sure of earning 5 per cent over the long period.

The offer from the Canadian National Railway was described to the meeting by the President as follows:

. . . and that the negotiations had been successful and an offer had recently been made by the Great North Western Company to pay the sum of \$115,660 00 for a release by this company of the covenants in the lease above mentioned. The amount was arrived at as a sum which would, invested at 4 per cent and interest compounded for the remainder of the term, produce the sum of not less than \$1,000,000.00 which would pay the shareholders the par value of their stock \$50.00 per share, and in the *meantime the rentals would continue to pay the dividends as heretofore*.

It is quite clear from all this that the minute of the meeting of April 2, 1924, sets forth the true agreement between the parties.

I find the annual payments of \$62,500.00 were rentals and not compensation and were income of the appellant.

I hold that the sum of \$1,000,000.00 was not capital in character merely because the sum of \$116,640.00 paid in 1925 *if* invested at 4 per cent, compounded annually, would produce this amount.

In any event the appellant did not invest the sum of \$116,640.00 in the method indicated at the meeting nor use the rentals as dividends. It issued bonds of a par value of \$1,000,000.00 and certificates of interest and distributed these among the shareholders and assigned the rentals to the trustee to pay the interest on the bonds.

The trustee used part of the rental income each year to pay the interest on the bonds in the hands of the

bondholders and used the remainder of the rental income (termed interest on bonds in the sinking fund) to acquire more bonds for the sinking fund.

The interest on the bonds in the sinking fund is not an expense which the appellant was entitled to charge against income in determining taxable income under the Act.

I find that these items were properly disallowed as expense chargeable against income.

The appeal is dismissed with costs.

*Judgment accordingly.*

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