BETWEEN:

1959 Sept. 22, 23, 24

1960 Apr. 25

ESPIE PRINTING COMPANY LIMITED .... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Revenue—Income—Income tax—Unreported income—Unclaimed expenses—Alleged illegality in payment of wages no bar to their deductibility for the purpose of ascertaining net profit or gain—The Income War Tax Act, R.S.C. 1927, c. 97, ss. 3 and 6(1)(a).

The appellant company failed to report the whole of its income for the years 1944 to 1953 inclusive and the Minister, following an investigation, added substantial amounts to its reported income and assessed accordingly. On an appeal from the assessments on the grounds that the amounts added were in excess of the unreported receipts, and that the amounts expended to earn income, for which no claim had been made, should have been deducted, the Minister submitted that no expenses in excess of those claimed had been made, and if they had, they were not deductible since they were made in carrying out illegal transactions.

Held: That on the evidence the appellant had established that some of the amounts added were not income of the appellant and that since on the material before the Court it was impossible to estimate how much, the matter should be referred to the Minister for reconsideration and reassessment.

2. That the Court was satisfied that certain cheques put in evidence, as well as additional debits, were in fact incurred for overtime wages, salesmen's commissions and other items, and were not claimed in the appellant's income tax returns as deductions.

1960

ESPIE PRINTING CO. LTD. *v.* MINISTER OF NATIONAL REVENUE

3. That the alleged illegality in connection with the payment of overtime wages did not affect their deductibility for the purpose of ascertaining net profit or gain within the meaning of the *Income War Tax Act*.

APPEAL under the *Income War Tax Act*.

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

J. G. McDonald and *D. A. Ward* for appellant.

W. G. Cassels and *J. D. C. Boland* for respondent.

THURLOW J. now (April 25, 1960) delivered the following judgment:

These are appeals from reassessments made on August 7, 1957, of income tax for the years 1944 to 1953 inclusive, in respect of the appellant's income. For each of the years in question, the appellant failed to report the whole of its income and, after an investigation, the Minister added substantial amounts to the income as reported and reassessed tax accordingly. It is admitted by the Minister that the amount so added was in each case an amount which the Minister assumed represented the unreported gross receipts for the year. The appellant now questions the amount so added for each of the years 1944 to 1948 inclusive as being in excess of the unreported receipts and further claims that for all ten years it is entitled to reduce the income so assessed by the amount of expenses incurred for which deductions have not been claimed in its income tax returns. The Minister denies that any expenses in excess of those claimed were in fact incurred and further disputes the right of the appellant to deduct any such expenses as may have been incurred on the ground that the evidence shows them to have been incurred in carrying out illegal transactions.

The appellant was incorporated prior to 1944 and throughout the years in question carried on a job printing business in Toronto. Omitting two shares held by a solicitor who does not appear to have had any beneficial interest in the company, from the time of incorporation until February 28, 1948, one-half of the issued shares of the appellant were held by Robert J. Espie and the other half by John J. Lynch. Mr. Espie was the President of the company and was engaged chiefly in its selling activities. Mr. Lynch was

1960
ESPIE PRINTING CO. LTD.
v.
MINISTER OF NATIONAL REVENUE
Thurlow J.

Treasurer of the company and Superintendent of its office and plant. On the date mentioned, Mr. Espie sold his interest in the company to Mr. Lynch, who thereupon became President and thereafter was for practical purposes its sole owner.

Throughout the years 1944 to 1953, there was a current account in the name of the appellant at a branch of the Royal Bank of Canada in Toronto in which moneys of the company were deposited and from which disbursements were drawn. Robert J. Espie had a personal savings account numbered 544 at the Guaranty Trust Company of Canada and John J. Lynch had a savings account numbered 429 in his name at a branch of the Canadian Bank of Commerce. From sometime prior to January 1, 1944 until March 9, 1948, there was also a joint savings account numbered 1415 at the same branch of the Canadian Bank of Commerce in the names of Robert J. Espie and John J. Lynch. Withdrawals from this account required the signatures of both Mr. Espie and Mr. Lynch.

It is conceded that substantial amounts which were payable to the appellant and formed part of its revenue receipts were not deposited in its account at the Royal Bank of Canada and were not included in the revenues reported in its income tax returns but were in fact deposited in either savings account 1415 or 429 in the Canadian Bank of Commerce and that these moneys or portions of them were subsequently divided equally between Mr. Espie and Mr. Lynch. Some of the amounts representing Mr. Espie's share of such moneys were then deposited in his account number 544 at the Guaranty Trust Company of Canada. Both Mr. Espie and Mr. Lynch were associated with E. R. Buscombe in another company known as Buscombe and Dodds Limited, in which income was also being suppressed and divided among the three, and some of this money, as well, found its way into Mr. Espie's personal account. In 1954 an investigation of the appellant's income took place, in the course of which efforts were made to trace the source of the moneys deposited in account number 544 and ultimately a list of amounts deposited in it, the source of which could not be identified, was prepared. The list so prepared was submitted to an agent of Mr. Espie, who was

no longer associated with the appellant, but no explanation of the source of the unidentified moneys was given, and in making the reassessments the Minister included the whole of such unidentified deposits in the income in respect of which the appellant was reassessed. The issue as to the amount representing gross receipts added by the Minister in making the assessments is limited to whether or not the unidentified deposits in this account were correctly added.

This issue is one of fact. The Minister has assumed that these unidentified deposits were part of the income of the appellant, and the onus is on the appellant to show that this assumption was not correct. *Vide Johnson v. Minister of National Revenue*[1] and *Dezura v. Minister of National Revenue*[2].

From the beginning of 1944 to the end of February, 1948, there had been 82 credits to account 544, of which eight were credits for interest on the account and the other 74 were deposits the total amount of which was $45,800.57. Of these, some 60 deposits, ranging from $14.31 to $2,409.49, were listed on Exhibit 7 as unidentified to the total extent of $28,406.69.

Evidence as to this savings account was given by Mr. Espie, who at the time of the trial of the appeal was in his 78th year. He had held for many years a high office in a fraternal order, and he and Mr. Lynch and the appellant, as well, had been convicted and fined for offences pertaining to the failure of the appellant to properly report its income. There was no evidence that he had any financial interest in the outcome of these proceedings. He appeared to me to be willing to tell the whole truth and anxious to tell nothing but the truth, but, as might be expected, he could not recall all of the details of deposits made in his personal account more than ten years earlier. He stated, however, that no payments from customers of the appellant had been deposited in account number 544. When asked the source of the deposits listed as unexplained, he referred to a number of sources from which they might have come, including savings from his salary—which had been $2,600 per year or thereabouts—repayment of expenses incurred in

[1] [1948] S.C.R. 486. [2] [1948] Ex. C.R. 10.

1960
ESPIE PRINTING CO. LTD.
v.
MINISTER OF NATIONAL REVENUE
Thurlow J.

travelling for the fraternal order, dividends and other payments from Buscombe and Dodds, rental from property, and repayments of loans.

I regard as credible Mr. Espie's evidence that he received moneys from such sources and have no difficulty in reaching the conclusion that moneys from such sources did account for some, and perhaps a substantial part, of the moneys so deposited, but I am not satisfied that any one or all of these sources combined is likely to account for deposits totalling in the vicinity of $28,000 over the period of four years and two months in question. There is, however, evidence that, over the four-year period, cheques drawn on accounts 1415 and 429 and totalling in the vicinity of $27,750 were received by Mr. Espie, some of which, amounting to about $10,000, were traced to account 544 and were thus identified, and others of which bear the endorsement of the Guaranty Trust Company, indicating that they or some of their proceeds may have been deposited there, and on the whole it seems to me not unlikely that a considerable portion of the unidentified deposits may be accounted for by such cheques. After a lengthy examination of the exhibits and consideration of Mr. Espie's evidence, I am, however, unable to conclude that these cheques, together with moneys from the other sources mentioned, would account for the frequent and substantial deposits to account 544 and, having regard to the admitted fact that Mr. Espie was a party to practices in which income of the appellant was being diverted to accounts other than its own and divided between himself and Mr. Lynch and, despite an inclination derived from the impression he made on the witness stand to regard his evidence as generally reliable, I find myself unsatisfied and unpersuaded that none of the money represented by the unidentified deposits belonged to the appellant. There is thus no satisfactory basis either for a sweeping conclusion that the whole of the money was suppressed income of the appellant or for an equally sweeping conclusion that none of it represented income of the appellant. The position, as I find it, accordingly is that the appellant has met the onus by showing that some of the moneys which the Minister included were not properly added but that, on the material before the Court, it is not possible to ascertain or to

estimate, otherwise than arbitrarily, how much of the sum so added was income of the appellant and how much came from other sources.

In this situation, I am of the opinion that the best course is not to accept or reject the claim of either side *in toto* nor to attempt to divide the amount arbitrarily but to refer the matter back to the Minister to reconsider the several items making up the unidentified deposits in the light of this opinion and to reassess accordingly.

The next issue is that respecting expenses which were not claimed as deductions in the appellant's returns. It is claimed that such expenses were in fact incurred for overtime wages, for paper purchased in black market transactions and used in the appellant's business, and for salesmen's commissions and other items. The evidence satisfies me and I accordingly find that between July 14, 1944 and November 14, 1947 the amounts represented by the cheques which were put in evidence and which are listed in Schedule A to these reasons were in fact paid for overtime wages of persons employed in the appellant's business and were not claimed as deductions in the appellant's returns. Moreover, from January 7, 1944 account 1415 shows additional debits at weekly intervals of amounts most of which are under $100 and for which no cheques were offered in evidence. Having regard, however, to Mrs. Bates' evidence, these, as well as the cheques listed in Schedule A, appear to me to have been withdrawals for paying overtime wages. I am also satisfied and find that the amounts represented by the cheques listed in Schedule B were paid for salesmen's commissions and other expenses of the business and were not claimed as deductions in the appellant's returns.

In addition, evidence was given by Mr. Lynch that he paid in cash employees who were unwilling to punch the time clock and that he paid salesmen's commissions and purchased paper from time to time for which he paid cash. No record was kept of any such payments, nor was evidence given of their amount, but it was argued that the Court should estimate the amount allowable as deductions in computing income on the basis of information as to the average relationship between profit and gross revenue of businesses of this kind.

1960
ESPIE PRINTING CO. LTD. v. MINISTER OF NATIONAL REVENUE
Thurlow J.

Evidence was given that the appellant's profit, as assessed, compared with the average as follows:

Year	*Appellant*	*Average for the Industry*
1944	41.00 %	9.82 % of gross revenue
1945	35.90	8.89
1946	30.90	10.53
1947	28.40	9.58
1948	20.70	8.19
1949	19.30	3.80
1950	24.80	4.98
1951	22.50	9.37
1952	15.28	6.05
1953	14.47	4.37

It was brought out in cross-examination, however, and indeed it is obvious, that the ratio of profit to gross revenue could vary considerably for a variety of reasons, such as whether the plant was new or old, the amount of expenses incurred for executive salaries, and for pension and fringe benefits to employees, the efficiency of the management, and the volume of work done, and it appears as well that the companies from which information was obtained and used in computing the average for the industry included some whose businesses were not of the same type as that of the appellant's business. A considerable discount must, accordingly, first be applied in comparing the average with the results of the appellant's operation. Secondly, it is apparent that, if the Minister has included too much gross revenue, as I have found, with respect to the years 1944 to 1948, the appellant's profit ratio for such years will be somewhat less. Next, it appears that the appellant's total expenses for items other than wages and materials were generally lower than the average and this, as well, appears to account for a portion of the difference between the ratio of the appellant's profit to its revenue and that of the industry. The fact that these other expenses were low compared with the average suggests the probability that the long experience of both Mr. Espie and Mr. Lynch in the printing business enabled them to run the appellant's business generally at lower than

average costs. Moreover, the study shows the appellant's reported expenses for materials to have been higher than the average in 1945, 1946 and 1949, and its expenditures for wages to have been higher than the average in 1949, 1950, 1951 and 1952. I am, accordingly, of the opinion that no firm conclusion can be drawn from the information presented either that additional expenses for paper and wages were in fact incurred or, if they were incurred, how much they amounted to, or in what years they were incurred and, while I do not discount entirely the evidence of Mr. Lynch that he paid additional expenses in cash, his evidence falls short of satisfying me that any such additional expenses were incurred in all the years in question and leaves me with no means of determining either the years in which such additional expenses were incurred or the amounts incurred. On the whole, I doubt that any substantial additional amount was paid in any year for wages or for salesmen's commissions, but I think it not unlikely that a considerable amount may, on occasion, have been paid for additional paper. I doubt, however, that even this occurred on many occasions or with any regularity or that it occurred in each year, and in the absence of evidence as to when it occurred or how much was expended, or even of how much paper was so purchased, I see no reasonable basis on which it may properly be estimated. With respect to such additional expenses, the appeals accordingly fail.

There remains the question whether the sums which I have found were paid for overtime wages are deductible in computing income, in view of the fact that they, or some of them, were incurred in circumstances suggesting that there was something illegal about them. Just what the illegality was was not clearly brought out. In the earlier years, there were war-time regulations which probably were infringed and, for the years 1944 to 1948, there is evidence on which one may conclude that, in the case of some, if not all, of the employees in question, there was an illicit arrangement between the appellant and the employee to enable the employee to avoid payment of income tax. In these circumstances, the Minister submits that the taxpayer's expenses

1960
ESPIE PRINTING CO. LTD.
v.
MINISTER OF NATIONAL REVENUE
Thurlow J.

for wages paid were illegally incurred and that it would be contrary to public policy to permit the appellant to deduct them in computing its income for income tax purposes.

I do not think it can seriously be questioned that the profits of illicit businesses were subject to tax under the *Income War Tax Act*. In *Minister of Finance v. Smith*[1], the Privy Council held that profits of a business carried on in violation of a provincial statute were taxable and, while some of the reasons for the judgment in that case applied only to cases involving the violation of provincial statutes, others were not so limited. Lord Haldane said at p. 197:

> Nor does it seem to their Lordships a natural construction of the Act to read it as permitting persons who come within its terms to defeat taxation by setting up their own wrong. There is nothing in the Act which points to any intention to curtail the statutory definition of income, and it does not appear appropriate under the circumstances to impart any assumed moral or ethical standard as controlling in a case such as this the literal interpretation of the language employed. There being power in the Dominion Parliament to levy the tax if they thought fit, their Lordships are therefore of opinion that it has levied income tax without reference to the question of Provincial wrongdoing.

The present problems is, however, not quite the same, since the appellant's business itself is not shown to have been an illegal one, and the taxpayer shows the illegality of what it has done not in the course of claiming that the statute does not apply but in the course of asserting a claim for a deduction in computing the income therefrom which is subject to the tax. If what the appellant did illegally were to have effect by way of reducing an amount of tax which was otherwise imposed by the statute, I should think that the principle asserted by the Minister might well apply to bar the taxpayer's claim. But I do not think that is the situation. In *Minister of Finance v. Smith,* Lord Haldane went on to say at p. 197:

> There are certain expressions at the end of the judgment of Scrutton L.J. in *Inland Revenue Commissioners v. Von Glehn* as to the scope of the British Income Tax Acts. Their Lordships have no reason to differ from the conclusion reached in that case, but they must not be taken to assent to any suggestion sought to be based on the words used by the learned Lord Justice, that Income Tax Acts are necessarily restricted in their application to lawful businesses only. So far as Parliaments with sovereign powers are concerned, they need not be so. *The question is never more than one of the words used.*

[1] [1927] A.C. 193; 95 L.J.P.C. 193.

In *Inland Revenue Commissioners v. Von Glehn*[1], the Court of Appeal had held that a statutory penalty incurred in the course of carrying on a business which was not of itself illegal was not deductible. It is noteworthy, however, that the grounds of the decision were not that the penalty was incurred for doing something illegal in the course of the business but that the penalty was not a commercial loss and thus not "a loss . . . connected with or arising out of such trade" within the meaning of an exception to a general statutory prohibition against deduction of losses and that the penalty was not "money wholly and exclusively laid out or expended for the purposes of such trade" within the meaning of an exception to a general prohibition against the deduction of expenses.

The provisions of the *Income War Tax Act,* which was applicable to the years 1944 to 1948, were quite different. Income for the purposes of that Act was defined by s. 3 as:

> the annual net profit or gain, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being . . . profits from a trade or commercial or financial or other business directly or indirectly received by a person . . . from any trade, manufacture or business . . . .

The expression "net profit or gain", in my opinion, connoted not gross receipts from a business but gross receipts less the expenses incurred to obtain such receipts. *Vide Imperial Oil Limited v. Minister of National Revenue*[2] and *Daley v. Minister of National Revenue*[3]. In the latter case, the President of this Court said at p. 521:

> The correct view, in my opinion, is that the deductibility of the disbursements and expenses that may properly be deducted "in computing the amount of the profits or gains to be assessed" is inherent in the concept of "annual net profit or gain" in the definition of taxable income contained in section 3.

The ordinary connotation of "net profit or gain" was, however, to be taken subject to s. 6, by which it was provided that

> In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*a*) disbursements or expenses not wholly, exclusively, and necessarily laid out or expended for the purpose of earning the income.

[1] [1920] 2 K.B. 553; 12 T.C. 232; 90 L.J.K.B. 590.
[2] [1947] Ex. C.R. 527.
[3] [1950] Ex. C.R. 516.

1960
ESPIE PRINTING CO. LTD. v. MINISTER OF NATIONAL REVENUE
Thurlow J.

Among the commonest of the expenses which are ordinarily deductible for the purpose of ascertaining net profit or gain from a business and which are not prohibited by s. 6(*a*) are the wages of employees engaged in carrying on the business and, apart from the point raised as to the illegality in the present case of the arrangements with the employees and of the payments to them, there could be no question but that these wages would be proper deductions for the purpose of ascertaining the profit or gain from the business in the ordinary sense and that their deduction was not prohibited by s. 6(*a*). The prohibition of s. 6(*a*), however, did not turn on the legality or otherwise of the payment in question but simply on the question of whether or not the expense was wholly, exclusively, and necessarily laid out or expended for the purpose of earning the income. For my part, I do not see how the illegality of the arrangements with the employees or of the payments has any bearing on the question whether these wages were wholly, exclusively, and necessarily laid out or expended for the purpose of earning the income. Whether the expense was or was not so incurred seems to me to be a question on which the illegality or otherwise of the payments or of the arrangements under which they were made leads to no conclusion one way or the other, and since, apart from this, the deduction of such wages was not prohibited by s. 6(*a*), it seems to me that the judgment in *Inland Revenue Commissioners v. Von Glehn* (*supra*), where general statutory prohibitions were applicable, has no bearing and that, for the present purpose, there is nothing in the language of the applicable statute to impose tax on anything beyond what would, in its ordinary acceptance, be contemplated in the expression "net profit or gain". This expression, as I have already said, in my opinion connotes not gross receipts but what is left after the expenses incurred to secure such receipts have been deducted and the question being, to use the words of Lord Haldane, *never more than one of the words used* in the statute, I do not see how the net profit or gain can be properly computed without deducting such expenses whether they or some of them bear the taint of illegality or not. I am accordingly of the opinion that the wages in question are deductible in computing the appellant's income for

the years 1944 to 1948 inclusive. There was no illegality suggested in connection with the commissions and other items mentioned in Schedule B, and in my opinion they are deductible as well.

The appeals, excepting those from the reassessments for 1949 and 1953, will be allowed with costs and the reassessments referred back to the Minister to be reconsidered and revised in accordance with these reasons. As the appellant obtains no relief from the reassessments for 1949 and 1953, the appeals against these reassessments will be dismissed with costs.

Judgment accordingly.