BETWEEN: 1955 Mar. 24 — 1956 Mar. 5

CANADA SAFEWAY LIMITED ....APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... } RESPONDENT.

Revenue—Income tax—Deductions—"Interest on borrowed capital used in the business to earn income"—Onus on taxpayer to prove income earned taxable or, if both taxable and non-taxable income earned apportionment of borrowed capital used to earn each—Income War Tax Act, R.S.C. 1927, c. 97, as amended, ss. 5(1)(b), 6(5)—Income Tax Act, S. of C. 1948, c. 52, ss. 11(1)(c), 12(1)(c).

The appellant and M company were incorporated in Canada as wholly-owned subsidiaries of a United States Corporation. The appellant to carry on a retail chain grocery business and M company a wholesale grocery and warehousing business to supply the requirements of the appellant. In 1947 the appellant issued debentures in the sum of three million dollars and preferred stock in the sum of two million and turned the entire proceeds so raised over to the parent company receiving from it all the outstanding stock of M company. No change was made in the operations of the two subsidiaries but thereafter the net profits of M company were paid to the appellant. In filing its income tax returns for the years 1947, 1948 and 1949 the appellant claimed as a deduction the interest paid by it on the debenture issue in each of these years as deductions authorized by the *Income War Tax Act* and the *Income Tax Act* as money paid on borrowed capital to earn income. The deductions were disallowed by the Minister and appeals from his decisions to the Income Tax Appeal Board were dismissed.

Held: That as the parent company was the sole owner of the appellant's capital stock there was no reason to believe that it would to its own detriment dispose of M company to outsiders and no evidence was adduced to establish such action was contemplated nor that the purchase by the appellant was the reason for the expansion of the latter's business.

2. That following the purchase the net profits of M company became the property of the appellant and the latter in claiming exemption from its taxable income had to establish that every condition required by the exempting section had been complied with. *Lumbers* v. *Minister of National Revenue* [1943] Ex. C.R. 202; *Robert Addie & Sons' Collieries* v. *Commissioner of Inland Revenue* [1924] S.C. 231.

3. That on the evidence no portion of the borrowed monies was applied to the appellant's business and therefore the interest paid on the debentures was not paid on borrowed capital actually used by it in its business to earn taxable income as defined by s. 5(1)(*b*) of the *Income War Tax Act*. *Strong* v. *Woodifield* [1906] A.C. 448.

4. That as to the contention that the expenses were incurred to earn both taxable and non-taxable income and that the Minister, under s. 6(5) of the *Income War Tax Act* and s. 12(1)(*c*) of the *Income Tax Act*,

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had power to apportion the expenses, the onus resting on the appellant to prove the necessary facts was not met. *Dezura* v. *Minister of National Revenue* [1948] Ex. C.R. 10; *Johnston* v. *Minister of National Revenue* [1948] S.C.R. 486; [1947] Ex. C.R. 483.

APPEALS from decisions of the Income Tax Appeal Board.

The appeals were heard before the Honourable Mr. Justice Fournier at Vancouver.

J. A. MacAulay, Q.C. and *D. C. McGavin* for appellant.

S. A. Gregory and *J. D. C. Boland* for respondent.

FOURNIER J. now (March 5, 1956) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board, dated April 4, 1953, dismissing the appellant's appeal from the income tax assessments levied against it for the taxation years 1947, 1948 and 1949, whereby it was sought to hold it liable to tax on the interest of debentures issued in 1947, for application towards the purchase price of the outstanding capital stock of MacDonald's Consolidated Ltd., and for other purposes.

It was agreed by the parties and ordered by the Court that the evidence and the argument in one cause would apply to the three appeals.

The appellant company and MacDonald's Consolidated Ltd., in 1947, before the transactions hereinafter dealt with took place, were wholly owned subsidiaries of Safeway Stores, Incorporated, a United States corporation. The appellant carried on a retail chain grocery business in the provinces of British Columbia, Alberta, Saskatchewan and Ontario, and MacDonald's Consolidated Ltd. had been set up to buy and distribute groceries, produce and similar commodities and make warehousing facilities available to Safeway Stores Ltd.

During the period from 1938 through 1945, the parent company had substantially increased its investment in Canada in Safeway Stores Ltd. and MacDonald's Consolidated Ltd. by permitting these companies to retain their earnings and by investing new monies. At the close of the year 1945, its investment in these subsidiaries was several million dollars out of balance with similar operations in the

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United States. What took place, from 1945 to 1947, is not clearly established, but the evidence is to the effect that Safeway Stores Ltd. in 1947 became Canada Safeway Ltd., the appellant in these appeals. Under this new corporate name it issued debentures for the sum of three million dollars and preferred stock for two million dollars, for which it received five million dollars. Out of the proceeds of these issues of debentures and preferred stock, three and a half million dollars was paid over to the parent company as purchase price of the outstanding capital stock of MacDonald's Consolidated Ltd. The balance of a million and a half was set up in the books as due to Safeway Stores Inc. This last amount was later transferred to the United States.

Through these transactions, MacDonald's Consolidated Ltd. became a wholly owned subsidiary of the appellant and the appellant remained a wholly owned subsidiary of the parent company, Safeway Stores Inc. From there on it appears that the appellant and its subsidiary continued to operate on the same basis as formerly. The subsidiary continued to be the appellant's warehousing and procurement agent, except that it reported the result of its operations to the appellant, instead of reporting to Safeway Stores Inc. It would make wholesale bulk purchases of groceries, fruits and vegetables which it sold to the appellant at cost price, plus overhead expenses and a small profit, and it sold to other retailers at a higher price. As to warehousing facilities, the appellant paid for the space needed to store the goods purchased until delivery was requested. The independent retailers availed themselves of the same facilities on the same conditions. These conditions prevailed after MacDonald's became a subsidiary of the appellant, except that as the appellant expanded its business it required more warehousing space and purchased more goods. Consequently, the subsidiary had fewer warehousing facilities and goods to offer to outsiders. The evidence, written and oral, in my view does not show that this expansion of the appellant's business was due to its purchase of MacDonald's Consolidated Ltd.

In its income tax returns for 1947, 1948 and 1949, the appellant claimed as a deduction from its income the sums of $44,876.72, $97,500 and $97,500 respectively, as being

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interest at $3\frac{1}{4}$ per cent per annum paid on its debentures. These deductions were not allowed by the Minister of National Revenue, who added the amounts to the taxable income of the appellant and assessed them accordingly. The appellant appealed to the Income Tax Appeal Board from these assessments and the Minister's decisions. The Income Tax Appeal Board, after hearing, dismissed the appeals. From this decision, the appellant now appeals to this Court.

The appellant bases its right to deduct the debenture interest from its income for the years 1947 and 1948 upon s. 5(1)(*b*) and upon the last sentence of s. 6(5) of the *Income War Tax Act,* c. 97, R.S.C. 1927, and its amendments. These sections provide as follows:

> 5. (1) "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—
>
> (*b*) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable.

and

> 6. (5) Expenses incurred by a corporation to earn non-taxable income shall not be allowed as a deduction in computing the income to be assessed. *Where general expenses are incurred to earn both taxable and non-taxable income the Minister shall have power to apportion the said expenses.*

In confirming these assessments, the Minister did not dispute the rate of interest paid as stipulated in the debentures; he contended that monies obtained through the issuance of debentures were borrowed capital when used to earn income, but that the proceeds of the sale of the debentures, in the present cases, were not borrowed capital within the meaning of s. 5(1)(*b*) because they were not used in the appellant's business to earn taxable income. Consequently, the interest paid on the debentures was not a disbursement or expense wholly, exclusively and necessarily laid out or expended for the purpose of earning taxable income, but was an expense incurred to earn non-taxable income. According to the provisions of s. 6(1)(*a*) of the Act such disbursements or expenses are not deductible in computing the amount of the profits or gains to be assessed.

The appellant submitted that, had the parent company sold the shares of MacDonald's Consolidated Ltd. to a third party, it would have been deprived of its warehousing facilities, and it would have lost the benefit of having a procuring agency. It had been led to believe that the above eventuality could happen, because some years previous the parent company had disposed of similar facilities in the Province of Ontario with the result that the appellant's business operations had been adversely affected. By purchasing the capital stock of MacDonald's Consolidated it obtained or retained the warehousing facilities and the right to have MacDonald's procure for it at a very low cost. Being the owner of the above facilities and benefits, the appellant submits that it earned additional income in the years in question. So the prime object of the purchase was to make additional profits, or in other words "additional taxable income." The purchase price, in part, came from the proceeds of the sale of debentures, so the interest paid on the debentures was interest paid on borrowed money used to earn income and was deductible in computing its income.

I think I should first consider the appellant's contention that it was justified in believing that it would lose its warehousing facilities and purchasing benefits. The parent company was the owner of all the capital stock of both subsidiaries. As a matter of fact, it could have disposed of the stock of MacDonald's to outsiders, but in my view it is inconceivable that it would have made such a deal, because it would have been detrimental to its own interest. It had sold certain assets of MacDonald's previously and the result had injured the appellant's operations. Would it have continued to divest itself of assets that were productive of income, if other means were at its disposal to correct a situation that did not appeal to it in the carrying on of its business or financial activities? I cannot bring myself to believe that it would have taken the step feared by the appellant. At all events, no competent witness was heard at the trial to establish, as a fact, that the parent company had contemplated or decided on making such a transaction.

I agree with the appellant's contention that by purchasing the capital stock of MacDonald's it retained its warehousing and purchasing facilities, but I do not believe it had to do so, because the parent company did not dispose

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of its interest in MacDonald's to outsiders. If it had sold out to third parties, it would have lost control of its subsidiary, which was a useful complement to its other subsidiary, the appellant. Being the sole owner of the appellant's capital stock, it would have had to replace the facilities disposed of. There was, to my mind, no real, logical or good reason to disturb the organisation of its subsidiaries, except one, with which I will deal later. What took place, as will appear, is good evidence that the parent company, had it sold MacDonald's to outsiders, would have received the price of the stock, but would have lost control of an important subsidiary. If it sold to the appellant, it received the cash and kept control. If this is logical and in accordance with the facts, the appellant was not justified in its fear that it would be deprived of its facilities.

Now, the question to be determined is whether the proceeds of the sale of the debentures issued were borrowed monies used to earn taxable income or used to meet expenses incurred in earning non-taxable income as provided for by section 4(*n*) of the Act, which reads as follows:

> 4. The following incomes shall not be liable to taxation hereunder:
>
> (*n*) Dividends paid to an incorporated company by a company incorporated in Canada the profits of which have been taxed under this Act or to which paragraph (*w*) of this section applies, except as hereinafter provided by sections nineteen, twenty-two A and thirty-two A;

As the reasons for judgment herein given will apply to the three taxation years in question, I wish to state that ss. 11(1)(*c*) and 12(1)(*c*) of the *Income Tax Act,* Statutes of Canada 1948, c. 52, are applicable to the taxation year 1949. The only difference between 11(1)(*c*) and 5(1)(*b*) is in the wording. Section 11(1)(*c*) adds the following words: "other than property the income from which would be exempt." It is generally admitted that both sections have the same meaning, and there is no doubt that ss. 12(1)(*c*) and 6(5) are to the same effect.

The appellant raised capital by borrowing money on the issue of debentures bearing interest at the rate of $3\frac{1}{4}$ per cent per annum. The total proceeds of this loan and of the sale of preferred stock were paid over to the parent company. In return for this outlay, the appellant became the owner of the outstanding stock of MacDonald Consolidated Ltd. So it may reasonably be assumed that all the capital raised by the loan went into the purchase of the stock of another company. This company continued to operate as formerly and made or did not make profits. If it made gains or profits, they were taxable income. After payment of income taxes, the residue of the gains or profits became the property of the appellant and part of its own income, but not taxable income and not liable to tax in its hands.

It was argued at length that from the standpoint of earning power of the appellant, MacDonald's was a very important factor. In fact, if the appellant were to maintain or increase its earnings, it was an essential factor because MacDonald's acted as its procurement and warehousing agents. I cannot agree with this argument, if I take into consideration all the circumstances. MacDonald's was its purchasing and warehousing agent before the acquisition of its outstanding capital stock and there is no evidence to indicate that it was to be sold to a third party or that its purchase by the appellant was the reason for the expansion of its business.

There is no doubt in my mind that the borrowed capital was used to purchase the stock of another company. Can it be said that it was used in the appellant's business to earn income, is the question to be answered. The appellant claims a deduction from what is its taxable income. To do so, it invokes an exempting provision of the Act. It is a well established principle that "taxation is the rule and exemption the exception" and that the exempting provisions must be construed strictly.

In the case of *Lumbers* v. *Minister of National Revenue* (1), Honourable J. T. Thorson, President of this Court, expressed the rule with reference to the exempting provisions of the *Income War Tax Act* as follows:

> . . . in respect of what would otherwise be taxable income in his hands a taxpayer cannot succeed in claiming an exemption from income tax unless his claim comes clearly within the provisions of some exempting section of the *Income War Tax Act:* he must show that every constituent element necessary to the exemption is present in his case and that every condition required by the exempting section has been complied with.

I believe that the correct interpretation to be given to s. 5(1)(*b*) of the *Income War Tax Act* and s. 11(1)(*c*) of the *Income Tax Act* is that the borrowed capital must be

(1) [1943] Ex. C.R. 202.

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used in the business. Following the above rule this should be construed literally and would bar extending the meaning of the sections to include disbursements or expenses not wholly, *exclusively* and *necessarily* laid out or expended for the purpose of earning the income. I italicized the words "exclusively" and "necessarily" because I think they are essential elements to the deduction of interest on borrowed capital. The appellant carries on a retail chain grocery business. Borrowed capital used to buy a wholesale and warehousing business, to my mind, is not a disbursement or expense wholly, exclusively and necessarily laid out or expended for the purpose of earning the income of a retail chain grocery business.

I explained why I did not think that the appellant was compelled to purchase MacDonald's or that it had to borrow capital to retain its facilities. The proceeds of its borrowings and of the sale of its preferred stock all went to the parent company. The relationship between this company and the appellant could hardly indicate that it would seriously injure the appellant's business and by the same token lose income on its own investment by disposing of its interests in MacDonald's to third parties.

Be that as it may, I will refer to the case of *Robert Addie & Sons' Collieries* v. *Commissioners of Inland Revenue* (1), where the Lord President stated at page 235:

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

What was the true nature of the expenditure in this instance? It appears that the appellant borrowed capital on which it obligated itself to pay interest, turned over all the proceeds to its parent company, and in return became vested with the ownership of MacDonald's, a subsidiary of the parent company. No portion of the borrowed capital was retained by the appellant to invest in the expansion of its own business. By this transaction, the parent company kept control of the appellant company, which in turn gained control of the wholesale and warehousing firm. I have tried

(1) [1924] S.C. 231.

to convince myself, but without success, that this expenditure was necessary to the earning of the appellant's income or that part of the borrowed capital became a portion of its working expenses. In the final result nothing was changed in the operations of the business of the appellant or MacDonald's.

Lord Davey, in *Strong & Co. Ltd.* v. *Woodifield* (1), stated that:

> 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.

This principle was later approved and followed in *Tata* v. *Income Tax Commissioner* (2). Lord MacMillan, in delivering the judgment, stated:

> Adopting this test, their Lordships are of opinion that the deduction claimed by the appellants is inadmissible as not being expenditure incurred solely for the purpose of earning the profits or gains of the business carried on by the appellants.

The evidence being to the effect that no portion of the borrowed money was applied to the appellant's business, I am of the opinion that the interest paid on the debentures was not on borrowed capital which was actually used in the business and that it is not the creation of the obligation but the amount the appellant put into its business to earn income which justifies, in computing its profits or gains, the deduction of interest paid on borrowed capital.

I also find that the word "income" in s. 5(1)(*b*) means taxable income as defined by s. 3 of the Act. This taxable income, if it clearly falls within the ambit of some provision of the Act, allowing an exemption or deduction, may become non-taxable. The exemption claimed by the appellant is based on the deduction allowed by s. 5(1)(*b*) and the last sentence of s. 6(5). If the amount or part thereof, claimed as a deduction, does not meet with every condition required by these sections, no deduction can be allowed. This would be the case in the present appeal where the borrowed money was used to earn non-taxable income.

(1) [1906] A.C. 448. (2) [1937] A.C. 685.

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In the case of *Baymond Corporation Ltd.* v. *Minister of National Revenue* (1), at page 16 the President of this Court expressed the view that:

> The expression "used in the business to earn the income" contained in section 5(*b*) of the *Income War Tax Act* shows in clear and explicit terms that the right of a taxpayer to deduct from what would otherwise be his taxable income interest on borrowed capital is not to be measured by the extent of his obligations in respect thereof but is restricted to only such borrowed capital as has actually been used in his business to earn the income. It is not the obligation incurred through the borrowing but the asset in the form of money or other property received from it and actually put into the business to earn the income that is the measure of the taxpayer's right, . . .

To succeed in its last contention that the expenses were incurred to earn both taxable and non-taxable income and the Minister had the power to apportion the said expenses, the appellant had to establish what part or portion of the proceeds of the sale of debentures had been used to earn taxable income and what portion served to earn non-taxable income. The onus of proving the facts necessary to entitle it to the deduction claimed rested with the appellant. It had to show that it had complied with the conditions required to avail itself of the provisions of the section.

It has been held in the case of *Dezura* v. *The Minister of National Revenue* (2) "that the onus of proof of error in the amount of determination rests on the appellant."

In *Johnston* v. *Minister of National Revenue* (3) it was held:

> That an assessment for income tax is valid and binding unless an appeal is taken from such assessment and the Court determines that such was made on an incorrect basis and where an appellant has failed to show that the assessment was incorrect, either in fact or law, the appeal must be dismissed.

On appeal to the Supreme Court of Canada this decision was affirmed. In that case Mr. Justice Rand, speaking for the Court, said (page 489):

> . . . the proceeding is an appeal from the taxation; and since the taxation is on the basis of certain facts and certain provisions of law either those facts or the application of the law is challenged. Every such fact found or assumed by the assessor or the Minister must then be accepted as it was dealt with by these persons unless questioned by the appellant. If the taxpayer here intended to contest the fact that he supported his wife within the meaning of the Rules mentioned he should have raised that issue in his pleading, and the burden would have rested on him as on any appellant

(1) [1945] Ex. C.R. 11.
(2) [1948] Ex. C.R. 10.
(3) [1947] Ex. C.R. 483; [1948] S.C.R. 486.

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to show that the conclusion below was not warranted. For that purpose he might bring evidence before the Court notwithstanding that it had not been placed before the assessor or the Minister, but the onus was his to demolish the basic fact on which the taxation rested.

These decisions establish that an assessment carries with it a presumption of validity and legality and the onus of showing that it is erroneous in fact or in law is on the taxpayer who appeals against it. In my opinion, the appellant failed to establish that the assessments were wrong in fact and in law and that the Minister's conclusions were not warranted.

For these reasons, I have arrived at the conclusion that the Minister's assessments of the appellant's income in the taxation years 1947, 1948 and 1949 were made according to the established facts of the case and to the provisions of the *Income War Tax Act* and the *Income Tax Act*.

The appeals are dismissed with costs.

Judgment accordingly.