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THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

THE DAVIDSON CO-OPERATIVE ASSOCIATION LIMITED ..... RESPONDENT.

Revenue—Income—Co-Operative Association—Patronage dividends paid —Amount of income subject to tax—The Income War Tax Act, R.S.C. 1927, c. 97, ss. 2 (h) (k), 5 (8) (9).

The respondent, a corporation registered under the *Co-Operative Association Act*, R.S.S. 1947, c. 179, was incorporated in 1914 on a share capital basis to purchase and sell commodities upon the co-operative plan. In 1945 it repurchased all shares held by each member except two by crediting him in a Demand Loan account an amount equal to their value. In 1947 it repurchased the remaining shares by depositing an amount equal to their value to each member's credit in a Members' Deposit account. The latter deposits were repayable on a member leaving the district, on his death, by resolution of the directors or, on the dissolution of the Association. The practice of other retailers was followed by the Association in its purchases and sales except that at the end of its fiscal year, after deduction of overhead, the payment of interest on the Demand Loan and Members' Deposit account and

payment of one per cent of total sales to a Patrons' Emergency Fund, the remaining surplus was credited in even percentages to the Members' Deposit account as a patronage dividend calculated on each member's annual purchases. By by-law it was provided a member could make additional deposits to this account payable on demand and that any purchaser could become a member but that no refund be paid him in cash until he had $20 on deposit and that any patronage refund due him be credited his deposit account until that amount was reached.

The Association was assessed under the *Income War Tax Act*, R.S.C. 1927, c. 97 as amended, for the years 1947 and 1948 on amounts shown in its financial statements for each of those years. It appealed the assessment to the Income Tax Appeal Board contending it had no income as it had distributed all its profits in the form of cash or goods in even percentages to its patrons and that the residue held in a surplus fund was the property of all its patrons. The appeal was allowed and the present appeal is from the Board's decision.

Held: 1. That the respondent was a legal entity as distinguished from its members and a taxpayer as defined by s. 2(*h*) and (*k*) of the Act.

2. That it carried on business for its own purposes and the profits it made were subject to income tax. *Minister of National Revenue* v. *Saskatchewan Co-Operative Wheat Producers* [1930] S.C.R. 402.

3. That having pursuant to s. 5(8) deducted the amounts it paid out as patronage dividends it was left with income subject to tax under s. 5(9) and such income was 3 per centum of the capital employed in its business at the beginning of the relevant taxation year less any allowable deductions for interest paid on borrowed moneys, other than moneys borrowed from a bank or credit union, and deductible as an expense in computing income. All other deductions for interest claimed by the respondent were not allowable under the Act. *Jones* v. *South West Lancashire Coal Owners Assn.* [1927] A.C. 827 and *Municipal Mutual Insurance Ltd.* v. *Hill*, 147 L.T.R. 62, distinguished.

APPEAL from a decision of the Income Tax Appeal Board (1).

The appeal was heard before the Honourable Mr. Justice Fournier at Regina.

J. L. McDougall, Q.C. and *F. J. Cross* for the appellant.

J. G. Diefenbaker, Q.C. and *M. W. Coxworth* for the respondent.

FOURNIER J. now (January 20, 1956) delivered the following judgment:

This is an appeal from the decision of the Income Tax Appeal Board (1), dated December 29, 1953, which allowed the respondent's appeal from its income tax assessment for its taxation years 1947 and 1948, on the ground that

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the respondent was not deriving any profit for itself from its operations but was acting on behalf of its members and had no taxable income.

The question to be determined is whether the respondent had income liable to tax in respect of these taxation years. In the affirmative, was the amount of the tax to be paid by the respondent under the provisions of the *Income War Tax Act*, R.S.C. 1927, c. 97, and amendments thereto, in each of its 1947 and 1948 taxation years, properly determined.

According to its Memorandum of Association the respondent is an association incorporated under the provisions of the Saskatchewan Agricultural Co-operative Associations Act and registered as such on April 14, 1914, and its objects were to produce, purchase or sell livestock, farm products, building and fencing material, fuel, flour, feed and such other commodities as may be shipped in car lots and distributed from a warehouse upon the co-operative plan. The capital stock of the Association was to consist of 500 shares of $10 each.

It is admitted that during its taxation years 1947 and 1948 the respondent was a corporation registered under *The Co-operative Associations Act*, being c. 179 of the Revised Statutes of Saskatchewan, 1940, and amendments thereto. The purpose of associations incorporated under the above-mentioned Act is to establish and operate any co-operative business or enterprise specified in its memorandum of association. The objects of these associations are enumerated in s. 5 of the Act as follows:

(*a*) purchasing, procuring, selling, exchanging, hiring and dealing in goods, wares and merchandise;

(*b*) producing, purchasing and selling livestock and farm products;

(*c*) preparing, adapting, producing, processing and manufacturing goods, wares and merchandise for sale by it to its consumer members and patrons;

(*d*) establishing, maintaining and operating any one or more of the following: a library, a rest room, a club room or a public hall;

(*e*) erecting, purchasing, taking on lease or otherwise acquiring apartment blocks, houses, dwellings and lodgings, and operating the same;

(*f*) rendering to its members and patrons services of any kind whatsoever incidental to its objects.

These associations have ancillary and incidental powers to do all the things conducive to the attainment of the

above objects and their memorandum of association may be amended with the approval of the registrar. They may also pass by-laws not inconsistent with the provisions of the Act or of the standard by-laws. S. 10 of the above statute reads as follows:

> 10. (1) An association may at an annual meeting or a general meeting called for the purpose pass such supplemental bylaws not inconsistent with the provisions of the standard bylaws as may be deemed advisable by the association, and without limiting the generality of the foregoing may, notwithstanding anything in this Act contained, pass supplemental bylaws . . .

These supplemental by-laws may deal with the application of members or patrons dividends, the retention, variation or limitation of dividends, the payment or non-payment of interest on loan capital, etc.

On March 21, 1947, the respondent passed and registered supplemental by-laws providing that the standard by-laws as prepared by the registrar of Co-operatives shall not apply to their association. The by-laws hereinafter referred to and passed on or after the above-mentioned date were passed in accordance with the provisions of the aforesaid section of the Statute.

The respondent association, from its incorporation till October 29, 1943, operated on a share capital basis. But on that date, by By-law No. 23, it purchased all the shares held by each of its members, except two which were retained by the said members. From there on, members could not own more than two shares each. The purchase was made by crediting the shareholders with an amount equivalent to the value of the shares on a demand loan account in the name of the member, on which interest at the rate of 4 per cent was to be paid.

On March 21, 1947, by By-law No. 30, it was provided that the remaining two shares held by each member be re-purchased and an amount equivalent to their value be placed to the member's credit in a deposit account. These deposits were repayable to the member on his leaving the district, on the association being dissolved, on the death of the member or on the association deciding to repay a member his deposit account. The same by-law also provided that "a member shall be a person who obtains his supplies or part thereof through the Association". It further provided that no patronage dividend would be

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payable to a member in cash until he had $20 on deposit in the association and that any patronage refunds due to him would be credited to his account until it reached that amount.

On the same date, By-law No. 32 was passed providing that members could deposit funds with the Association in addition to the $20 deposit, such funds repayable on demand. Interest could be paid on these deposits and has been paid to members since 1947 and for many years has been paid at a rate of 4 per cent per annum.

While operating on a share capital basis, the respondent had at its disposal for its operations, amongst others, the amount paid by the shareholders for the shares. Since its reorganization, it has for its operations the amount of the repurchase price of the shares, credited to the members as a loan deposit and the membership fee deposits. It also has the accumulated sum of the co-operative's surplus fund and the accumulated amount of what it calls the Patrons Emergency Benefit fund. Interest is paid at an annual rate of 4 per cent on the member's loan and membership deposits and on the surplus and emergency benefit funds. The amounts of the deposits and funds are administered by the directors of the respondent Association but no trust was set up for the aforesaid purposes and no special bank account was opened to set aside these deposits or funds but were kept by the respondent and carried in its books. It would appear that the surplus funds and the Emergency Benefit funds, for bookkeeping purposes, were noted in special accounts. Needless to say that, when the need arises, it also borrows monies from the banks to finance its operations. The above facts outlining the basis on which the respondent operates are not in dispute.

The respondent association's objects set forth in its memorandum of association and in the Statute under which it operates are as above described, to wit: "To produce, purchase or sell livestock, farm products, building and fencing materials, fuel, flour, feed and other such commodities upon the co-operative plan".

The evidence, written and oral, establishes that the respondent purchases, as any other retailer, its merchandises from manufacturers or wholesalers. It also purchases from other co-operatives. When the goods are received

the selling price is marked down. Mr. Wilson stated that prices thus marked were about the same as the selling prices of other merchants in the district. This was carefully checked, so that there would be as little discrepancy as possible between the respondent's prices and those of the other tradesmen. In other words, the prices that were put on its goods were the same or practically the same as the local prices so as to keep in line with the price structure in the other stores of the district. It would follow that those prices comprised the respondent's overhead cost, plus the ordinary profit on the goods handled. Then the goods were sold not only to members but to the public at large. The income tax returns show that over 14 per cent of the business was done with the general public. The respondent does business on the same basis as the ordinary businessman, only there is a return to the members at the end of the year. The invoice issued to the customers bears the words "Sold to" and the words "This is an interim charge". At the end of the year, the books and accounts are totalled up and a patronage dividend is credited to the member's account. It may be also paid in cash, but it would seem that the general practice is to credit the member's account for these dividends. If a customer has during the year purchased for $50 or more of goods, an amount is credited to him as part of his membership fee, up to $20, which entitles him to become a member. But before paying the patronage dividends, interest at the rate of 4 per cent per annum is credited to the loan and member's deposits and to the surplus and emergency benefit fund; also one per cent of the total sales is credited to this last fund.

This summary of the situation, in my mind, covers the essential facts on which the respondent based its income tax returns for the years 1947 and 1948 and on which the appellant based its appeal from the decision of the Income Tax Appeal Board. (1)

On or about April 10, 1948, and November 26, 1949, the respondent filed with the appellant its income tax returns for the taxation years 1947 and 1948 in which it reported that it had no income subject to tax in those two

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years because it was a consumer's co-operative, and a non-profit purchasing agency. The appellant, not satisfied that the business carried on by the respondent in its 1947 and 1948 taxation years was that of a purchasing agency, and that there existed any contract between the respondent and its members requiring that the respondent make no income, assessed the respondent under the *Income War Tax Act*, R.S.C. 1927, c. 97, and amendments, for its taxation years 1947 and 1948. Notices of these assessments were sent to the respondent on February 8, 1951.

On April 3, 1951, the respondent sent notices of objection to the appellant from the above assessments, wherein a tax in the sum of $844.79, plus interest of $56.41, was levied in respect of income for the taxation year 1947 and a tax of $909.86, plus penalty $45.49 and interest $63.42, in respect of the income for the taxation year 1948.

On November 6, 1951, the appellant, after having reconsidered the assessments and having considered the facts and reasons of the respondent in the notices of objection, confirmed the assessments as having been made in accordance with the provisions of the Act.

These assessments were appealed to the Income Tax Appeal Board and the appeal was allowed. From this decision, the Minister of National Revenue appeals to this Court.

The appellant contends that the respondent is a duly incorporated co-operative association and is a distinct, separate and legal person as distinguished from its members, in the same way that an ordinary joint stock company is a separate legal entity as distinguished from its individual shareholders. On the other hand, the respondent claims that it owns nothing and that everything it possesses is the property of its members collectively. It is only the agent of the members in the carrying on of the business. The business and the profits derived therefrom belong to the members; therefore, the association as such has no income, and having no income, is not liable to taxation.

To my mind, the respondent was duly incorporated under a provincial statute and the moment the incorporation formalities were fulfilled it became a legal entity. As a legal person, it has objects and powers which may be

found in its memorandum of association and *The Co-operative Associations Act*, R.S.C. 1940, c. 179, and amendments. The request for incorporation states that the Association desires to go into the business of producing, purchasing or selling goods. There is no mention in its application that it intends to do business for a group of shareholders or members or that in organizing the business it would divest itself of its powers or purposes as a corporation or forgo its right to have income or profits. As to the Act itself it states clearly that any five or more persons who desire to associate themselves together as a co-operative association for any purpose permitted by the Act may do so by fulfilling certain formalities. When incorporated, the association is empowered to establish and operate any co-operative business or enterprise specified in its memorandum of association in its own name and not as agent for its members. I have no hesitation in finding that The Davidson Co-operative Association Limited, the respondent in this instance, is a corporation and as such a separate legal entity as distinguished from its individual members.

As a legal person, the respondent is the owner, in its own right, of land, buildings, furniture and equipment, merchandise and other personal property, including Dominion of Canada Bonds, it employs officials and servants, takes depreciation on its plant, pays taxes and other business expenses and makes provision for bad debts in exactly the same manner as any ordinary corporation. It even collects from its patrons and pays over to the Province of Saskatchewan sales tax imposed by the Province. This tax is collected and remitted to the provincial authorities by the vendor in respect of a retail sale made to a purchaser in the Province.

The evidence before the Court is to the effect that the respondent bought goods on its own account from the ordinary sources of supply, paid for these goods, stocked them in its store and put them up for sale, as any other storekeeper, in the usual course of business. These goods were not purchased to fulfil orders previously received. They were sold to members and customers at a marked up price in line with prices available in the other stores of the region. These prices comprised the cost of purchase,

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the overhead expenses and a profit, plus the education tax. I find that everything the respondent did in the carrying on of its business was similar to what is generally done by businessmen or business firms.

According to the evidence of the respondent's manager the only difference in the procedure followed in making a sale in the respondent's place of business was the handing to its patrons and customers an invoice carrying the words "This is an interim charge". A copy of this invoice was not available at the trial, nor is it on file before the Court. In my opinion, these words could not mean that at some time in the future the prices paid for these specific goods would be less than the invoice price. The fact is that, at the end of the year, the accountant totalled up the books and the difference between the total cost of the goods with the overhead expenses, the interest paid on the loan credits, the membership credits, the emergency benefit fund and the surplus fund, plus one per cent of the total sales credited to the Emergency Benefit Fund, and the moneys received, became the respondent's surplus earnings or income. Most of this income was credited to the members' account in proportion to patronage or (which does not appear to have been the practice) paid in cash, but could have been. The patron or customer dividend was calculated on the amount of money paid by the member or customer to the respondent during the year.

It would seem that prior to 1947 no difficulty arose concerning the taxation of the respondent's income. This is easily understood because previous to 1947 the *Income War Tax Act*, under s. 4, s.s. (*p*), provided that the income of co-operative companies and associations was not liable to taxation. S. 4, s.s. (*p*) reads as follows:

4. Income not liable to tax. The following incomes shall not be liable to taxation hereunder:—

(*p*) Co-operative companies and associations. The income of farmers', dairymen's, livestockmen's, fruit growers', poultrymen's, fishermen's and other like co-operative companies and associations, whether with or without share capital, organized and operated on a co-operative basis, which organizations

(*a*) market the products of the members or shareholders of such co-operative organizations under an obligation to pay to them the proceeds from the sales on the basis of quantity and quality, less necessary expenses and reserves;

(b) purchase supplies and equipment for the use of such members under an obligation to turn such supplies and equipment over to them at cost, plus necessary expenses and reserves.

Such companies and associations may market the produce of, or purchase supplies and equipment for non-members of the company or association provided the value thereof does not exceed twenty per centum of the value of produce, supplies or equipment marketed or purchased for the members or shareholders.

But in 1946 the Act was amended, the above provision disappeared from the Statute and was replaced by a new subsection (*p*). The new section gave temporary relief only to corporations commencing business on or after the first day of January 1947. The income during the first three taxation years after the commencement of the business of these corporations was not liable to tax.

I do not believe the respondent was entitled to avail itself of this new provision of the Act. The business carried on by the Association was the continuation of a previous business in which a large number of members of the corporation had a substantial interest, either as shareholders or otherwise. To benefit from the relief provided for by this subsection (*p*) the respondent had to establish that it fell within the ambit of its terms.

Clause VII of s.s. (*p*) of s. 4 of the Act reads as follows:

(VII) the business carried on by the corporation is not, in the opinion of the Minister, a continuation of a previous business in which, in the opinion of the Minister, a substantial number of members of the Corporation had a substantial interest, either as shareholders of a corporation carrying on the previous business or otherwise.

It seems to me that the respondent cannot claim the relief provided for in this section. In 1947 it continued the business it was carrying on previously and the patrons and members had a substantial interest in that business, if not as shareholders, as members, if the contention of the respondent that it owns nothing and has no income and that the members collectively are the sole owners of the business is to be taken into account. The amount of the value of the shares repurchased by the association was deposited to the account of the members, and the evidence does not establish that this amount was reimbursed to the members. Therefore, the members' interest in the business would be the same as it was when they were shareholders. Furthermore, the Minister by making the assessment referred to above, clearly indicated that he was of the

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opinion that the respondent's income was liable to tax. Had he thought that the business carried on by the respondent was not a continuation of a previous business, he would not have made the assessment in dispute.

Having found that the respondent was a legal person doing business in its own right on a profit basis and did have an income in the taxation years referred to herein, the next question to be determined is whether its income was liable to tax.

The contention put forward on behalf of the respondent is that the difference between the proceeds of its sales and the cost of the goods, the overhead and the disbursements heretofore described having been distributed to its members, at the end of each year in proportion to patronage, in an aggregate amount equal, or almost equal, to its surplus earnings, it had no income liable to tax. It was also contended that it was never intended that the Association should make any profits and this was done by paying nearly all its earned surplus to the members.

In this last submission it is admitted that the respondent had earned surpluses, though it is claimed that they were not income liable to tax because most of these surpluses were paid over to its members.

In my view, once it has been established that the respondent derived profits from its business, the liability to pay income tax is to be governed by the terms and provisions of the taxation statute, though the intention of the respondent was that no profit should be made out of the operation of its trade or business. Viscount Simon in *Simon's Income Tax*, second edition, volume 2, paragraph 27, states:

> There may be a carrying on of a trade for tax purposes even though there is no intention to make a profit. The question is whether or not a trade is or was being carried on, and once that question is answered in the affirmative there is liability to tax on any resulting profit, irrespective of whether the trading activities were directed to the making of the profit and irrespective of the purpose to which the profit is applied.

What is material to the present issue is not the respondent's intention, but what was the result of its carrying on of a business. If it derived profits from its operation, were those profits liable to tax or exempted from taxation by some provision of the *Income War Tax Act?* To answer this question, different provisions of the Act have to be considered.

In the *Income War Tax Act*, 1927, R.S.C., c. 97, and amendments, in 1947 and 1948 the word "person" is defined in s. 2, s.s. (*h*), which reads thus:

2. (*h*) "Person"—"person" includes any body corporate and politic and any association or other body, and the heirs, executors, administrators and curators or other legal representatives of such person, according to the law of that part of Canada to which the context extends;

* * *

(*k*) *"Taxpayer"*—"taxpayer" includes any "person" whether or not liable to pay tax;

Having decided that the respondent was a body corporate, a legal entity, it follows that it fell within the ambit of the definition of "person" and was a "taxpayer".

S. 3 of the Act, as amended, defines "Taxable income" in the following words:

(3) Income—1. For the purposes of this Act "income" means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be whether derived from sources within Canada or elsewhere; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source . . .

The evidence adduced clearly indicates that the respondent during its taxation years 1947 and 1948 received net profits or gains derived from its business, but it is established that though it was a corporation it was incorporated as a Co-operative Association. As such it could claim the benefits of the provisions of the Act relating to co-operative companies or associations. I expressed the view that it did not meet the conditions laid down in s. 4, s.s. (*p*), and could not claim the relief provided for in that section.

Having so found, it follows that the respondent would be liable for income tax as any other corporation, at the corporate rate, on its income in each of the two taxation years, because its profits in each of these years were in excess of $30,000, were it not for certain provisions of s. 5 of the *Income War Tax Act*.

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Under the heading "Deductions and Exemptions Allowed", s. 5 provides that deductions may be made to the taxpayer's income when payments are made to members or customers within a taxation year, pursuant to allocations in proportion to patronage.

Paragraph 8 of section 5 reads as follows:

8. *Deductions allowable.* There may be deducted from a taxpayer's income as hereinbefore defined, the aggregate of the payments made by him

(*a*) within the taxation year or within twelve months thereafter to his customers of the taxation year, and

(*b*) within the taxation year to his customers of a previous taxation year, the deduction of which from income of a previous taxation year was not permitted under paragraph (*a*) of this subsection

pursuant to allocations in proportion to patronage for the said years; provided that, if the taxpayer has not made allocations in proportion to patronage in respect of all his customers of the taxation year at the same rate, with appropriate differences for different types or classes of goods, products or services, or classes, grades or qualities thereof, the amount that may be deducted from his income under this subsection shall be

(*c*) the aggregate of the payments previously mentioned in this subsection, or

(*d*) an amount equal to the aggregate of

(i) the amount of the income of the taxpayer of the taxation year attributable to business done with members of the taxpayer, and

(ii) the amount of allocations in proportion to patronage to customers of the taxpayer of the taxation year other than members of the taxpayer

whichever is less.

I am convinced that the respondent gave consideration to this subsection of the Act when preparing its balance sheet and income tax return, but seems to have neglected to pay close attention to the following paragraph 9 of section 5 which is correlative to the previous subsection. It reads:

9. *Interest on borrowed moneys.* Notwithstanding anything contained in subsection eight of this section, if the amount that may be deducted thereunder would leave the taxpayer with an income subject to tax under this Act less than an amount determined by deducting from three per centum of the capital employed in the business at the commencement of the taxation year, the interest, if any, paid.

Section 5, subsection 8, read as follows:

5. 8 *Deductions allowable.* There may be deducted from a taxpayer's income as hereinbefore defined, the aggregate of the payments made by him

(*a*) within the taxation year or within twelve months thereafter to his customers of the taxation year, and

(*b*) within the taxation year to his customers of a previous taxation year, the deduction of which from income of a previous taxation year was not permitted under paragraph (*a*) of this subsection.

pursuant to allocations in proportion to patronage . . . in respect of all his customers of the taxation year at the same rate, with appropriate . . . different types or classes of goods, products or services, or classes, grades or qualities thereof, the amount that may be deducted from his income . . . shall be

(*c*) the aggregate of the payments previously mentioned in this subsection or

(*d*) an amount equal to the aggregate of

(i) the amount of the income of the taxpayer of the taxation year attributable to business done with members of the taxpayer, and

(ii) the amount of allocations in proportion to patronage to customers of the taxpayer of the taxation year other than members of the taxpayer

whichever is less.

I am convinced that the respondent gave consideration to this subsection of the Act when preparing its balance sheet and income tax return, but seems to have neglected to pay close attention to the following s.s. 9 of s. 5 which is correlative to the previous subsection. It reads:

5. 9 *Interest on borrowed moneys.* Notwithstanding anything contained in subsection eight of this section, if the amount that may be deducted thereunder would leave the taxpayer with an income tax subject to tax under this Act less than an amount determined by deducting from three per centum of the capital employed in the business at the commencement of the taxation year, the interest, if any, paid during the taxation year by the taxpayer on borrowed moneys (other than moneys borrowed from a bank incorporated under the Bank Act or from a corporation or association incorporated or organized as a credit union as described in paragraph (*q*) of section four of this Act), and . . .

This provision of the Act, in my opinion, is applicable to this litigation, but it seems that the respondent or its officials overlooked it. When the income tax returns were sent to the Department they showed "no income taxable" for the years under discussion. The respondent took the stand that the business operated by it was not one in which it purchased or produced merchandise for its own account, but that it being a consumer co-operative was purchasing agent for its members and customers. Well, I cannot agree with this statement and it does not agree with the facts of the case nor with the law governing taxation on income. On the one hand, the respondent admits being a duly incorporated body with objects, purposes and powers. It is in business as any other corporation or person and conducts

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its affairs in like manner. It has earned surpluses as any other business, and though it calls these surpluses "overages", it does not change the facts. Furthermore, there is no contract between the respondent and its members and customers to the effect that it make no profit or income.

It is a recognized rule in income tax matters that profits from the operation of a trade or business are taxable. This principle was expressed by the Supreme Court of Canada in the case of the *Minister of National Revenue and The Saskatchewan Co-operative Wheat Producers* (1) in the following words:

> The basis of chargeability to income tax is the operation of a trade or business giving rise to a profit.

The respondent in this case undoubtedly carried on a business for its own purposes which certainly made profits which, in my mind, were subject to income tax.

The respondent took advantage of s-s. 8 of s. 5 of the Act in the preparation of its income tax returns of the years in question and deducted the amounts paid out in patronage dividends during these years. The sums thus deducted left it with an income subject to tax under the Act (s. 5 (9)) less than 3 per cent of the capital employed in the business at the commencement of both taxation years. I am satisfied that the capital employed in the business at the beginning of 1947, less a small amount added through an error, was $93,864.93 and 1948, $101,095.07.

As the returns show that the respondent's profits in the years 1947 and 1948 were in excess of $30,000, which is far in excess of 3 per cent of the capital employed, and that the income subject to tax being 3 per cent of the capital employed in the relative taxation years, less any allowable deduction for interest paid during the taxation year by the taxpayer on borrowed moneys other than moneys borrowed from a bank or credit union and deductible as an expense in computing the taxpayer's income as provided in s-s. 9 of s. 5. It is necessary to consider s. 5 (1) (*b*). It reads:

> 5 (1) (*b*) Interest on borrowed capital—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

(1) [1930] S.C.R. 402 at 415.

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;

In my opinion, clause (*b*) above means that the only interest on borrowed capital used in the business which is deductible as an expense is interest on moneys borrowed to earn income. I do not believe that the evidence before the Court is to the effect that the amounts on which interest is being paid in the present instance were used to earn income. The members not withdrawing their patronage dividends or making deposits with the respondent were paid interest on the sums left in their account and the interest on the surplus and emergency benefit funds was automatically credited to the amount of these funds. But, even if these moneys were used to earn income and the rate stipulated in a contract, the only amount deductible as an expense is the amount that the Minister in his discretion may allow. In the present instance, I repeat the respondent failed to establish that the moneys on which interest was paid were used to earn income or that the interest was paid in virtue of a written document or that the Minister allowed the interest to be paid at the rate at which it was paid.

The Minister used his discretion in disallowing the interest paid or part of that interest so that the provisions of s. 5 could be met, that is to say that the income subject to tax would not be less than the amount determined by deducting from 3 per cent of the capital employed in the business at the beginning of the taxation years, the interest paid in accordance with the conditions stated in s. 5 (1) (*b*) above cited.

It is with these facts and the above provisions of the Act in mind that the appellant proceeded to assess the respondent's income. The reports of the respondent's auditors were used as the basis of the assessments. As it appears in the respondent's reply to the Minister's appeal that the dispute between the parties concerns the deductions made by the respondent for interest paid on moneys borrowed from the members' deposits and from the Patrons' Emergency Fund, the payments made to the Patrons' Emergency Benefit Fund, the capital employed by the respondent for its operations and depreciation, I think it useful to consider the items of the 1947 assessment as an illustration.

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The proceeds from the sale of goods by the respondent amounted to $477,632.33 and the cost to produce or purchase these goods was $442,215.92.

Wholesale cost of goods	$386,948.67
Management salaries	7,895.00
Directors' fees	621.40
Audit	250.00
Wages	29,417.98
Fuel, light and power	1,652.00
Taxes, insurance and license	4,557.75
Interest and discount	3,424.43
Telegraph and telephone	602.45
Travel	195.07
Postage, stationery and adv.	1,785.69
Repairs	419.45
Delivery	3,931.71
Unemployment insurance	58.61
Siding rental	150.48
Miscellaneous	305.23
Total	$442,215.92

The amount of profit from the sale of the goods sold was the difference between the proceeds from the sales, amounting to $477,362.35, and the above detailed costs of producing or purchasing and selling the goods sold amounted to $442,215.92, or an amount of $35,146.41. The respondent, in addition to this amount of profit, had income from other sources amounting to $1,884.87. These two amounts make a total income of $37,031.28 before deductions. The deductions which were assessed comprised charitable donations, $140, allowance for bad debts, $1,000, and allowance for depreciation, $2,144.01, making a total of $3,284.01. After these deductions the respondent's net income was $33,747.27.

The capital employed in the respondent's business at the commencement of the taxation year 1947 amounted to $93,864.93, less a small amount added through error, as I have hereinabove mentioned.

The amount determined by deducting from 3 per centum of the capital employed in the respondent's business at the commencement of the said year, and by the interest paid on borrowed moneys and that was deductible as an expense in computing its income under the *Income War Tax Act*, was $2,815.95. On this basis, the respondent's income sub-

ject to tax for its 1947 taxation year was assessed at the sum of $2,815.95 and for its 1948 taxation year at the sum of $3,032.85.

Before arriving at the above findings, I had carefully considered the decisions on the subject of mutual organizations which were referred to by the parties, because the respondent took the stand that it was a consumers' co-operative with no income or profit. It contended that it was an association of the nature of a mutual company and that the principles governing mutual companies with regard to taxation should be applied to its operations and that it could not be held that there was any profit or gain within the ambit of the taxation Act.

In all the decisions considered, it seems to have been established that the contributors or members were also the owners of the surplus or reserve funds set up for protection against future claims or liabilities and that a real mutuality existed because there was absolute identity between the contributory members and the participators.

In support of its contention, it seemed to rely on the principles laid down in the following cases.

Jones v. *South West Lancashire Coal Owners Association* (1). At page 830 Viscount Cave, L.C. said, quoting from Lord Watson in the *Styles* case (2):

> When a number of individuals agree to contribute funds for a common purpose, such as the payment of annuities, or of capital sums, to some or all of them, on the occurrence of events certain or uncertain, and stipulate that their contributions, so far as not required for that purpose, shall be repaid to them, I cannot conceive why they should be regarded as traders, or why contributions returned to them should be regarded as profits. That consideration appears to me to dispose of the present case. In my opinion, a member of the appellant company, when he pays a premium, makes a rateable contribution to a common fund, in which he and his co-partners are jointly interested, and which is divisible among them, at the times and under the conditions specified in their policies. He pays according to an estimate of the amount which will be required for the common benefit; if his contribution proves to be insufficient he must make good the deficiency; if it exceeds what is ultimately found to be requisite, the excess is returned to him. . . .

In *Municipal Mutual Insurance Ltd.* v. *Hills* (3) Lord Warrington at page 65 said:

> Mutual Insurance business is now perfectly well known. It consists essentially in the association of a number of persons who insure each other against certain risks by contributing by way of premiums to a

(1) [1927] A.C. 827 at 830.
(2) [1889] 14 App. Cas. 381 at 394.
(3) (1932) 147 L.T.R. 62.

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common fund to be used, together with further contributions if necessary, for the purpose of indemnifying any member or members who may have suffered injury in consequence of a risk insured against, any surplus being either carried forward or used to reduce future premiums as the members may determine.

In *New York Life Insurance Co.* v. *Styles* (1) at page 412 (in fine) Lord Macnaghten said:

> . . . I do not think that that decision compels your Lordships to hold in a case like the present, where the business is a mutual undertaking pure and simple, that persons who contribute in the first instance more than is wanted, and then get back the difference, are earning gains or profits, and so liable to income tax.

In mutual insurances persons join together to protect themselves and each other against certain risks, each contributing to a fund deemed sufficient to cover the risks insured. This fund is used to pay the losses that occur. The amount remaining in the fund at the expiration of a fixed period is paid over or credited to the account of each contributor on a *pro rata* basis and applied on future contributions. A contract exists between the members by which each member has a right to get back that portion of contribution he made and was not necessary to be used to pay the losses to be compensated under the mutual insurance contract. He is entitled by contract to the return of that part of his contribution which is not required. It is easily understood that in these cases no profit can be made out of the contributions of the members. On the other hand, were the company to do business which was not purely mutual and made profits, even if distributed to its members, they would be subject to income tax. This rule was applied in *The Cornish Mutual Assurance Co.* v. *Inland Revenue Commissioners* (2). At page 286, Viscount Cave said:

> It is true that it only carries on that business with its own members; but, as every person who chooses to effect a policy with the Company *ipso facto* becomes a member, the restriction does not appear to me to prevent the transactions of the Company from being business transactions.

The above decisions, except the last one cited, are certainly distinguishable from the present case inasmuch as the respondent is not bound by a contract with its members to allocate or divide or return all or any part of its surpluses to the individual members. There is no evidence before the Court that there exists any agency contract

(1) (1889) 14 App. Cas. 381. (2) [1926] A.C. 281.

between the respondent and its individual members to act as their purchasing agent. Furthermore, the respondent is not the agent of a number of persons who have joined together to further a common purpose of protection and have contributed to a common fund to that end. It has dealings with the public at large and the evidence shows that a member is a person who obtains his supplies or part thereof through the association, that is to say that any person who makes a purchase from the respondent may/or becomes a member of the association. To my mind, none of the essential elements to constitute a mutual organization exist in the respondent association.

I am of the view that the Davidson Co-operative Association Limited has all the characteristics of an ordinary incorporated company. Its members in meeting assembled elect the directors and control the operations of the company and of its directors by majority vote. The company employs personnel to carry on its operations of producing or purchasing and sellings goods to their members and all comers at prices comparable to the prices charged for similar goods in the local stores. The difference between the cost of the goods, overhead and other expenses and the amount received from the sale of the same goods is called by the witness "overages" but in business, trade and ordinary parlance it is called "profit" or "gain". In my opinion, the surpluses or profits earned in the taxation year fall within the terms of the definition of taxable income of s. 3(1) of the Act.

What becomes of the net profits or income is shown in the respondent's balance sheets and income tax returns and nowhere else. The Minister's assessments are based on these documents.

The association allocates a certain amount for depreciation; appropriates funds to the Patrons Emergency Benefit Fund for the purpose of making grants and deducts a substantial reserve for uncollectable accounts receivable. These operations are held to be similar to those made by any trading company.

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It was held by the Privy Council in the case of *English and Scottish Joint Co-operative Wholesale Society Ltd.* v. *Commissioner of Agricultural Income Tax, Assam* (1):

that certain of the application of net profits which may be made under the rules of the society is in essentials not different from the application of net profits which might be made by any trading company, being allowance for depreciation; appropriation to a special fund for making grants; appropriation to a reserve fund.

In the above case the appellant was liable to income tax.

In the present case, it may also be noted that the respondent has an item of accounts receivable and an item of goods on hand at the end of the years, which show that the relationship between the association and its members was not simply the relationship of principal and agent and that the association carried on a business for gain. The fact that part of the gains was divided amongst its patrons is clearly evidence that it did make a profit. The distribution to its members of these profits, in part or in whole, does not alter the fact that these profits were income subject to tax.

The Minister, not being bound by the income tax returns made by the respondent, proceeded to determine the amount of tax to be paid by the respondent. His authority to do so is contained in s. 47 of the Act, which reads as follows:

47. The Minister shall not be bound by any return or information supplied by or on behalf of a taxpayer, and notwithstanding such return or information, or if no return has been made, the Minister may determine the amount of the tax to be paid by any person.

The Minister having determined the amount of the tax to be paid by the respondent for the taxation years under discussion, his assessments were valid and binding unless an appeal was taken and the Court determined that such were made on an incorrect basis, but the onus of establishing that the assessment was incorrect, either in fact or in law, rested with the respondent herein (appellant before the Income Tax Appeal Board).

This rule is now well known and was clearly expressed in the case of *Johnston* v. *Minister of National Revenue* (2), wherein 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

(1) [1948] A.C. 405 at 414. (2) [1947] Ex. C.R. 483.

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 (1) this decision was affirmed. In that appeal Mr. Justice Rand, speaking for the Court, said at p. 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 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.

This rule applies in all instances, even when the appellant has been successful in an appeal before the Income Tax Appeal Board and the Minister appeals from the Board's decision to the Exchequer Court, the burden is his to show that the assessment was made on an incorrect basis either in fact or in law. In the present case, I have no hesitation in saying that the taxpayer has failed to refute the facts on which the taxation was made and that the assessment was correct in law.

I find that the basic facts on which the assessments were made were correct, except that for the taxation year of 1947, the Minister should have deducted in the calculation of the capital employed the sum of $100 which, through error was added to the amount of the accounts receivable. By allowing the item of $100 it would decrease the amount of capital employed in the business at the commencement of the year to $93,764.93 instead of as computed for the purposes of taxation—$93,864.93, and therefore, the amount of the assessment for the taxation year 1947, instead of being as assessed $2,815.95, should be $2,812.95 with a corresponding adjustment as to the amount of the tax and interest thereon.

(1) [1948] S.C.R. 486.

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For the above reasons, therefore, I would allow the appeal and confirm the Minister's assessments as set forth in the notices of assessment, saving and excepting that the assessment in respect of the year 1947 should be reduced from $2,815.95 to $2,812.95 with a corresponding adjustment as to the amount of interest thereon.

The Crown is entitled to costs, if it insists upon same.

Judgment accordingly.