1956 Sept. 25 — 1957 Apr. 2

THOMPSON CONSTRUCTION (CHEMONG) LIMITED .......... APPELLANT;

AND

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

*Revenue—Income—Income tax—New engine purchased to replace worn-out unit of power shovel—Whether "an outlay . . . made . . . for the purpose of . . . producing income from . . . business of the taxpayer" or "an outlay . . . on account of capital"—The Income Tax Act, S. of C. 1948, c. 52 as amended, ss. 11(1)(a), 12(1)(a) and (b), 20(4)(a) and (b).*

The appellant, a road-building contractor, in 1949 purchased a used power shovel powered by a 125 h.p. diesel engine for $27,075. Up to the end of the taxation year 1952 the shovel was treated by both parties as a depreciable asset and under regulations authorized by s. 11(1)(*a*) of the *Income Tax Act* the annual capital cost allowances claimed and allowed had for depreciation purposes reduced the shovel's book value to $9,268. In 1953 the engine, in need of major repairs, was replaced by a new one at a cost of $8,894 less $3,200, the trade-in value of the old engine, or a net cost of some $6,000. The appellant in its income tax return for that year deducted the latter amount as an outlay incurred for the purpose of gaining income from its business. The Minister disallowed the amount as an expense, added it to the appellant's declared taxable income and then deducted 30 per cent thereof as a capital cost allowance. An appeal from the assessment to the Income Tax Appeal Board, at which the appellant offered no evidence, was dismissed. On appeal from the Board's decision the the appellant contended that the net outlay for the new engine was an expense incurred for the purpose of gaining income from its business and was therefore within the exception stated in s. 12(1)(*a*) of the Act and consequently deductible in full. The respondent submitted that it was an outlay on account of capital and barred by s. 12(1)(*b*).

*Held:* That in determining whether an outlay or expense was incurred for the purpose of gaining or producing income from a business and therefore within the exception stated in s. 12(1)(*a*) of the *Income Tax Act,* sub. para. (*a*) cannot be read by itself or as providing the sole test of deductibility; and even if the outlay passes the primary test referred to in *The Royal Trust Co. v. Minister of National Revenue* [1957] C.T.C. 32; D.T.C. 1055; the deduction will be denied if it be specifically excluded by any other provision of the Act.

2. That, although as a general rule repairs necessitated by wear and tear of equipment used in the business are allowed as deductions (although no specific reference is found in the *Income Tax Act* regarding "repairs") if the outlay brings into existence a capital asset, such as a new piece of machinery, such outlay will not be allowed as a deduction.

3. That the outlay here brought into existence a new capital asset, namely the new engine, *Minister of National Revenue v. Dominion Natural Gas Co.* [1941] S.C.R. 19, and consequently could not be considered an outlay on revenue account. (The Court was influenced in part by the magnitude of the outlay when related to the value of the power shovel as a whole.) *Samuel Jones & Co. (Devondale) Ltd. v. C.I.R.* (1950-52) 32 T.C. 513 and 518.

4. That to allow a deduction in full as an operating expense of an outlay such as this which brought into existence a new capital asset would be to frustrate the clear intent of the provisions of s. 11(1)(*a*) of the Act and the regulations passed thereunder in regard to capital cost allowances.

5. That the outlay for the purchase of a new engine would properly be considered in accounting practice as a capital expenditure because of the enduring nature of the new asset.

APPEAL from a decision of the Income Tax Appeal Board.

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

*W. J. Anderson* for appellant.

*D. W. Mundell, Q.C.* and *J. D. C. Boland* for respondent.

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CAMERON J.:—This is an appeal from a decision of the Income Tax Appeal Board (1) dated April 24, 1956, dismissing the appellant's appeal from a re-assessment dated June 29, 1955, in respect of the appellant's taxation year ending March 31, 1953. At the Board hearing no evidence was led on behalf of the appellant and the chairman held that in view of the complete lack of evidence there was nothing before him to warrant any change in the re-assessment.

The principal facts are not in dispute. The business of the appellant is that of general contracting, its work consisting mainly of road building. In May 1949, it purchased a used Model 6, Northwestern power shovel at a cost of $27,075; it was of the type shown on page B of Exhibit 1. It was powered by a Murphy M.E.6 diesel engine having a rated capacity of 125 h.p.; the engine was probably new when it was installed in the shovel in 1948 although there is no clear evidence on that point. The shovel was used by the appellant in its operations in Ontario and Newfoundland in 1949, moving approximately 130,000 cubic yards of earth and rock. In each of the next three years it was used in Newfoundland moving about 100,000 cubic yards of rock and earth annually. These operations, particularly in Newfoundland, were said to be of an extremely heavy and rugged nature, entailing an unusual amount of wear and tear on the shovel and its parts, including the engine. In the spring of 1951, the engine was completely overhauled at a cost of about $3,500. In 1952 further sums of $900 for parts and $600 for labour were expended in repairing the engine. These outlays were allowed as deductions for the year in which they were incurred.

In January 1953, the directors of the appellant company found that major repairs were again needed, both for the shovel and the engine. It was estimated that the cost of putting the engine in good condition would be approximately the same as had been expended on it in 1951, namely, $3,500. The directors, however, came to the conclusion that it would be wiser to install a new engine; accordingly the appellant then purchased a new Caterpillar D. 13,000 engine with a rated capacity of 125 h.p., at a cost of $8,894, and installed it in the shovel. Exhibit 2 is

(1) (1956) 15 Tax A.B.C. 62; 56 D.T.C. 204.

the conditional sale contract entered into by the purchase of the engine, dated January 26, 1953; it shows that Crothers Limited (the vendors) in part payment of the purchase price took over the old engine, allowing therefor a trade-in value of $3,200. With some adjustments, the net cost of the new engine to the appellant totalled $6,006.13.

In computing its income tax return for the taxation year ending March 31, 1953, the appellant showed an item of expense entitled "Repairs to shovel—$11,671.32". Included in that amount was the net cost of the new engine, namely, $6,006.13. In re-assessing the appellant, the respondent disallowed the latter amount entirely as an expense, added it to the declared taxable income and then deducted 30 per cent. thereof ($1,801.84) as a capital cost allowance. The appellant objected to that assessment, its stated reasons being—

> We feel that it is most essential that the full maintenance of our equipment be allowed as an expense when incurred during the period it is in operation and earning income.

By his Notification, the respondent confirmed the assessment as having been made in accordance with the provisions of the Act and in particular on the ground that—

> The cost of a Caterpillar D. 13,000 engine claimed as a deduction from income was not an outlay or expense incurred by the taxpayer for the purpose of gaining or producing income within the meaning of paragraph (*a*) of subsection (1) of section 12 of the Act, but was a capital outlay within the meaning of paragraph (*b*) of the said subsection (1) of section 12.

Forming part of the appellant's return is a schedule of fixed assets and capital cost allowances as at March 31, 1953. This statement shows that since the purchase of the power shovel (including the engine) in 1949 at a cost of $27,075, the shovel had been treated as a depreciable asset and the capital cost allowance in respect thereof had been allowed annually under the regulations authorized by the provisions of s. 11(1)(*a*) of the *Income Tax Act*. It is common ground that up to the taxation year ending March 31, 1952, the shovel as a whole was treated by both parties as being within Class (*h*) of Class 10 of Schedule B to the Regulations, namely, "contractors' movable equipment (including portable camp buildings)", the rate of capital cost allowances in such being 30 per cent. The statement that I have referred to also shows that at

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March 31, 1952, depreciation of $17,788.27 had been taken on the shovel, thus reducing its book value as of that date to $9,286.73. In the statement referred to, a further 30 per cent. depreciation was claimed and allowed, thus reducing the book value as of March 31, 1953, to $6,500.71. For depreciation purposes, that amount would have correctly shown the book value of the shovel as a whole had the old engine not been replaced.

As both parties rely on the provisions of s. 12(1) of the *Income Tax Act*, 1948, as amended, I will quote at once the relevant portions thereof as they were in the taxation year in question:

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

For the appellant it is submitted that the net outlay for the new engine was an expense incurred for the purpose of gaining or producing income from its business and was therefore within the exception stated in para. (*a*); and that consequently it is deductible in full. Further, it is submitted that the outlay was not of a capital nature and did not fall within the provisions of para. (*b*). The respondent, on the other hand, submits that the outlay was not incurred for the purpose of gaining or producing income from the appellant's business within the meaning of the exception stated in para. (*a*), but rather was an outlay on account of capital and therefore barred from deduction by the provisions of para. (*b*).

I must admit that I have found some difficulty in ascertaining the precise meaning of para. (*a*). If an outlay or expense falls within the exception therein as being one made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer, does it necessarily follow that the outlay is deductible if it has also passed the primary test referred to by the President of this Court in *The Royal Trust Company v. M.N.R.* (1)—namely, that it was made or incurred by the taxpayer in accordance with the ordinary principles

(1) [1957] C.T.C. 32; D.T.C. 1055.

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of commercial trading, or well accepted principles of business practice? In that view, the deduction of expenses not prohibited by para. (*a*) is thereby "granted". Support for that view may be found in *Smith v. Incorporated Council of Law Reporting for England and Wales* (1) (referred to in Simon's Income Tax, Vol. 2, p. 202), in which Scrutton J. said:

> That form of words contemplates that certain deductions are to be allowed; what one finds is that certain deductions are prohibited, but in some cases the prohibition is in this form: "No deductions shall be made except"; and from that system of exceptions one ascertains, rather unscientifically as it seems to me, what deductions are in fact allowed.

The difficulty I have found in accepting that view of the matter is that the phrase "for the purpose of earning *the* income" found in the former s. 6(1)(*a*) of the *Income War Tax Act* has been interpreted to mean "in the process of earning the income" (*Minister of National Revenue v. Dominion Natural Gas Co. Ltd.* (2)). That subsection was considered generally as referable only to operating and maintenance expenses. Under the *Income Tax Act*, however, a very similar phrase, "for the purpose of gaining or producing income therefrom (property) or for the purpose of gaining or producing income from a business", used in s. 20(4)(*a*) and (*b*), is made clearly applicable to s. 11(1)(*a*) which is the statutory authority for the deduction of *capital* cost allowances. It is perhaps arguable, at least, that para. (*a*) of s. 12(1) is broad enough in its terms—and when considered by itself—to permit the deduction of all outlays or expenses made or incurred for the purpose of producing income whether such outlays be of a capital or revenue nature.

I am satisfied, however, that whatever be the true interpretation to be put upon para. (*a*) of s. 12(1), it cannot be read by itself or as providing the sole test of deductibility. The primary test is that referred to above in the *Royal Trust Company* case. Moreover, if the outlay in question passes the test of the excepting portion of the paragraph, its deduction will be denied if it be specifically excluded by any other provision of the Act. For example, para. (*c*) of s. 12(1), relating to exempt income, is clearly an additional

(1) 6 T.C. 477 at 482. (2) [1941] S.C.R. 19.

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limitation to the general limitations of para. (*a*). Similarly, if the outlay be within the ambit of para. (*b*) (*supra*), the deduction will not be allowed.

In a broad sense it may be said that the outlay for the new engine was an expense incurred for the purpose of earning the appellant's income. The same might be said of all outlays of capital for all types of buildings, machinery and the like, to be used in the business. In the instant case, the provision of a new engine enabled the appellant to earn income from the operation of the shovel without the likelihood of frequent breakdowns. The real question, therefore, is whether that outlay was one, the deductibility of which was prohibited by para. (*b*).

For the appellant, it is submitted that the outlay here in question was in the nature of a repair; that by reason of the rugged nature of the company's operations, the old engine had worn out to a substantial extent; that to put it in a condition in which it could be used for the purpose of producing income for the appellant it was necessary either to incur heavy repair bills or, alternatively, to replace the worn-out engine, and the latter alternative was decided upon. Then it is said that the engine was merely a subsidiary part of the "entirety", that is, the power shovel; that the replacement of the engine was therefore not a replacement of the "entirety" but merely of a subsidiary part of the whole. It is pointed out that the new engine was of precisely the same rated capacity as the former engine and did not constitute an improvement over the old engine; that the replacement of the engine merely restored the shovel to its original condition so that it could continue to earn revenue.

By this argument it is sought to bring the case within the decision of the Court of Session in *Samuel Jones & Co. (Devonvale), Ltd. v. C.I.R.* (1). The headnote in that case is as follows:

> The Company carried on a trade of processing paper. A chimney of its factory was replaced because of its dangerous condition but the replacement did not constitute an appreciable improvement. The Company claimed a deduction in computing its profits for Income Tax purposes of the cost of removing the old chimney and building the new one.
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> On appeal before the Special Commissioners it was contended for the Company that the chimney was an integral part of a unit, which unit was the factory as a whole; that the expenditure on the new chimney was

(1) (1950-2) 32 T.C. 513.

to maintain the revenue-earning capacity of the factory; and that removal of the old chimney was in the nature of a repair. It was contended on behalf of the Crown that the replacement of the chimney was capital expenditure; that the expenditure incurred should be borne by the owner as such and not by the trader; and that any deduction should be given under Rule 8(*a*) of No. V of Schedule A, and not under Schedule D. The Commissioners held that the cost of replacement of the chimney was capital expenditure but allowed the cost of removing the old chimney.

Held, that the whole cost of replacing the chimney (including the cost of removing the old chimney) was an admissible deduction.

In that case the Lord President (Cooper) said at page 518:

. . . but so far as this case is concerned the facts seem to me to demonstrate beyond a doubt that the chimney with which we are concerned is physically, commercially and functionally an inseparable part of an "entirety", which is the factory. . . It is doubtless an indispensable part of the factory, doubtless an integral part; but none the less a subsidiary part, and one of many subsidiary parts, of a single industrial profit-earning undertaking.

So viewing the matter I am unable to see why the expense incurred in relation to this transaction should not be treated as an admissible revenue expenditure on repairs, and I am in part influenced in reaching that conclusion by the fact that the factory as a whole is insured for something in the region of £165,000 whereas the expense incurred in taking down the old chimney and building the substitute is only a matter of £4,300 or about 2 per cent. The line of approach which in a case of this kind impresses me as preferable to that adopted by Rowlatt, J., is that which was taken by the Privy Council in *Rhodesia Railways, Ltd.,* [1933] A.C. 368, which although relating to quite a different type of subject seems to me to afford a sounder basis in authority, in so far as authority is needed, for the contention which the Company has brought before us.

It is of particular interest to observe that the Lord President was influenced in reaching his conclusion by the fact that the expense incurred in taking down the old chimney and building the substitute represented about 2 per cent. only of the fully insured value of the factory as a whole. Lord Carmont, who agreed with the opinion of the Lord President, was apparently influenced by the same consideration as shown by the concluding paragraph of his opinion: "The money value of the renewal was relatively insignificant. . . ." The other member of the Court, Lord Russell, gave no separate opinion but expressed himself as in full agreement with the opinions of the other members of the Court.

It may be conceded that as a general rule repairs necessitated by the wear and tear of equipment used in the business are allowed as deductions, although no specific refer-

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ence is found in the *Income Tax Act* regarding "repairs". It may also be conceded that in normal circumstances the repairing of machinery frequently involves the necessity of *replacing* worn-out parts. But I think it is clear that if the outlay brings into existence a capital asset, such as a new piece of machinery, such outlay will not be allowed as a deduction.

In the instant case I have reached the conclusion that the outlay in question did bring into existence a new capital asset, namely, the new engine. The evidence is that the old engine was in use for at least five years and at the end of that period still had a substantial commercial value. It is probable that the new engine would have a useful life of at least the same number of years. The expenditure therefore brought into existence an advantage for the enduring benefit of the trade and which should be considered to be a capital asset (*Minister of National Revenue v. Dominion Natural Gas Co. Ltd.* (1)). In reaching the conclusion that the outlay was not one on revenue account, I am influenced in part, as were the members of the Court of Session in the *Samuel Jones* case (*supra*), by the magnitude of the outlay when related to the value of the power shovel as a whole. As pointed out above, the total cost of the new engine exceeded the written down value of the shovel as a whole after deducting all capital cost allowances made to the end of the appellant's taxation year 1953.

It seems to me, also, that to allow a deduction in full as an operating expense of an outlay such as this and which brought into existence a new capital asset, would be to frustrate the clear intent of the provisions of s. 11(1)(*a*) and the regulations passed thereunder in regard to capital cost allowances. As I have stated above, claims for capital cost allowances were made in previous years in respect of the power shovel as a whole and were allowed. It was considered as a capital asset and having been purchased with the engine was treated as one asset. If, for example, the appellant had purchased separately a drill and an engine to operate it, it would have been entitled to claim capital cost allowances in respect of each. If, after a few years' use, it had been considered advisable to replace that engine with a new one, the appellant would have been

(1) [1941] S.C.R. 19.

required to bring into account the amount received on the sale so that depreciation already received might (in a proper case) be recovered, and also the cost of the new engine, so as to ascertain the amount to which the fixed rate of depreciation would be applied. I am unable to conclude that it should be otherwise merely on the ground, as in the instant case, that the engine was installed in the power shovel. The engine clearly was a marketable entity, readily detached from the power shovel by the removal of a few bolts, and capable of being used for other purposes. I am of the opinion that under the *Income Tax Act* and the special provisions relating to capital cost allowances, the sale of a capital asset—or of a substantial part thereof as in the instant case—and the replacement of the asset or part so sold by the acquisition of a new asset or such part, must be dealt with only as has been done in this case by the respondent in assessing the appellant.

I have not overlooked the evidence given by the witness J. S. Clark on behalf of the appellant. He has been a public accountant for twenty years and the auditor of the appellant company since its formation. He was of the opinion that it was in accordance with good business and accounting practice to charge the net cost of the engine as an operating or maintenance expense of the year. He said that when a replacement or repair did not add to the value of the asset, the outlay in respect thereof should be regarded as an operating or maintenance expense. He stated that he relied on the authority of Professor Smails' book on Public Accounts but did not supply me with the precise reference. I shall have a word to say later in regard thereto.

Even if the test suggested by the witness be correct, it does not support the appellant's case when one considers the facts. It could scarcely be denied that the installation of the new engine did add to the value of the power shovel. The difference in value of the old and new engines as shown by the conditional sales contract was approximately $5,000, and surely that must have increased the value of the shovel by a very substantial amount.

As I have been unable to find the Canadian textbook of Professor Smails referred to by the witness Clark, I think that he probably had in mind that author's text on Account-

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ing Principles and Practice. In the 5th Edition of 1954, the author, in commenting on the distinction between capital expenditures and revenue expenditures, states the modern view by referring to two American authors, as follows:

> The modern view can best be expressed by quotation from two American authors. "One phase of the distinction between capital and revenue is presented by the terms 'capital expenditure' and 'revenue expenditure.' The former relates to an expenditure for property of a life duration extending over several accounting periods, the latter to an expenditure for property which will be consumed within one accounting period. This particular distinction is perhaps not especially significant; it refers to the first classification of expenditures between those expected to be charged against revenue, and those expected to be charged to an asset account and thus carried forward into succeeding periods. The really important distinction between capital and revenue charges is that which is effectuated at the end of the accounting period, when all the accounts are reviewed for the purpose of separating consumed costs from unconsumed costs." (T. H. Sanders, *Progress in Development of Basic Concepts*, p. 13.)
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> "Some writers have suggested that the distinction between capital and income is a fundamental principle of accounting. However, the distinction in accounting today between so-called capital expenditures and income expenditures does not rest on any such essential difference in the nature of the property acquired as that between land and other property which is often stressed in the field of economics. The distinction rests rather upon the relation between the length of the useful life of the property acquired and the length of the accounting period for which income is being determined. A capital expenditure is one, the usefulness of which is expected to extend over several accounting periods. If the accounting period were increased from the customary year to a decade, most of what is now treated as capital expenditure would become chargeable to income, while if the period were reduced to a day, much of what is now treated as current maintenance would become capital expenditure." (G. O. May, Financial Accounting, p. 45.)

I need not comment on this opinion of Professor Smails except to state that it does not warrant the interpretation placed thereon by the witness Clark. It does seem, however, to support the view which I have expressed that the outlay for the purchase of the new engine would properly be considered in accounting practice as a capital expenditure because of the enduring nature of the new asset.

For these reasons, I am of the opinion that the appeal fails. Accordingly, it will be dismissed and the assessment affirmed. The respondent is entitled to costs after taxation.

*Judgment accordingly.*