1957
June 20
Aug. 30

SEAGULL STEAMSHIP COMPANY OF CANADA LIMITED ..... APPELLANT;

AND

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

Revenue—Income tax—Deductions—Repairs to ships followed by sale—Outlay for purpose of gaining or producing income or payment on account of capital—The Income Tax Act, S. of C. 1948, c. 52, s. 12(1)(a),(b)—Depreciation and special charge against profits allowed on ships purchased from Crown—Ships subsequently sold—Proceeds of disposition used for replacement under conditions not satisfactory to Canadian Maritime Commission—The Income Tax Act, s. 20(1)—Canadian Vessel Construction Assistance Act, R.S.C. 1952, c. 43, ss. 3, 4.

The appellant steamship company in 1947 purchased three ships from the Crown, *La Grande Hermine, Saint Malo* and *La Petite Hermine,* but as they were under bareboat charter *La Grande Hermine* was not turned over to the appellant until March and the other two ships until May, 1951. Prior to taking delivery, the appellant arranged to have the ships surveyed and repaired in Germany. Repairs to *La Grande Hermine* were completed in May. The repairs to the other two ships, employed as cargo carriers until August, were completed in September. While *La Grande Hermine* was under repair, she was inspected by a prospective purchaser who executed agreements of sale to purchase her and the *Saint Malo,* subject to equivalent repairs being made to the latter, title to pass on delivery. Pursuant to the agreement, *La Grande Hermine* was delivered in June, the *Saint Malo* in September.

In its 1951 income tax return the appellant deducted the expense of the surveys and repairs and a further sum of $5,962.20 as "depreciation recaptured" under s. 4(1) of the *Canadian Vessel Reconstruction Act,* R.S.C. 1952, c. 43. The Minister disallowed the deductions and ruled: (i) that the expense items were not made or incurred for the purpose of gaining or producing income within the meaning of the exception to s. 12(1)(*a*) of the *Income Tax Act* but to comply with the provisions of the agreements for sale and constituted payments on account of capital under s. 12(1)(*b*); (ii) that the amount claimed for "depreciation recaptured" was properly added to the taxpayer's income pursuant to s. 20(1) of the Act.

Before this Court the appellant argued that the payments for the surveys and repairs constituted outlays for the purpose of gaining or producing income from its business within the meaning of s. 12(1)(*a*) of the Act. As to the "depreciation recaptured", it submitted that as the proceeds from the sale were used for replacements under conditions satisfactory to the Canadian Maritime Commission, s. 20 of *The Income Tax Act* pursuant to s. 4(1) of the *Canadian Vessel Construction Assistance Act,* was not applicable.

Held: That the appellant's decision to repair the ships was made prior to its entering into the agreements of sale.

2. That the expenses were incurred for the purpose of producing or gaining income from the taxpayer's business and were of a temporary and recurring nature, and not capital outlays and therefore deductible from its income.

3. That as the appellant failed to establish, as required by s. 4(1) of the *Canadian Vessel Construction Assistance Act,* that the proceeds of disposition arising from the sale of the ships had been used for replacement under conditions satisfactory to the Canadian Maritime Commission, s. 20(1) of the *Income Tax Act* applied and the "depreciation recaptured" was properly added to the appellant's taxable income.

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

The appeal was heard by the Honourable Mr. Justice Fournier at Montreal.

Roger Letourneau, Q.C. and *Renault St. Laurent, Q.C.* for appellant.

John Ahern, Q.C. and *Paul Boivin, Q.C.* for respondent.

FOURNIER J.:—This is an appeal and a cross-appeal from a decision of the Income Tax Appeal Board (1) dated February 15, 1954, allowing only in part the appellant's appeal against its tax assessment for 1951.

The appellant is a company which owns and operates steamships and also investments in the capital stock of other steamship companies. It derives its income from freight and charter revenue. In its income tax return for the year 1951 the appellant claimed that it was entitled, in computing its taxable income, to deduct as an expense the sums paid for the repairs of two of its ships, S.S. *La Grande Hermine* and S.S. *Saint-Malo,* along with Lloyd's Surveyor's fees and expenses while attending special surveys of the above vessels and legal fees, and it reported an operating loss of $38,533.32.

In assessing the appellant, the Minister, as appears from the notice of re-assessment dated January 23, 1953, considered that for the year 1951 the appellant had a taxable net income of $17,833.56, thus converting the reported net loss of $38,533.32 into a taxable income of $17,833.56 by disallowing as a deduction, in computing the appellant's

(1) 10 Tax A.B.C. 161; (1954) 54 D.T.C. 158.

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income, the following expenses and adding an amount for depreciation recaptured:

Repairs to S.S. *La Grande Hermine*		$ 12,280.51
Repairs to S.S. *Saint-Malo*		50,077.85
Survey expenses re S.S. *La Grande Hermine*		791.93
Survey expenses re S.S. *Saint-Malo*		792.47
Depreciation recaptured		5,962.20
Legal fees		1,505.34
		$ 71,410.30
Less:		
Portion of unabsorbed 1948 loss	$7,803.03	
Unabsorbed 1950 loss	7,240.39	$ 15,043.42
		$ 56,366.88
Less reported loss for 1951		38,533.32
Net taxable income		$ 17,833.56

The appellant objected to the assessment, with the exception of the item of $1,505.34 for legal fees, but the Minister confirmed it. The appellant then appealed to the Income Tax Appeal Board, which allowed the appeal, but only in part. It is from that decision that the appeal and cross-appeal to this Court were brought.

The Minister disallowed the expense items on the ground that they were not made or incurred by the appellant for the purpose of gaining or producing income and added that the amount of $5,962.20 "depreciation recaptured" was properly included in computing the income pursuant to s. 20(1) of the *Income Tax Act*.

So, there are two questions for a decision by the Court. First, are the expenses for the repairs of the two ships and the surveys deductible from income under s. 12(1)(*a*) and (*b*) of the *Income Tax Act*? The second question is the recapture of depreciation. Was it properly added to the appellant's taxable income and in accordance with the provisions of s. 20(1) of the *Income Tax Act* and the provisions of the *Canadian Vessel Construction Assistance Act* (R.S.C. 1952, c. 43)?

The provisions of s. 12(1)(*a*) and (*b*) of the *Income Tax Act* to be considered concerning the first point read as follows:

> 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 depreciation, except as expressly permitted by this Part, . . .

The issue is whether the payments made or incurred by the appellant for the repairs and surveys of its two ships constitute an outlay or expense made or incurred by it for the purpose of gaining or producing income from its property or business within the meaning of the exception expressed in s. 12(1)(*a*) of the Act and outside its prohibition.

The appellant argued for the affirmative, but the respondent contended that the payments for repairs and surveys were made for the purpose of complying with the provisions of certain deeds of sale in respect of the two vessels, in which case the expenses would come under s. 12(1)(*b*) as payments on account of capital.

At the hearing it was agreed by the parties that the admissions, testimony and documents which were made and filed before the Income Tax Appeal Board in 1954 form part of the record before the Exchequer Court and would constitute both the evidence of the appellant before the Court and the cross-examination by the respondent. The only oral evidence on record was adduced by the appellant's two witnesses.

Certain facts were established, others not in dispute. I will summarize them. The appellant, a company which owns and operates steamships and derives its income from freight and charter, became the owner of three ships, *La Grande Hermine, Saint-Malo* and *La Petite Hermine,* which it purchased from the Crown on October 16, 1947. At the time of the purchase *La Grande Hermine* and the *Saint-Malo* were under bareboat charter with the Dominion Shipping Co. The bareboat charter agreement had been made and concluded on April 10, 1946, for a period of about five years. The agreement then was to

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end some time in April 1951. In effect, the appellant took delivery of *La Grande Hermine* on March 1, 1951, and of the *Saint-Malo* on May 17, 1951.

When it became apparent—some time about the end of 1950—that the charterers would give back the ships, the appellant prepared a program for the repairs of the two vessels and other ships of their fleet and started negotiations to have them repaired. Having found out that the repairs would be more costly in Canadian shipyards than in European countries, it negotiated and contracted to have them repaired in Germany.

S.S. *La Grande Hermine* was repaired at Hamburg, Germany, from April 14 to May 20, 1951. Before the repairs had been undertaken or completed, she was chartered to carry cargo from Germany to the United States and thereby earned income for the appellant. The *Saint-Malo* was received on May 17, 1951, and from that date up to August 20, 1951, when it went into the shipyards for repairs, it was operated by the appellant to carry cargo, but after the repairs were completed it was immediately delivered to new owners.

After it was agreed that the two vessels would be returned to the appellant and that *La Grande Hermine* had been received and put into shipyards for repairs and that the *Saint-Malo* was waiting its turn to enter the shipyards for repairs, the appellant, on May 11 and 14, 1951, agreed to sell and the Panama Shipping Co. Inc. agreed to purchase the two vessels, title to pass on delivery. It would seem that the purchaser had inspected *La Grande Hermine* at Bremerhaven and had found her condition to be satisfactory. As to the *Saint-Malo,* the buyer had made a preliminary inspection of the vessel and found her condition satisfactory, subject to . . . "making such repairs, replacements and alterations and outfit the vessel, all in the same manner and to the same extent and to effect the same capacities as was done by the seller at Bremerhaven to the S.S. *La Grande Hermine,* which latter vessel, after such similar conversion and outfitting at Bremerhaven, was recently inspected by the buyer and contract made for her purchase (see agreement of May 14, 1951, between appellant and Panama Shipping Co.

Inc.)." *La Grande Hermine* was delivered to the purchaser at Baltimore, U.S.A., on June 22, 1951, and the *Saint-Malo* on September 18, 1951, at Bremerhaven, Germany.

It was established that the payments made for the repairs of the two vessels and disallowed were only part of the amount expended for the repairs and did not comprise the cost of converting the ships from coal burner to oil burner. The amounts spent and paid which were disallowed were made so that the vessels could produce income, avoid losses in their operation and meet the requirements of the *Canada Shipping Act*. The repairs were also necessitated to obtain Lloyd's classification 100 A.1 and to be insurable.

The real difficult question to be answered is whether the repairs to the ships were decided upon and contracted for before negotiations were undertaken or agreement arrived at to dispose of the ships or whether they were made to comply with the agreement of sale. What are the facts?

There is evidence that it became apparent by the end of 1950 that the vessels would be returned to the appellant some time in the spring 1951. The appellant then proceeded to have ships repaired. Necessary steps to that effect were taken. Delivery of S.S. *La Grande Hermine* was made on March 1, 1951; she entered the shipyard on April 14 and the repairs were completed on May 20, 1951. She was chartered on May 5, 1951, to carry cargo and delivered to the new owner on June 22, 1951.

What was the evidence as to the *Saint-Malo?* She was delivered to the appellant on May 17, 1951; she entered the shipyard on August 20, was repaired and delivered to the new owners at the beginning of September.

A third ship, S.S. *La Petite Hermine*, which was not sold in 1951, was delivered about the same time, was repaired and continued to be operated by the appellant. The repair expenses were considered deductible.

Now, as to the evidence in respect of the sale of these vessels. At the hearing the agreement for the sale was filed; it was dated May 11, 1951. *La Grande Hermine* was delivered to the purchasers on June 22, 1951. The agreement for the sale of the *Saint-Malo*, dated May 14, 1951, was filed. She was delivered to the purchasers in September.

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There remains the uncontradicted testimony of Mr. Papachristidis to the effect that long before the sale of the two vessels the repairs had been decided and acted upon for the purpose of having them operated by the appellant and producing income from its business. Maintenance repairs, alterations and conversion changes were made not only to the two vessels in question but also to a third vessel of the same class. However, only the amounts paid or incurred for the maintenance and operating repairs were claimed as deductions. In the case of the two vessels sold they were disallowed, but were allowed in the case of the third vessel because it was not sold.

The above facts and a careful consideration of the evidence have convinced me that the repairs were decided and acted upon before negotiations were undertaken or agreement arrived at to dispose of the two vessels. If this were not so, how explain the repairs, alterations and conversions made at about the same time to the third vessel, which after the execution of these works was operated by the appellant for the purpose of gaining income from its business.

Furthermore, I am of the opnion that the outlays which were claimed as deductions were incurred for repairs of a maintenance character and not of a capital nature.

Would these findings be sufficient to conclude that these outlays are deductible from income for tax purposes within the exception contained in s. 12(1)(*a*) of the *Income Tax Act?*

Let us consider this section with s. 6(1)(*a*) of the *Income War Tax Act.*

The exception contained in s. 12(1)(*a*) applies to outlays made or incurred for the purpose of producing or *gaining income.*

The exception in s. 6(1)(*a*) would apply to disbursements or expenses wholly, exclusively and necessarily expended for the purpose of earning the income.

There is no doubt that the extent of the deductible outlays is far greater in the first instance than in the second. Under s. 6(1)(*a*) the deductibility was based on the test that the disbursements were made necessarily, exclusively and wholly for the purpose of earning income

whilst in this case the purpose of the expenses for earning income made in accordance with the ordinary principles of business and practices of accounting would bring them under the provision of s. 12(1)(*a*) relating to deductibility. This in my opinion would meet the definition of *annual profit or gain* of s. 3 of the Act. This principle for the computation of profits or gains was expressed by Lord Halsbury L. C. in *Gresham Life Assurance Society v. Styles* (1) as follows:

> Profits and gains must be ascertained on ordinary principles of commercial trading.

In the present instance it would seem that the expenses were incurred by the appellant in a way which would have commended itself to any owner of commercial ships desirous of operating them for gaining or producing income from its property or business. I believe it was good business, because the appellant had decided to use the ships itself for carrying freight or leasing them to others. To my mind it is immaterial that after incurring the expenses to have the repairs made it became more advantageous for the appellant to dispose of the ships rather than operate them. If this reasoning is wrong, s. 12(1)(*a*) would receive application only in cases where outlays were made and income had resulted from such outlays, which would contradict decisions where expenses were deductible in the year although no gain or profit from the business was made during that year and would exclude outlays or expenses incurred.

The test, when expenses are made or incurred for recurring maintenance repairs, is that the outlays or payments were made or incurred *for the purpose.* It is the purpose which is essential, but the purpose must be that of making profit from the taxpayer's business or property.

When the evidence establishes that expenses were incurred for a purpose and that the purpose is to produce or gain income from the taxpayer's property or business and that the expenses were of a temporary and recurring nature, and not capital outlay, such expenses should be deductible from the taxpayer's income. This is what I find in this case on the evidence adduced.

(1) [1892] A.C. 309 at 316.

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I would distinguish this case from that of the *Montship Lines Ltd. v. Minister of National Revenue* (1) wherein Cameron J. found that the outlays were not made for the purpose of gaining income but to comply with agreements of sale. The headnote reads:

> In 1948, the appellant company which operated a number of freight vessels sold two vessels while they were undertaking a voyage on its behalf. Under the agreements of sale both vessels were to be delivered to the purchasers in Lloyd's 100 A-1 class. Upon completion of their respective voyages the vessels went into dry dock and there certain repairs were made before their delivery . . . On the facts the Court found that the repairs were maintenance repairs, . . .

The learned judge held that the sole purpose of the appellant in incurring the expenses was to comply with the requirements of the agreements of sale.

In this case no such agreement existed at the time the appellant decided to have the repairs made. The uncontradicted evidence and a careful perusal of the documents filed would indicate that the appellant had decided to operate the vessels itself and thought it advisable to incur expenses for repairs in order to increase its income from their operation. It was only after putting the first vessel in dry-dock for repairs that it was disposed of. As to the second, it had decided on the repairs and had incurred expenses before agreeing to sell it. On the facts I cannot agree with counsel for the respondent that the repairs were made and paid for to comply with the agreements. The fact is that the appellant had three of its vessels repaired, one of which was sold while it was in dry-dock, another was sold before going into dry-dock and the third was repaired but not sold. The three vessels had been received at about the same time as the bareboat charter lapsed and arrangements had been made for their repairs prior to their being received. No agreements of sale existed when this was taking place. The Minister refused to deduct the outlay for repairs on the first two vessels but allowed as deduction the outlay for the repairs of the third. Why discriminate? Because the first two were sold. I do not believe the sales at the time they were agreed upon could change the fact, which was established, that expenses had been incurred for the purpose of gaining income from its business.

(1) [1954] Ex. C.R. 376.

For these reasons, I find the sums expended for repairs and surveys should be deducted from the appellant's income for taxation purposes and dismiss the cross-appeal.

As to the second point relating to the depreciation recaptured.

The Minister, in his re-assessment of the suppliant's income, added, for the year 1951, the sum of $5,962.20 as depreciation recaptured in accordance with the provisions of s. 20(1) of the *Income Tax Act* which reads as follows:

20. (1) Where depreciable property of a taxpayer of a prescribed class has, in a taxation year, been disposed of and the proceeds of disposition exceed the undepreciated capital cost to him of depreciable property of that class immediately before the disposition, the lesser of

(*a*) the amount of the excess, or

(*b*) the amount that the excess would be if the property had been disposed of for the capital cost thereof to the taxpayer,

shall be included in computing his income for the year.

The appellant contends that the above section does not apply to these vessels. They had been purchased from the Crown, then sold to a third party. The proceeds of the sales had been deposited in escrow and later transferred to other parties which "used them for replacement under conditions satisfactory to the Canadian Maritime Commission." Under these conditions and in view of the provisions of s. 4(1) of the *Canadian Vessel Construction Assistance Act* s. 20(1) of the *Income Tax Act* was not applicable.

This section reads as follows:

4. (1) Where a vessel in respect of which an allowance has been made under section 3, or in respect of which "special depreciation", "extra depreciation" or allowances in lieu of depreciation were allowed for the purposes of the *Income War Tax Act* or the *Income Tax Act*, is disposed of, subsection (1) of section 20 of the *Income Tax Act* does not apply in respect of the proceeds of disposition to the extent that they are used for replacement under conditions satisfactory to the Canadian Maritime Commission.

The appellant submits that s. 3 hereinabove referred to applies to its vessels, because they belong to a class of depreciable property to which s. 20(1) of the *Income Tax Act* refers.

The above amount of $5,962.20, described as depreciation recaptured, is part of a larger sum of $41,448.67 which the appellant had been allowed to deduct from its 1947 profits,

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pursuant to the provisions of a memorandum issued by the Deputy Minister of National Revenue, Inspector of Income Tax, under date of January 10, 1946, and relates to depreciation on ships. Paragraph 3 applies to ships purchased from the War Assets Corporation.

> 3. In addition to the depreciation allowances set out in 1 and 2 above, a special charge may be made against profits on the cost of ships purchased from the War Assets Corporation or other Crown companies at the rate of 13%. This allowance may only be permitted in the first year the ship is acquired.

The last paragraph of the memorandum summarizes the regulations of depreciation, namely:

> The rate applicable to all ships has been increased from 4% to 6%; ships purchased in the period between November 10, 1944, and December 31, 1946, are eligible for depreciation at not more than double the rate normally allowed, i.e. 12%, and a special allowance of 13% is permitted on ships purchased from the War Assets Corporation or other Crown companies in the first year of operation only. Thus, on a ship acquired from the War Assets Corporation, depreciation is permitted to a maximum amount of 12% in subsequent years until 80% of the cost of the ship has been written off, after which the normal rate of 6% will apply.

So in 1947, the first year of operation of the appellant's two vessels, a total depreciation of 25% was allowed on their cost. It is clear, by this last paragraph that the special charge made against profits on the cost of the ship is depreciation calculated on the cost of the vessels. Though the memorandum describes the 13% as a special charge, I believe it is an allowance in lieu of depreciation. The words "a special charge may be made against profits" means that in computing a taxpayer's taxable income an amount equal to 13% of the cost of the ship may be deducted from his profits. The principle of recapturing depreciation applies to allowances in lieu of depreciation, as it does to special, extra or double depreciation.

Depreciation, in computing taxable income in 1947, is dealt with in s. 6(1)(*n*) of the *Income War Tax Act*.

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
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> * * *
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> (*n*) depreciation, except such amount as the Minister in his discretion may allow.

The memorandum of regulations relating to depreciation of ships was without doubt issued pursuant to the power and discretion provided for in the above section

of the Act. If not, I do not know of any other section of the Act which deals with this subject. This being the case, the appellant benefited from a charge against its profits on a depreciation based on the cost of its vessels, which depreciation could be recaptured under certain circumstances, unless specifically exempted by some provision of law.

There would be no doubt concerning the appellant's contention if it was established that "the proceeds of the disposition of the two vessels to the extent that they were used for replacement 'were made' under conditions satisfactory to the Canadian Maritime Commission."

What is the evidence on this point? In the preamble of agreement of sale of the vessels by His Majesty the King in the right of Canada to the appellant it is stated.

> Whereas the said ships were sold by His Majesty to the shipowner on a deferred payment basis with the object of creating and developing a privately-owned Canadian ocean-going merchant fleet by Canadians for the benefit of Canada at large; (See Replacement and Escrow Agreement on file).

The vessels were later sold to a foreign corporation and registered under a foreign flag. The proceeds were deposited in escrow under control of the Canadian Maritime Commission. The proceeds were then sold, assigned or transferred to third parties which used them to construct vessels of other types than those mentioned in the above preamble. In other words, the proceeds were not used to fulfil the object which the Crown had in mind at the time of the sale. Nothing in the agreements barred the use of the proceeds in such a way, but it is clear that such a use of the proceeds did not meet the object specified in the agreement of sale.

The approval of the transactions by the Commission was made with the reservation that the question of whether the appellant would qualify under s. 4 of the *Canadian Vessel Construction Assistance Act* would be taken up later. In a letter dated March 7, 1953, the Commission informed the appellant that a certificate stating that the proceeds of disposition of the vessels had been used under conditions satisfactory to the Commission was required by the Income Tax Division before exemption would be allowed from the provisions of s. 20 of the *Income Tax*

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Act. The Commission had decided that it would not issue such certificate in cases where the proceeds of disposition were assigned to be used towards the construction of ships other than ocean-going vessels. I believe that the decision was based on the object described in the preamble of the agreement of sale. This seems to me to be a valid reason for declaring that the funds were not used under satisfactory conditions.

I find that the amount of $5,962.20, depreciation recaptured, was properly added to the appellant's taxable income for the year 1951.

The appeal is allowed in part, the assessment vacated, the sums of $13,072.44 and $50,870.32 directed to be deducted from the appellant's taxable income for the year 1951 and the matter referred to the Minister for re-assessment accordingly, with costs to be taxed in the usual manner. The cross-appeal is dismissed.

Judgment accordingly.