1961

Feb. 20 & 28

Sept. 11

BETWEEN:

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

AND

UNITED AUTO PARTS LIMITED .....RESPONDENT.

Revenue—Income tax—Income Tax Act 1948, S. of C. 1948, c. 52, ss. 11(1)(c), 12(1)(c), 42(6) and 124(12)—The Income Tax Act, R.S.C. 1952, c. 148, ss. 11(1)(c), 12(1)(c), 46(7) and 136(12)—Deductions—Interest on debentures—Validity of assessment—Defect in notice of assessment—Appeal allowed.

Respondent company, a dealer in auto parts, bought and sold them to the general public at a profit and also to companies it controlled. In October, 1946, it borrowed $1,060,000 at 4½% interest from a bank and in December of the same year purchased several companies dealing in auto parts at a cost of $988,029. In December 1947 it issued debentures amounting to $1,000,000 bearing 3½% interest and sold them to its bank which applied most of the proceeds in reduction of the company's bank loan. Respondent claimed a deduction for the interest paid on these debentures which deduction was disallowed by the appellant on the ground that the proceeds were not used to earn income from a business or property under s. 11(1)(*c*) of the Act but were used to acquire property the income of which was exempt and that s. 12(1)(*c*) applied. An appeal to the Tax Appeal Board was allowed and from that decision the Minister appeals to this Court. The respondent contends that the proceeds from the debenture issue had no connection with the purchase of shares of subsidiaries because the shares had already been bought and paid for in the previous year. The Minister at the hearing of the appeal from the Tax Appeal Board introduced new evidence which showed that the debentures issued in April, 1947 had been antedated to August 1, 1946. A subsidiary point raised was

that the notice of assessment bore the facsimile signature of a person who was no longer the Deputy Minister of National Revenue for Taxation at the time.

Held: That the appeal must be allowed.

2. That the respondent and its officers treated the debentures in the same manner as if they had been issued in August, 1946, when no bank loan existed and the debenture issue was contemplated when the loan was effected.

3. That the proceeds of the debentures were not used for the purpose of earning income from a business or property within the meaning of s. 11(1)(*c*) of the Act, and respondent was not entitled to deduct the interest payable on the debentures.

4. That any defect that may have existed in the assessment notice was remedied by s. 42(6) now s. 42(7).

APPEAL from the Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Kearney at Montreal.

Lovell C. Carroll, Q.C. and *Paul Boivin, Q.C.* for appellant.

Neil F. Phillips and *Ivan E. Phillips* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

KEARNEY J. now (September 11, 1961) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board rendered on June 26, 1953[1].

In computing its income tax return for the year 1950, the respondent, on the ground that it represented interest on borrowed money used for the purpose of earning income from its business, claimed as a deduction an amount of $24,500 paid out as interest on serial debentures which it issued in 1947 amounting to one million dollars. By notice of assessment, the appellant disallowed the said deduction, the respondent objected thereto, but on review the assessment was confirmed by the appellant. The Board, in its decision, allowed the appeal and the deduction sought and referred the matter back to the Minister for reassessment accordingly.

On October 31, 1946 the respondent borrowed on call loan from the Bank of Toronto $1,060,000 bearing interest at 4½ per cent and on that date $988,029 thereof was used by the respondent in respect of a purchase, as later described,

[1] 8 Tax A.B.C. 358.

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of all the outstanding shares of several companies which were engaged in a similar business to its own. Debentures amounting to $1,000,000 were issued by the respondent on April 2, 1947 and sold to the same Bank, which applied $988,029 thereof in reduction of and in substitution *pro tanto* of the respondent's outstanding call loan. The connection, if any, between the shares purchased and the proceeds of the debentures to the extent of $988,029 and the consequences which follow in either event constitute the main issues in the present case.

The applicable provisions of the *Income Tax Act*, S.C. 1948, c. 52, are ss. 11(1)(*c*) and 12(1)(*c*), which read as follows:

> 11 (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:
>
> (*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income) pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or
>
> (ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt) or a reasonable amount in respect thereof, whichever is the lesser;
>
> 12 (1) In computing income, no deduction shall be made in respect of
>
> (*c*) an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt.

The parties agreed that the evidence and argument before the Tax Appeal Board should form part of the record, and it was filed as Exhibit 1; and in addition, as not infrequently happens in an appeal such as this, which is in reality a trial *de novo*, the appellant adduced new evidence which was not before the Board.

It appears by the evidence given before the Board that the respondent, as its name implies, is engaged in various facets of the auto parts business. It purchases this type of merchandise from manufacturers and sells it at a profit partly to the general public and partly to such subsidiary companies which it may own or acquire. It likewise derives

income from management fees which it charges to its subsidiaries. Since it supplies the inventory required by its subsidiaries as well as its own, the volume of its purchases is large and it is, consequently, able to obtain discounts or reduced prices from the manufacturers, the larger the volume the larger is the reduction. It does not pass on the benefit of the discounts it receives to its subsidiaries but charges them a set up price approximately equal to the purchase price which these various subsidiaries would have been required to pay had they individually made such purchases themselves.

The new evidence was introduced by the appellant for the purpose of disproving the respondent's contention that the debentures issued in 1947 and subsequent interest paid thereon had no connection with the purchase of the newly acquired shares of the subsidiary companies and that they were part-payment of one continuing transaction. This evidence consisted of Exhibits 2, 3, 4 and 5 comprising extracts from the respondent's books of account which include a copy of its balance sheet and auditors' report for the year 1946, minutes of directors' meetings held in December 1946 and February 1947.

Perhaps the most revealing part of this new evidence is Exhibit 4. It contains a copy of the minutes of a meeting of the directors of the respondent company held on December 27, 1946. There were present all of the three directors of the company and Mr. Charles E. Préfontaine acted as president. Mr. Préfontaine stated to the meeting that he was then the owner of all the capital shares of five companies (previously referred to as subsidiaries), which he offered to sell to the respondent company for $1,115,769, on account of which the respondent had already paid to his exoneration the sum of $1,026,829.

It appears from the evidence taken before the Board that the shares of the five above-mentioned companies were closely held but not by Mr. Préfontaine. So it is clear that Mr. Préfontaine must have acquired four of them with monies supplied by the respondent, which it had borrowed from the Bank. This appears by Exhibit 2 (p. 3), which is

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an extract from the respondent's general ledger entitled: "Account C. E. Préfontaine re Purchase of Shares Affiliated Co's Account", which shows that on October 31, 1946 his account was debited with $988,829.09, which was cancelled by a credit entry for the same amount on the same day.

Minutes also show that in addition Mr. Préfontaine offered to sell all the issued shares of about twenty-five other companies, of which he himself had been the owner for some time and most of which were regional offshoots of the respondent company, for a sum totalling $427,308; and at the same time he offered to subscribe for 28,866 common shares and 5,000 preferred shares of the respondent company for a total amount of $543,077. The directors voted in favour of accepting the two above-mentioned offers, Mr. Préfontaine abstaining. The latter transaction is also reflected on Exhibit 2, p. 3. As a result of the aforesaid transactions, the respondent's investment in shares of subsidiaries was in excess of $1,500,000.

Exhibit 4 also contains a copy of the minutes of the meeting of directors of the respondent company held on the 12th of February 1947, whereat a special borrowing by-law was enacted which, *inter alia,* authorized the directors to borrow money upon the credit of the company and, by trust deed, to create and issue debentures up to an aggregate amount of $1,000,000 at such rate of interest, maturity and redemption as the directors may see fit to approve.

The minutes of a subsequent meeting of directors held on the 17th of February 1947 show that the above-mentioned special by-law has been approved at a meeting of shareholders held on February 15, 1947 and that the directors passed a resolution creating serial debentures not exceeding $1,000,000. A draft trust deed was likewise approved, subject to such changes, additions and variations as may be approved by the president and vice-president of the company prior to the execution thereof, and a trustee appointed. The debentures were to be dated August 1, 1946 and bear interest at 3½ per cent per annum. It appears that subsequently a provision for their redemption, at the rate of $100,000 per year, dating from August 1, 1946, was inserted in the trust deed.

A short time after the above meeting, namely, on April 2, 1947, another meeting of directors was held, an extract from which was filed before the Board as Exhibit 2, which reads in part as follows:

It was resolved:

That the company sell at par to the Bank of Toronto debentures of this company for $1,000,000.00 such debentures bearing interest at the rate of 3½% per annum, secured by a trust deed of hypothec, mortgage and pledge bearing formal date of August 1st 1946, executed by this company in favor of Crown Trust & Guarantee Co. as trustee on the 2nd of April 1947, before Lionel Leroux, notary.

That this company having received from the Bank of Toronto payment in full of the said amount of $1,000,000.00 does hereby authorize the Crown Trust & Guarantee Co. to deliver to the Bank of Toronto such debentures for an amount of $1,000,000.00.

That the President be and is hereby authorized to instruct the Crown Trust & Guarantee Company accordingly.

Page 1 of Exhibit 2, which is an extract from the Company's general ledger dealing with its bank loan, indicates that as of August 31, 1946 the respondent company had no bank loan and that the bank loan of $1,060,000 with which we are concerned was obtained on October 31, 1946. The ledger also shows that on July 31, 1947 the bank loan was reduced by the proceeds of the debenture issue of one million dollars, and there is no doubt that $988,029 of it cancelled a like amount that the respondent had borrowed on call loan to pay for the shares of the subsidiary companies.

The auditors' report for the year ended December 31, 1946 (Ex. 3) brings into that year the debentures issued on April 2, 1947, and they were antedated to August 1, 1946. This million-dollar-debenture issue also appears on the "liability" side of the respondent's balance sheet as of December 31, 1946 (Ex. 3).

In *Canada Safeway Limited* and *The Minister of National Revenue*[1] at page 727, *in fine*, Rand J. observed:

. . . . in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense.

In order to succeed, I think the respondent has a double burden to discharge. It must prove that the interest paid on the debentures issued in 1947 was not an outlay that may be reasonably regarded as having been incurred in connection with property the income from which would be exempt

[1] [1957] S.C.R. 717.

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within the meaning of s. 12(1)(*c*); and even if this is established, it must also prove that it can be said that the proceeds from the debenture issue were used for the purpose of earning income from a property or business within the meaning of s. 11(1)(*c*). It follows that the case, in a large measure, resolves itself into a question of appreciation of the foregoing evidence.

In my opinion, the proof before me indicates that the Company itself and its officers treated the debentures in April 1947 in the same manner as if they had been issued in August 1946, at which time the respondent had no bank loan. There is no suggestion that on $988,029 of the $1,060,000 which the respondent borrowed on October 31, 1946 it paid any other rate of interest than the 3½ per cent as provided by the debentures. It is important to note that, in contrast with the proof made before the Board, the evidence before me shows that C. E. Préfontaine was the owner of the shares of the entire group of subsidiary companies until December 27, 1946, when the directors of the respondent company authorized their purchase, and that the by-law creating the debentures followed some weeks later.

The provisions of s. 12(1)(*c*) with which we need be concerned read:

> No deduction shall be made in respect of an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred .... in connection with property the income from which would be exempt.

The words "in connection with" are very broad terms, and particularly on the strength of the new evidence and in the absence of any contradictory proof, I think it is not unreasonable to conclude, as the appellant has done, that the debenture issue was contemplated when the loan was effected and that the steps which were taken in the interval form part and parcel of one continuing transaction.

Even if one were to accept the respondent's submission that the proceeds from the debenture issue realized in 1947 had no connection with the purchase of shares of subsidiaries because they had already been bought and paid for in the previous year, I do not see how it can be successfully urged by the respondent that such proceeds were used for the purpose of earning income from a business or property within the meaning of s. 11(1)(*c*)(i) so as to entitle the respondent to deduct the interest paid thereon. In such event, I think

the respondent is precluded from claiming that the repayment had any connection with income in the form of management fees and trade discounts which it was already enjoying because of the purchase of the subsidiary companies, and not one tittle of evidence was offered by the respondent to show that the above-mentioned repayment of the loan was used to produce income in some other form. If the respondent were in the borrowing and lending business—which it is not—any transaction involving repayments of loans might be regarded differently.

Counsel for the respondent relied greatly on the case of *Minister of National Revenue* and *People's Thrift and Investment Co.*[1] I think, in some particulars, the facts in the two cases resemble one another, but they are strikingly different in certain vital respects. In the present case, the lapse of time between the original borrowings from the Bank, which were used to pay for the shares, and the subsequent borrowings from the same party through debentures can be counted in terms of months if not weeks. The corresponding lapse of time in the *Thrift* case has to be reckoned in years. Moreover, in the *Thrift* case, the subsequent borrowings were made from other parties than the original lender. Unlike in the present case, where a retroactive effect was given to the later borrowing which, to all intents and purposes, eliminated the first to the same extent as if it had never been made, in the *Thrift* case it was proven that it was impossible to trace back the later borrowings, which were effected in 1949-1951, or connect them with the purchase of shares made in 1945. In the *People's Thrift* case, the taxpayer's stock-in-trade, so to speak, was that of borrowing and lending money.

For the above reasons I think the respondent has failed to establish that it is entitled to deduct the interest payable on the debentures in question, as contemplated by s. 11(1)(*c*)(i).

I mentioned earlier that by its investment in shares of other companies the respondent stood to derive benefits in its business by way of management fees and trade discounts. It was urged on behalf of the appellant that, regardless of what funds were made use of by the respondent to purchase the shares of subsidiaries, the investment was of a capital

[1] [1959] Ex. C.R. 262.

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nature and the management fees and discounts were only an indirect result therefrom; and that what is contemplated in s. 11(1)(*c*) is the employment or use of borrowed funds which directly result in the earning of income. Because of the conclusion I have already reached, I do not think it necessary to deal with this latter issue.

A subsidiary issue of a technical nature was raised which arose in the following admitted circumstances.

The notice of assessment or reassessment dated January 18, 1952 (see Ex. 1) and mailed to the respondent by the Department of National Revenue in the instant case, bore the name of V. W. Scully, Deputy Minister of National Revenue, Taxation Division. At the date in question Mr. Scully was not the Deputy Minister as above described. The respondent submits that the absence of the name in writing of the person in authority renders the notice of no effect and vitiates all subsequent proceedings taken herein. In support of his denial of this contention the appellant invokes section 42(6), now 46(7), and section 124(12), now 136(12), of the *Income Tax Act*, which read as follows:

> s. 42(6) An assessment shall, subject to being varied or vacated on an objection or appeal under this Part and subject to a re-assessment, be deemed to be valid and binding notwithstanding any error, defect or omission therein or in any proceeding under this Act relating thereto.
>
> s. 124(12) Every document purporting to be an order, direction, demand, notice, certificate, requirement, decision or assessment over the name in writing of the Minister, the Deputy Minister of National Revenue for Taxation, or an officer authorized by regulation to exercise powers or perform duties of the Minister under this Act, shall be deemed to be a document signed, made and issued by the Minister, the Deputy Minister or the officer unless it has been called in question by the Minister or by some person acting for him or His Majesty.

Counsel for the respondent, speaking of the error, observed in his argument before the Board:

> I appreciate it probably issued by reason of a clerical mistake, and the clerical mistake is attributable to the stationery which was used by an old administration, and it was not in the public interest that all this stationery should be used up.

It appears Mr. Scully, who, to common knowledge, had held the office of Deputy Minister of National Revenue, Taxation Division, for many years, was at the date in question *functus officio*. Where facsimiles of signatures are extensively used, errors such as the above described are apt to occur. However,

Exhibit 1, which contains the evidence before the Board, shows that the respondent acted upon said notice of assessment and filed an objection to it, whereupon the appellant, on May 29, 1952, notified the respondent that, having considered its objection, he confirmed the said assessment, and at the bottom of this last-mentioned notice the following inscription is found:

> James J. McCann
> Minister of National Revenue
> (signed)
> Per Charles Gavsie
> Deputy Minister of National
> Revenue for Taxation.

It is not suggested that there is any error or defect in the last-mentioned notice, and I consider that any defect which may have existed in the notice complained of was remedied by the concluding lines of s. 42(6). Consequently, I do not think it necessary to discuss the provisions of s. 124(12).

In the course of his argument, counsel for the appellant conceded that the amount of $24,500 which the Minister disallowed was a little larger than was justified by the facts because it should have been based on the relationship between $988,829.09 and $1,060,000. Another factor which should not be overlooked is that by 1950 $300,000 of the principal amount of the debentures had been repaid.

For the above reasons I think the decision *a quo* should be set aside and the appeal maintained; and I would refer the case back to the Minister for the purpose of reassessment by taking into account the factors previously referred to; and should the parties fail to agree in respect of the reduction to be effected, I will allow counsel to again speak to the matter. Under the circumstances, I do not propose to make any order with respect to costs.

Judgment accordingly.