BETWEEN:

WILLIAMS BROTHERS CANADA LIMITED ..... APPELLANT;

AND

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

1960
June 2
1962
May 22
July 31

Revenue—Income tax—Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(a) and 12(1)(b)—Deductibility of cost of acquiring a construction contract by a contractor—Outlay or expense on account of capital or outlay or expense for purpose of gaining income—Appeal allowed.

Appellant was incorporated for the purpose of constructing pipe lines as a contractor. It acquired the interest of Canadian Pipe Line Construction Co. Ltd. in a joint venture together with some equipment at a total cost of $325,000. The equipment was valued at $95,000 and the Court found that the sum of $230,000 had been paid for the acquisition of the contract to do the construction work. The appellant completed the work called for and in its income tax return for the taxation year deducted the payment of $230,000 to Canadian Pipe Line Construction Co. Ltd. The respondent disallowed the deduction and re-assessed the appellant accordingly. On appeal to this Court the respondent contends that the payment constituted an outlay or expense on account of capital and was therefore barred by ss. 12(1)(*a*) and 12(1)(*b*) of the *Income Tax Act*, and, alternatively, that the appellant had not merely bought a construction contract but had actually purchased an interest in a joint venture or partnership which should be considered as a capital asset.

Held: That the $230,000 was laid out for the purpose of earning the income within the meaning of s. 12(1)(*a*) of the *Income Tax Act* since appellant, a pipe line contractor, in order to earn a profit must first acquire construction contracts before it would be able to complete contracts profitably by performing the work.

2. That no asset or advantage of an "enduring" nature was acquired by appellant and so the deduction was not barred by s. 12(1)(*b*) of the Act.

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3. That the acquisition of an interest in a joint venture by a construction company was not the acquisition of a capital asset because the construction company was in the business of acquiring such interests.

APPEAL under the *Income Tax Act.*

The appeal was heard before the Honourable Mr. Justice Cattanach at Ottawa.*

W. E. P. DeRoche, Q.C. and *J. B. Tinker* for appellant.

R. N. Starr, Q.C. and *P. M. Troop* for respondent.

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

CATTANACH J. now (July 31, 1962) delivered the following judgment:

* The appeal was originally heard before the Honourable Mr. Justice Fournier who died without rendering a decision and re-heard before the Honourable Mr. Justice Cattanach. Counsel shown appeared at both or either of the hearings.

This is an appeal against the appellant's income tax assessment for the taxation year ending April 30, 1953.

The appellant was incorporated under Part I of the Companies Act 1934 by letters patent dated April 5, 1949 under the name of Dokken Pipe Line Construction Limited, which name was changed to that of Williams Brothers Corp. (Canada) Ltd. by Supplementary Letters Patent dated April 26, 1950. By further Supplementary Letters Patent dated December 2, 1959, the corporate name was changed to Williams Brothers Canada Ltd., its present style. The purposes and objects of the appellant are to construct pipe lines as a contractor.

During the year 1952 Trans-Northern Pipeline was incorporated for the purpose of causing to be constructed and to operate a products pipe line from Montreal, Quebec, to Hamilton, Ontario, with a branch line from Farran's Point, Ontario, to Ottawa, Ontario, a total distance of approximately 411 miles. There was considerable competition among pipe line contractors, both Canadian and foreign, to obtain contracts for the building of these lines. The appellant was one of the unsuccessful competitors, the contract being granted to a "joint venture" comprised of Mannix Ltd. and Canadian Pipe Line Construction Co. Ltd.

The particulars of the joint venture between Mannix Ltd. and Canadian Pipe Line Construction Co Ltd. are set out in an agreement dated October 1, 1951, filed in evidence as Document 1 of Exhibit 1, and are substantially that the parties to the joint venture shall enter into a construction contract with Trans-Northern Pipeline Company as joint contractors, that all interest in the property and equipment of the venture and on the profits derived from the contract and all contributions to working capital and all possible losses shall be equally shared. It was further provided that the joint venture should be known as Mannix Canadian Pipe Line Construction Company, hereinafter referred to as Mannix Canadian.

The contract between Trans-Northern Pipeline Company and the parties to the joint venture was executed on March 31, 1952, which contract was filed in evidence as Document 2 of Exhibit 1.

Three subcontracts, each dated March 31, 1952, were then entered into by Mannix Canadian, the first with Mannix Ltd., the second with Canadian Pipe Line Construction Co. Ltd. and the third with Sparling-Davis Company Limited for the construction of their respective portions of the pipe line. Subsequently, Mannix Ltd. subcontracted a portion of the work called for by its subcontract to the appellant and Mannix Canadian subcontracted to the appellant two river crossings which had not been previously subcontracted.

The appellant, when first incorporated, enjoyed only moderate success. Subsequently, the appellant became a wholly owned subsidiary of Williams Brothers Company incorporated under the laws of the State of Nevada and then began a more aggressive policy to obtain pipe line construction work. The present pipe line was the first work of major proportions which the appellant was in a position to undertake. Having been unsuccessful in obtaining a contract to construct the pipe line as prime contractor and being desirous of obtaining a still greater portion of the work than called for by its subcontracts with Mannix Ltd. and Mannix Canadian, the appellant agreed to accept from Canadian Pipe Line Construction Co. Ltd. an assignment of all "rights, title and interest in and to that agreement between Trans-Northern Pipeline Company and Mannix

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Ltd. and ourselves as contractors", that is to say in the agreement dated March 31, 1952 and filed as Document 2 of Exhibit 1 and in addition undertook the obligations and benefits of the subcontracts, both dated March 31, 1952, filed as Documents 3 and 4 of Exhibit 1, between Canadian Pipe Line Construction Co. Ltd. and Mannix Canadian. In short, the appellant by virtue of this agreement stands precisely in the shoes of Canadian Pipe Line Construction Co. Ltd. The consideration for the assignment and the sale of certain equipment was $325,000. This agreement was confirmed by a letter dated April 3, 1952, from Canadian Pipe Line Construction Co. Ltd. to the appellant, filed as Document 8 of Exhibit 1. Attached to the letter was an agreement respecting the sale of equipment which was for a consideration of $95,000. By subtraction therefore, the consideration for the assignment of the interest of Canadian Pipe Line Construction Co. Ltd. in its contract with Trans-Northern Pipeline Co. and its subcontracts was $230,000.

The foregoing arrangements were embodied in an agreement dated April 30, 1952, filed as Document 9 of Exhibit 1, between Canadian Pipe Line Construction Co. Ltd., the appellant, Mannix Ltd. and Trans-Northern Pipeline Company whereby the interest of Canadian Pipe Line Construction Co. Ltd. in the principal contract and in the subcontracts was assigned to the appellant and Trans-Northern Pipeline Company and Mannix Ltd. consented to such assignment.

The appellant completed the work called for in its subcontracts in its taxation year ending April 30, 1953, as did the other subcontractors.

The appellant filed its income tax return for its taxation year but in computing the tax payable, the appellant deducted the payment of $230,000 to Canadian Pipe Line Construction Co. Ltd. for the assignment, as an expense incurred for the purpose of gaining or producing income.

By notice of re-assessment dated November 17, 1953, the respondent disallowed the deduction of $230,000 as an expense.

On November 15, 1954, the appellant filed a Notice of Objection to the Re-assessment under section 58 of the *Income Tax Act*, 1952 R.S.C. c. 148, and by notification

dated May 30, 1955, the respondent confirmed the assessment on the ground that the amount of $230,000 paid to Canadian Pipe Line Construction Co. Ltd. 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 *Income Tax Act,* but was a capital outlay within the meaning of paragraph (*b*) of the said subsection (1) of section 12.

It is from this assessment that an appeal is brought to this Court.

The appeal, therefore, involves consideration of sections 12(1)(*a*) and 12(1)(*b*) of the *Income Tax Act* which provides as follows:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*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,
>
> (*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.

The issue in the appeal is whether the payment of $230,000 made by the appellant to Canadian Pipe Line Construction Co. Ltd., in the circumstances described above, constitutes an outlay or expense made or incurred by it for the purpose of gaining or producing income from its business within the meaning of the exception expressed in section 12(1)(*a*) of the Act and is therefore outside the prohibition of the section, as contended by the appellant, or whether the said payment was a capital outlay within the meaning of section 12(1)(*b*) and accordingly is not properly deductible in computing income, as contended by the respondent.

The appellant was in the business of pipe line construction as contractor which means that it was not a seller of goods but its function is merely to put the pipe into the ground and it is from this work any profit is derived. Therefore, to earn a profit the appellant must do two things, first it must get the job and secondly it must complete the job and it follows that expenditures made for the purpose of getting the job would be an outlay or expense made or

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incurred by the taxpayer for the purpose of gaining income from the business of the taxpayer, (if not otherwise prohibited by the Act).

The evidence discloses that pipe line construction jobs are obtained in a variety of ways, first by contract with the owner, which in the present case the appellant attempted to do but was unsuccessful or secondly by way of subcontracts of various types.

The evidence also discloses that joint ventures or syndicate arrangements such as entered into between Mannix Ltd. and Canadian Pipe Line Construction Co. Ltd. are commonplace in the business of constructing pipe lines and are accordingly an accepted method of business practice in this particular trade.

It was also established that very frequently a prime contractor does not perform any part of the actual work, but subcontracts the whole job out to other pipe line contractors, or the prime contractor sometimes retains a section or sections for his own completion and lets out sections of the pipe line to other contractors.

There was considerable evidence adduced as to the method of arriving at the compensation as between the prime contractor and the subcontractor. Obviously the prime contractor would seek to retain as much of contemplated profit as possible and the subcontractor would endeavour to obtain as much profit as was possible which would be determined by negotiation. The methods of payment vary, the most common methods being on a unit price basis or on a percentage basis and more rarely a lump sum payment.

In the present case the estimated profit of Canadian Pipe Line Co. Ltd. for its share of the work was approximately $500,000. Therefore it follows that the appellant was prepared to expend the amount of $230,000 for the prospect of earning that estimated profit.

In my opinion the method of payment determined upon does not have a material bearing on the essential nature of the transaction.

In *Royal Trust Company v. Minister of National Revenue*[1] the President of this Court categorically stated that in a case under the *Income Tax Act* the first matter to be

[1] [1957] C.T.C. 32.

determined in deciding whether an outlay or expense is outside the prohibition of section 12(1)(*a*) of the Act, is whether it is made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice.

In my opinion there is no doubt that it was consistent with accepted business practice in this particular trade for the appellant to make the payment in question.

Having so concluded the next step is to consider whether the deduction of the amount in question is prohibited by section 12(1)(*a*) or falls within its expressed exception. The mere fact that the outlay or expense was made or incurred by the taxpayer in accordance with the principles of commercial trading and was consistent with good business practice does not automatically make it deductible for income tax purposes.

The essential limitation expressed in section 12(1)(*a*) is that the outlay or expense should have been made by the appellant "for the purpose" of gaining or producing income "from the business".

This I think to be the situation in the present case. The appellant is in the business of constructing pipe lines. When control of the appellant company was acquired by its present parent company a vigorous policy was inaugurated. Having been unsuccessful in obtaining the prime contract the appellant set about getting as much of that contract as it possibly could. This was done by acquiring from Canadian Pipe Line Construction Co. Ltd., one party to the joint venture, the rights of that party in the prime contract and in its subcontracts and the appellant eventually entered into a novation back to the owner with the appellant standing in the stead of Canadian Pipe Line Construction Co. Ltd. Had the appellant not done so it would not have been able to do as much of the construction of the pipe line as it thereby did. The income of the appellant is derived from building pipe lines, but in order to earn that income it must first obtain the work. The conduct of the appellant was directed to obtaining participation in the contract work as a means to the end of earning income.

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The next provision relied upon by the respondent is section 12(1)(*b*) of the Act which for the purpose of convenience is repeated here.

> In computing income, no deduction shall be made in respect of,
> (*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.

The classical statement as to what constitutes a capital outlay is that of Lord Cave in *British Insulated and Helsby Cables Limited v. Atherton*,[1] at page 213.

> But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

Applying that test to the present case, the payment in question did not bring into existence any advantage for the enduring benefit of the appellant's trade within the meaning of the statement of Lord Cave because "enduring" as used in that context undoubtedly means enduring in the way that fixed capital endures. In the present case the work covered by the agreement was completed within the fiscal year of the appellant and that work was but one job in the business of the appellant from which it earned its income. Therefore, it follows that the true nature of the expenditure was to acquire the means of earning a profit and accordingly the expenditure was laid out as part of the process of profit earning.

Counsel for the respondent submitted that the joint venture agreement between Mannix Ltd. and Canadian Pipe Line Construction Co. Ltd. dated October 1, 1951, was a partnership or syndicate interest and that the agreement between the appellant and Canadian Pipe Line Construction Co. Ltd. outlined in the letter dated April 3, 1952, from Canadian Pipe Line Construction Co. Ltd. to the appellant, was in effect a sale of that interest to the appellant and therefore the payment of $230,000 made to acquire this interest was a capital outlay.

Counsel for the respondent then placed reliance on, *The City of London Contract Corporation, Limited v. Styles*,[2] and *John Smith and Son v. Moore*[3]. However, in neither of

[1] [1926] A.C. 205. [2] (1887) 2 T.C. 239.
[3] [1921] 2 A.C. 13.

these cases were the circumstances similar to those in the present case. In *The City of London Contract Corporation Limited v. Styles* the taxpayer purchased a continuing business as a whole, whatever it consisted of, and accordingly the purchase price so paid was the caapital with which the taxpayer embarked in business, and to carry on that business other moneys must be found. The business acquired was that of carrying on contracts for works and as part of the business the contracts on hand were purchased. The outlay was made to acquire the concern rather than for the purpose of carrying on the concern.

In *John Smith and Son v. Moore* the underlying structure of the business rested upon forward coal contracts which had been negotiated on most advantageous terms. The whole price paid was a sum employed, or intended to be employed, as capital in the trade of the company and was not paid as an outlay in an already acquired business in order to carry it on and to earn a profit out of this expense.

The present case differs in that what the appellant acquired from Canadian Pipe Line Construction Co. Ltd. was the right to perform the work rather than Canadian Pipe Line Construction Co. Ltd. and the right to enter into a novation with Trans-Northern Pipeline which in fact it did by the agreement dated April 30, 1952.

Had the appellant been successful in its attempt to obtain the prime contract there is no doubt that expenses incurred in negotiating that contract would not have been a capital outlay. Accordingly it would follow that expenses incurred to acquire the prime contract or a part thereof from the successful contractor and the right to enter into a novation with the owner would properly be a revenue expenditure rather than a capital outlay.

The Supreme Court of Canada, in *General Construction Company Limited v. The Minister of National Revenue*[1], dealt with this specific problem. In that case counsel for the appellant argued the sale of an interest in a joint venture was the sale of a partnership interest and was therefore

[1] [1959] S.C.R 729.

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the sale of a capital item. Martland J. in delivering the judgment of the Court rejected that argument. The appellant, General Construction Company Limited, made a business of entering into joint ventures with a view to profit. The joint venture was entered into with the intention of investing moneys in the joint venture and of recouping the same, plus a profit, at the conclusion of the venture.

The Canadian Pipe Line Construction Co. Ltd. in the present instance entered into the joint venture with the intention of doing its allocated part of the work at a profit and when the interest was sold to the present appellant it was not the intention of Canadian Pipe Line Construction Co. Ltd. to sell, nor was it the intention of the present appellant to buy an interest in a going concern.

I am satisfied, on full consideration, that the payment of $230,000 made by the appellant herein was an outlay or expense made or incurred for the purpose of gaining or producing income from its business within the meaning of the exception expressed in section 12(1)(*a*) of the Act and not a capital outlay within the meaning of section 12(1)(*b*).

The appeal herein is therefore allowed with costs.

Judgment accordingly.