1954

Apr. 20, 21

May 21

BETWEEN:

MONTSHIP LINES LIMITED.....APPELLANT,

AND

MINISTER OF NATIONAL REVENUE..RESPONDENT.

Revenue—Income—Income Tax—The Income Tax Act, S. of C. 1948, c. 52, s. 12(1)(a) and (b)—Deductions not allowed from income—Deductions not incurred by taxpayer for the purpose of earning income—Expenses incurred to comply with requirements of agreement of sale of property—Appeal from Income Tax Appeal Board dismissed.

In 1948 the appellant company which operates 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. The amounts of those repairs were claimed as deductions by appellant in its 1949 income tax return as ordinary expenses incurred in the course of its business but disallowed by the Minister on the ground that they were made pursuant to the terms of the agreements of sale and not for the purpose of earning the income. From the assessment an appeal was taken to the Income Tax Appeal Board which dismissed it and from the decision appellant appealed to this Court. On the facts the Court found that the repairs were maintenance repairs and none of them incurred for improvements or alterations and that the annual inspection of the vessels, as required by the Canada Shipping Act, S. of C. 1934, c. 44, s. 387, was not made in 1948 by a steamship inspector, prior to their delivery to the purchasers.

Held: That s. 12(1)(a) of the Income Tax Act being a positive enactment and excluding deductions which were not made or incurred by the taxpayer *for the purpose* of gaining or producing income from his property or business, it is not enough to establish that the dilapidations which occasioned the expenditures arose out of or in the course of the business, but that the *purpose* of the taxpayer in making the outlays was that of gaining or producing income from the business.

Here that was not the purpose of the taxpayer. The outlays were incurred at the time each vessel entered the drydock, and it was then known that they would no longer be operated by appellant, but, following the inspection by Lloyds' surveyor would be delivered to the purchasers. The sole purpose of appellant in incurring the expenses was to comply with the requirements of the agreements of sale.

APPEAL from a decision of the Income Tax Appeal Board.

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

Léon Lalonde for appellant.

Raymond Décary and *W. R. Latimer* for respondent.

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

CAMERON J. now (May 21, 1954) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated April 28, 1953 (8 T.A.B.C. 247), dismissing the appellant's appeal from an assessment to income tax in respect of the appellant's taxation year ending February 28, 1948. The assessment was dated May 7, 1951, and therein the respondent deducted from the declared net income of the appellant the sum of $255,103.34 as "1949 loss applied". The appellant submits that this deduction should be increased by $22,780.07, that amount being made up of certain disbursements made by the appellant in its taxation year ending February 28, 1949, which were not allowed by the respondent as proper deductions in that year.

There is no dispute whatever as to the facts. The appellant company is a shipping company operating a number of freight vessels, some of which it owns and others of which it operates under charter. In 1946 it purchased from War Assets Corporation two vessels of the Canadian Victory type (10,000 ton dry cargo class) namely, the *Mont Clair* and the *Mont Sorrel*. Thereafter, the vessels were used mainly in freight service from Eastern Canada to North European and Mediterranean ports.

1954

MONTSHIP LINES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

By agreement in writing dated April 28, 1948 (Exhibit 5), the appellant agreed to sell the *Mont Clair* to Mihammadi Steamship Co. Ltd., of Pakistan, for $740,000.00. Clause 5 of that agreement was as follows:

5. The vessel shall be delivered safely afloat in a seaworthy condition, tight, staunch and strong, and in Lloyd's 100 A-1 class, without reservation, and in every way satisfactory for normal service of a vessel of her type, size and description, and, to ascertain the fulfillment of these requirements, the Seller agrees to have the vessel inspected and examined in a dry-dock in Canada, without the tailshaft being drawn and without opening up the main engines, boilers and auxiliaries, by a surveyor of Lloyd's, and to give notice of such inspection to the Purchaser by letter, telegram or cable, at his address at least three (3) days before such inspection takes place. The Seller hereby undertakes to promptly carry out at his expense any repairs ordered to be carried out by Lloyd's Surveyor to enable him to issue a Certificate maintaining the classification of the vessel 100 A-1 without reservation; dry-docking and other expenses incidental to the inspections to be paid by the Purchaser if the Vessel does not require any repairs or does require repairs, the cost of which shall be less than FIVE HUNDRED DOLLARS ($500.00), but said expenses to be paid by the Seller if the vessel requires repairs other than painting, the cost of which will be in excess of the sum of FIVE HUNDRED DOLLARS ($500.00); the cost of painting to be borne by the Purchaser except for the painting of those parts which needed repairs. Vessel to be delivered with all holds cleanswept.

On the date of the agreement, the *Mont Clair* was loading a cargo at Port Sulphur, Louisiana, its voyage thereto from Montreal having commenced on April 18. That cargo was delivered to ports in Eastern Canada, the voyage having earned a substantial amount of revenue for the appellant. Immediately on completing the delivery of the cargo, it went into dry-dock in Canada on May 25 and there certain repairs were made at a cost of $17,934.44 (certain other expenses were incurred but were not claimed as deductions). Exhibit 1 is a list of the repairs and the cost thereof. Exhibit 2 is a summary thereof divided into: voyage repairs—$1,057.20; annual repairs—$14,970.02; and deferable or quadrennial repairs—$1,907.22.

The uncontradicted evidence establishes that all these repairs so claimed as deductions by the appellant in his 1949 income tax return were maintenance repairs, occasioned by ordinary wear and tear and that none of the expenses were incurred for improvements or alterations.

Delivery of the *Mont Clair* was made to the purchaser immediately upon leaving dry-dock, on May 31, 1948.

Similarly, the appellant on April 30, 1948, entered into an agreement to sell the *Mont Sorrel* to the Kingdom of the Netherlands for $743,250.00 (Exhibit 6). Clause 5 of that Agreement for Sale was practically identical with Clause 5 of the Agreement of Sale of the *Mont Clair* (*supra*). On the date of that agreement, the vessel was on a voyage which had commenced on April 27 and which was completed on June 11. Then followed two other voyages made on behalf of the appellant company. About July 23, 1948, and upon completion of the last of these voyages, the *Mont Sorrel* went into dry-dock and underwent a survey. Certain repairs aggregating $4,854.63 were made, the details of which are shown in Exhibit 3 and summarized in Exhibit 4. These repairs fell within the same categories as those made to the *Mont Clair,* all being in the nature of maintenance repairs occasioned by ordinary wear and tear. The *Mont Sorrel* was delivered to the purchasers immediately after leaving dry-dock, namely on July 26.

It is the aggregate of these two amounts, namely $22,780.07, which the respondent disallowed as deduction for the taxation year 1949 and which, as I have pointed out, were not added to the amount of the 1949 losses of the appellant which were allowed as a deduction for its 1948 taxation year.

It is not necessary to go into the details of these amounts in view of the admissions made by counsel for the respondent at the hearing. He conceded that they fell within the category of maintenance repairs and that had the vessels not been sold and had the appellant continued thereafter to operate them in its business, all of the expenses so incurred would have been treated as deductible expenses in the taxation year ending February 28, 1949.

Briefly, the contention of the appellant is that these expenses were ordinary expenses incurred in the course of the appellant's business; that the repairs were made necessary by the continuous operation of the vessels while earning income for the appellant; that they were incurred for the purpose of earning the income of the appellant and were therefore deductible. Counsel for the respondent submits, on the other hand, that the repairs were made pursuant to

1954

MONTSHIP LINES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

the terms of Clause 5 of the two Agreements of Sale (*supra*) and in order that the appellant might deliver the vessels in Lloyds' 100 A-1 Class and not for the purpose of gaining or producing income from the business of the appellant; that they are therefore barred by the provisions of s. 12(1)(a) of the Income Tax Act. He submits, also, that they were outlays on account of capital and are therefore barred by s. 12(1)(b) of the said Act.

These subsections are 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.

It is of particular importance to note that neither of the vessels, following completion of the repairs, was used in the business of the appellant, and that at the time the expenses were incurred the appellant had entered into agreements to dispose of the vessels and knew that thereafter they would not be used to earn income for the appellant.

Counsel for the appellant emphasized the fact that the repairs were occasioned by the continuous operation of the vessels in the ordinary course of its business. I accept the evidence that such was the fact. Then he submits that under the provisions of s. 387 of the Canada Shipping Act, Statutes of Canada, 1934, c. 44, the hull, equipment and machinery of every steamship registered in Canada was required to undergo an inspection by a steamship inspector at least once in each year and that a certificate under the Act could not be granted unless and until all the repairs required by the steamship inspector to be made had actually been completed. He points to the fact that the last annual inspection of the vessels had been made in the summer of 1947 and that the annual inspection for 1948 would be required at or about the time when these repairs were undertaken.

The fact is that no such inspection was made under the Act in 1948 by a steamship inspector, prior to delivery of the vessels to the purchasers. Under the circumstances here existing, it was not necessary for the appellant to have such an inspection as it had no intention of operating the vessels

after they left dry-dock. S. 387(2) of the Canada Shipping Act provided that no vessel (which goes from any place in Canada) shall be so used unless such a certificate is on board and penalties are provided for cases in which a voyage is made without such a certificate. Under the circumstances, it was wholly unnecessary for the appellant to comply with the provisions of s. 387(1) inasmuch as no further voyages were to be undertaken by either vessel on its behalf.

S. 12(1)(a) of the Income Tax Act is a positive enactment and excludes deductions which were not made or incurred by the taxpayer *for the purpose* of gaining or producing income from his property or business, subject, of course, to the specific deductions allowed under s. 11. It is not enough to establish that the dilapidations which occasioned the expenditures arose out of or in the course of the business. It must be established that the *purpose* of the taxpayer in making the outlays was that of gaining or producing income from the business. In the present case I am unable to find that that was the purpose of the officers of the appellant. The outlays, in the particular circumstances, could not in any way affect the income of the company either in its past or future operations. The business of the company was the operation (and not the sale) of vessels. The outlays were incurred at the time each vessel entered the drydock, and it was then known that they would no longer be operated by the appellant, but, following the inspections by Lloyds' surveyor and the completion of the repairs he might require to be made in order to place the vessels within Lloyds' 100 A-1 Class, would be delivered immediately to the purchasers. In my view, the sole purpose of the appellant in incurring the expenses was to comply wtih the requirements of Clause 5 of the agreements, namely, to meet the terms of its contract to have the vessels put into Lloyds' 100 A-1 Class.

It is reasonable to assume that these outlays were not lost to the appellant. I have no doubt that in entering into the contracts of sale and before agreeing to the requirement that the vessels should be repaired as required by a Lloyds' surveyor so as to bring them into Lloyds' 100 A-1 Class, the appellant took into consideration the estimated cost of such repairs and that the sale values were based on the values of the ships after such prospective repairs were made.

1954

MONTSHIP LINES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

The evidence is that a purchaser would offer more for a vessel when the contract of sale included such a covenant by the vendor as is found in Clause 5, than he would otherwise do.

For these reasons the appeal will be dismissed and the assessment affirmed. The respondent is entitled to his costs after taxation.

Judgment accordingly.