1941
June 30.
1942
April 24.

BETWEEN:

HIS MAJESTY THE KING, on the Information of the Attorney-General of Canada ..... PLAINTIFF;

AND

THE TORONTO GENERAL TRUSTS CORPORATION ..... DEFENDANT.

*Revenue—Income tax—Mortgage—Agreement extending time for payment of principal and interest due on mortgage—Principal and interest treated as one sum with payments to be made thereon by quarterly instalments with interest on that sum—Whether such quarterly payments include payment on account of interest due on original mortgage—Whether agreement evidenced an intention to merge principal and interest into a new debt or obligation which was to extinguish old mortgage debt—Interest payments made to non-resident of Canada—Income War Tax Act, R S C , 1927, c. 97, s. 9B, ss. 2 (b) and s. 84, ss. 1—Liability for tax.*

The action is brought by the Crown to recover from defendant the tax imposed by s. 9B, ss. 2 (*b*) of the Income War Tax Act, on certain alleged payments of interest to a non-resident of Canada, and for interest as provided by s. 84, ss. 1, of the Act.

Defendant is the agent in Canada of the trustees of the estate of the late William Ramsay, in his lifetime a resident of Scotland. Ramsay, in 1912, loaned $200,000 at 5½ per cent per annum on real estate in Toronto, Ontario. Ramsay is now dead and the equity of redemption in the mortgaged premises is owned by Scholes Limited. The trustees in 1932 brought an action for foreclosure and possession of the mortgaged premises. During the course of the action an order of Court was obtained requiring that the judgment be one for sale of the property. On July 1, 1936, an agreement was entered into between the trustees and Scholes Limited which set forth that there was owing the sum of $127,000 for principal and $52,000 for interest, a total of $179,000 on account of the mortgage. The agreement provided that the trustees grant and extend to Scholes Limited "time for payment of the said sum of $179,000, being the consolidated amount of principal money and interest due at the date hereof as follows": $1,000 on 1st October, 1936; $1,000 on 1st days of January, April, July and October in each of the years 1937, 1938, 1939 and 1940; $1,000 on 1st January and 1st April, 1941; the balance of the principal sum on 1st July, 1941. Scholes Limited was to pay interest on the unpaid principal at the rate of 4½ per cent per annum on the 1st day of the months of October, January, April and July in each year. The defendant as agent for the trustees has received $13,000 from Scholes Limited pursuant to the terms of the agreement and interest thereon at 4½ per cent per annum. Defendant has paid income tax on the interest, but has not paid any income tax on the $13,000 or any part thereof. The Crown claims that there is income tax payable on 52/179 of each quarterly payment of $1,000 made under the agreement to defendant as agent for the trustees.

*Held:* That the undertaking of Scholes Limited to pay interest on interest as per the agreement of July 1, 1936, is not to be construed as evidence of an intention to merge the principal and interest due under the mortgage into a new debt or obligation which was to extinguish or vacate the old mortgage debt.

2. That where a tax is imposed upon what are in substance and in fact interest payments, an obligation to pay interest will not be deemed to have been extinguished and a new obligation substituted therefor except on the clearest of evidence, and that when principal and interest have become mixed, any payments made may be disintegrated to ascertain what portions, if any, of such payments were on account of capital and what were on account of interest.

3. That some payment on account of interest was included in the quarterly payments made and defendant is liable for the tax thereon.

INFORMATION exhibited by the Attorney-General of Canada to recover from the defendant the tax and interest alleged due to the Crown under the provisions of the Income War Tax Act, R.S.C., 1927, c. 97, s. 9B, ss. 2 (*b*) and s. 84, ss. 1.

The action was tried before the Honourable Mr. Justice Maclean, President of the Court, at Toronto.

*F. P. Varcoe, K.C.*, and *H. H. Stikeman* for plaintiff.

*E. G. McMillan, K.C.*, and *R. J. Dunn* for defendant.

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

THE PRESIDENT, now (April 24, 1942) delivered the following judgment:

This is an Information exhibited by the Attorney-General of Canada, seeking recovery from the Toronto General Trusts Corporation of the tax imposed by s. 9B, sub-s. 2 (*b*) of the Income War Tax Act in respect of certain alleged payments of interest made to a non-resident of Canada, and for interest at the rate of 10 per cent. per annum as provided by s. 84, sub-s. 1, of the Act. No *viva voce* evidence was heard and the matter was presented to the Court by means of a Special Case prepared and agreed upon by the parties to the action.

The defendant is the agent in Canada of the trustees of the estate of the late William Ramsay of Scotland, a person within the terms of sub-s. (*h*) of s. 2 of the Income War Tax Act and a non-resident of Canada.

1942

THE KING v. TORONTO GENERAL TRUSTS CORPN.

Maclean J.

William Ramsay, in 1912, laid out $200,000 at 5½ per cent. per annum by way of mortgage on certain lands and premises in the City of Toronto. The mortgagor was one, Benjamin Harding Bramble. Ramsay is now dead and the defendant is the agent of the trustee of Ramsay's estate. The equity of redemption in the mortgaged lands is now claimed by a corporation known as Scholes Limited (hereafter called "Scholes") through transfer to it, in 1924, of the mortgaged premises by the purchaser thereof from the original mortgagor.

In 1932 an action for foreclosure and possession of the mortgaged premises was commenced in the Supreme Court of Ontario by the trustees of Ramsay's estate; and during the progress of the action an Order of Court was obtained requiring that the judgment be one for sale of the property rather than foreclosure. The judgment, dated April 27, 1932, directed that Scholes deliver immediate possession of the premises to the plaintiffs in the action and that the premises be sold, unless Scholes paid the sum of $141,665.83 before October 28, 1932. This sum was not paid but the sale was not proceeded with and the whole matter was held in suspension until May, 1936, when Scholes, not wishing to be held in continual default under the judgment, proposed a method of consolidation and capitalization of interest and principal then owing. Accordingly on July 1, 1936, an agreement was entered into between the trustees of Ramsay's estate and Scholes which recited *inter alia,* that on that date there was unpaid under the said mortgage, the sum of $127,000 for principal and $52,000 for interest, altogether $179,000; and it provided that the trustees grant and extend to Scholes "time for payment of the said sum of $179,000, being the consolidated amount of principal money and interest due at the date hereof as follows":—$1,000 the first day of October, 1936; $1,000 on the first day of the months of January, April, July and October in each of the years 1937, 1938, 1939 and 1940; $1,000 on the first day of January and April in the year 1941; and the whole balance of the said principal sum on the first day of July, 1941, Scholes "in the meantime and until final payment of the principal money paying interest on the unpaid principal quarterly on the first day of the months of October, January, April and July in each year at four and one-half per cent. per annum, as well after as before maturity".

The agreement provided that if at any time during the said term Scholes should make default in payment of the interest secured by the mortgage, or any part thereof, or in performance of any of the covenants contained in the said mortgage, the extension granted by the agreement should become void, if the trustees did so elect. The Special Case states (Par. 13) that "no default has been made in any of the payments provided for in the said new agreement and therefore no election has been made by the Executors that it became void". Therefore, the agreement is in full force and effect and the defendant, as agent for the trustees of Ramsay's estate, has received from Scholes the sum of $13,000, pursuant to the terms of the agreement. The defendant has also received from Scholes on the said quarterly dates interest at the new rate of $4\frac{1}{2}$ per cent. per annum on the principal instalments from time to time remaining due and has paid income tax on that interest, but has not paid any income tax on the said sum of $13,000 or any part thereof.

The Crown claims that there is income tax payable on 52/179 of each quarterly payment of $1,000 made under the agreement to the defendant as agent for the trustees; that is to say, that that fraction represents the amount of interest that was received by the defendant on account of the original mortgage loan; and it is agreed that if the defendant is liable for the tax as claimed by the Crown, then the said fraction of the said quarterly payments received by the defendant, is the amount subject to the tax claimed.

The defendant contends that the interest of $52,000 owing on account of the original mortgage loan was merged in the single amount represented by the judgment, and that in any event any interest then outstanding was intended by the parties to be and was consolidated and capitalized for all purposes by and as of the date of the agreement, and that therefore the amount of $179,000 is new principal or capital; and that the whole of each of the said quarterly payments, amounting to $13,000, is a repayment of capital.

As a dispute on construction arises here on the meaning of certain words or phrases in the agreement entered into between the trustees of Ramsay and Scholes it may be

1942

THE KING v. TORONTO GENERAL TRUSTS CORPN.

Maclean J.

desirable to quote the exact language of certain paragraphs of the same. Passing over several of the earlier recitals of the agreement it proceeds to state:

And whereas, the party hereto of the Second Part has applied to the parties of the First Part to extend further the time for payment upon the terms hereinafter set forth which the parties of the First Part have agreed to do on the express condition that should default be made in the payments hereinafter provided for this agreement shall cease to have effect and the parties of the First Part shall be entitled to exercise all rights under the said Judgment and Final order of sale as if this agreement had not been executed;

And whereas, there still remains unpaid under the said mortgage the sum of one hundred and twenty-seven thousand dollars for principal and the sum of fifty-two thousand dollars for interest up to the date of this agreement;

Now this indenture witnesseth that in consideration of the premises and the sum of one dollar to them paid by the said party of the Second Part they the said parties of the First Part do subject to the terms hereinafter set forth grant and extend to the said party of the Second Part time for payment of the said sum of one hundred and seventy-nine thousand dollars being the consolidated amount of principal money and interest due at the date hereof as follows: . . . , with the privilege to the party hereto of the Second Part to pay without notice or bonus any further sum in even multiples of one hundred dollars on account of principal upon any interest day, the said party of the Second Part in the meantime and until final payment of the principal money paying interest on the unpaid principal quarterly on the First day of the months of October, January, April and July in each year at Four and one-half per cent per annum, as well after as before maturity. The first of such quarterly payments of interest to be made on the First day of October, 1936.

The said party of the Second Part doth hereby covenant with the said parties of the First Part to pay said principal money and interest at the rate and in manner hereinbefore mentioned, and to well and truly keep, observe, perform and fulfill all the covenants, provisoes and agreements in said mortgage contained and to keep the said principal money until the expiration of the said extended term.

And it is expressly declared and agreed that if at any time during the said term the said party of the Second Part shall make default in payment of the interest secured by the said mortgage, or any part thereof, or in the performance of any of the covenants contained in said mortgage, the extension hereby given shall, if the said parties of the First Part so elect, become void, and the said principal money and every part thereof shall become due and payable, and the said parties of the First Part shall be at liberty to take any proceedings they may see fit for the purpose of enforcing payment of the said principal and interest, or of the interest only and performance of the said covenants or to proceed under the Judgment and Final Order of sale hereinbefore referred to in like manner as if these presents had not been executed.

It is hereby agreed and declared that nothing herein contained shall in any way affect or prejudice the rights of the said parties of the First Part as against the said party of the Second Part, its successors and assigns, or as against any party to the said mortgage or as against any surety or other person whomsoever for the said mortgage debt or any

part thereof or as against any collateral which the said parties of the First Part may now or hereafter hold against the said mortgage debt or any part thereof.

The foregoing will reveal the point at issue between the parties and there is no other matter in controversy. So the neat point before the Court raised by the Special Case is: does interest on a mortgage loan in arrear lose its identity as interest and become principal by a declaration that it be capitalized with the amount due for principal on account of the mortgage when an agreement is entered into providing for an extension of the time for payment of both interest and principal and varying the method of payment of the original loan?

Section 9B, sub-s. 2 (*b*) of the Income War Tax Act reads:

> In addition to any other tax imposed by this Act an income tax of five per centum is hereby imposed on all persons who are non-residents of Canada in respect of (*b*): All interest received from or credited by Canadian debtors, if payable solely in Canadian funds, except the interest from all funds of or guaranteed by the Dominion of Canada.

And sub-s. 8 reads:

> Whenever an agent of a non-resident person receives payment of any interest or dividends taxable under this section from which the tax has not been withheld, such agent shall withhold the tax from his principal and remit the same to the Receiver-General of Canada.

I need not traverse the arguments of counsel at any length as the course they would take would readily be conjectured from my reference to the Special Case and the agreement between the trustees and Scholes. Mr. Varcoe contended that a debt for interest cannot be extinguished unless it is plain that the liability therefor has been replaced by another liability which was of a capital nature and not a payment of interest, or, unless the liability for the interest debt was extinguished by a *bona fide* payment in money's worth received in satisfaction of interest payable under the original obligation. In this connection he referred to the case of *Cross* v. *London & Provincial Trust Ld.* (1), where the Brazilian Government having suspended interest payments upon certain bonds had issued funding bonds in lieu of unpaid interest to bond holders and it was held that the issue of the funding bonds was the issue of a capital asset and not a payment of interest and therefore not taxable. Another case to which Mr.

(1) (1938) 1 A.E.R. 428.

1942

THE KING v. TORONTO GENERAL TRUSTS CORPN.

Maclean J.

Varcoe referred was *Re White Star Line Ld.* (1), where it was held that what were called "deferred creditors' certificates" did not constitute a valid release of a claim made by the liquidator of the White Star Line upon the Royal Mail Steam Packet Company (also in liquidation), the holders of shares in the White Star Line, as contributories in respect of such shares, on the ground that upon the particular facts of the case there was no payment in money's worth of the calls upon the shares and that the consideration for the release was illusory and did not amount to a payment under the Companies Act. Then reference was made to the case of *Lord Howard De Walden* v. *Beck* (2), in which it was held that payments made by a company, under a written obligation which contained no reference to interest or any rate of interest might be disintegrated to ascertain what part of such payments represented capital and therefore tax free and how much represented interest and therefore liable to the tax. This was done in that unusual case, and the taxpayer was held liable for the income tax upon such part of the payments as were held to represent interest. The case of *In re Middlesborough & Building Society* (3) might usefully be referred to as being against the proposition that where principal and interest are mixed together they must both be treated as capital.

Mr. Varcoe referred to two other cases, which cannot be readily abbreviated, and the first to be mentioned is *In re Craven's Mortgage* (4). Craven was indebted to one Lewis in a large sum of money but being unable to pay the same it was agreed by a memorandum of August 10, 1887, that payment should be postponed. Then, by a mortgage of June 1, 1888, in consideration of the sum of £18,042 then owing, Craven covenanted that on his death or on his son's death, whichever event should first happen, he, or his executors, would pay to the mortgagee the principal sum secured, together with simple interest thereon at the rate of 5 per cent. per annum, reckoned from August 10, 1887, up to the time of such death, and, if the aggregate amount of such sum and interest or any part thereof should not then be paid and in such case and so long as the same aggregate sum or any part thereof should remain unpaid,

(1) (1938) 1 A E R. 607.
(2) (1940) 23 T.C. 384.
(3) (1885) 53 L T R 492.
(4) (1907) 2 Ch. D. 448

would pay to the mortgagee interest for the said aggregate sum or for the unpaid part thereof for the time being, at the rate of 5 per cent. per annum by equal half-yearly payments. Craven predeceased his son. At that date the simple interest at 5 per cent. per annum from August 10, 1887, calculated on the principal due, amounted to £15,937, without making any deductions for income tax. Craven's executor paid to Lewis's executors interest at 5 per cent. on the aggregate amount of principal and interest, then amounting to £32,479, after deducting income tax. The executor of Craven now proposed to pay off the aggregate amount due on the mortgage, but he claimed the right in doing so to deduct income tax on the £15,937 which represented interest, on the ground that the mortgage deed did not effect a capitalization of that interest in any sense which would discharge the covenant to pay interest. It was held by Warrington J. that the interest had not been capitalized by the contract between the parties, and that the mortgagor's executor was entitled to deduct income tax. The other case was *In re Morris* (1), in which the *Craven* case was followed and approved. By deed dated June 6, 1898, some of the then next of kin of a lunatic, for valuable consideration, conveyed by way of mortgage their expectancies in the estate of the lunatic to an insurance society subject to redemption on payment to the society of £40,000 at any time after the death of the lunatic with compound interest thereon at the rate of 4½ per cent. per annum with annual rests. The mortgage may be shortly stated in these terms—that in consideration of £20,000 paid to the mortgagors by the mortgagees, subject to redemption on payment by the mortgagors at any time after the death of the lunatic to the insurance society of the sum of £40,000 with compound interest on the same at the rate of 4½ per cent. per annum from the day of the death of the lunatic, with yearly rests. In consideration therefore of an advance of £20,000 the mortgagors were to pay £40,000 on the death of the lunatic; and if that £40,000 were not then paid, compound interest at the rate of 4½ per cent., with yearly rests, was to be paid from that date. The question to be decided was stated by Lord Sterndale M.R. to be this:

(1) (1922) 1 Ch. D. 126.

1942

THE KING
v.
TORONTO GENERAL TRUSTS CORPN.

Maclean J.

On payment off of the mortgage the mortgagors seek to deduct income tax upon the amount of the interest from the date of the death of the lunatic, whereas it is contended by the mortgagees that that amount cannot be deducted, but that all that can be deducted is the tax upon the interest for the last year, if that were paid in the last year, because it is contended that the meaning of the words "compound interest" is that at the end of each year, when the rest is taken, any interest which is overdue at that time, at once becomes capital for all purposes, and therefore when it is paid to the mortgagees it is a repayment of capital, and not a payment of interest. The question is whether an amount which is equal to a number of years' interest until then unpaid, is "interest of money, whether yearly, or otherwise, or any annuity, or other annual payment", within the meaning of the Income Tax Act (1). If it be, then income tax is payable upon it, and if the income tax is payable upon it, the mortgagors, when the money comes to be paid over would be entitled to deduct this tax.

It was held by the trial judge that the mortgagees were entitled to deduct income tax from the annual payments of interest on the mortgages, and it was held by the Court of Appeal that the case was rightly decided. Lord Sterndale M.R. in his judgment discusses at some length the meaning to be attached to the words "compound interest" and this discussion he concludes thus:

I think that the word "capitalization" used in many of the books quoted is a convenient word, but for the purpose for which it has been used in the argument before us it is a fallacious word, because it is taken as referring to capitalization for all purposes, income tax and otherwise. I do not think that is the meaning of the word In my opinion—not to beg the question—when these sums of interest come to be paid at the end of the time when payment is made, although interest has been charged upon them, and although, as a matter of bookkeeping, they have from time to time been added to capital, they do not cease to be interest of money—that is to say, they are overdue interest upon which interest has been paid.

I should perhaps here add that Mr. Varcoe discussed many other authorities but it is not my intention to make reference to them.

The question here to be determined does not lend itself to any extended discussion, and my opinion of it, whether right or wrong, may be stated in comparatively short terms. It seems to me that it is the agreement that affords the foundation for any conclusion to be reached. In the first place the agreement between the trustees and Scholes was essentially one for the extension of the time for payment of the sums due for principal and interest under the mortgage, with a modification of the interest rate. I cannot but feel that if the agreement were intended

(1) (1918) Sch. D., Case III, r. 1 (*a*).

by the parties to represent what was so ably argued by Mr. McMillan, a consolidation of the principal and interest due under the mortgage and the creation of a new mortgage loan principal, altering the effect of the Judgment and Final Order of sale which was to stand as if the agreement had never been executed, it would have been so easy to have expressed that intention in clear and unequivocal language. The language of the agreement is far from showing a clear intention by the parties to make what is claimed to be virtually a new mortgage contract. It is true that the agreement does state that the sum of $179,000 is "the consolidated amount of principal money and interest due at the date hereof". The word "consolidated" was a convenient word to employ but, I think, it was only intended to mean that the extension of the time for the payments, due under the mortgage, applied to both principal and interest; and, therefore, it was convenient to state the aggregate amount in that way; and also because under the terms of the extension a new rate of interest was being established for the balance due and owing on the date of the quarterly payments. The word "aggregate" might have been used just as well as the word "consolidated", and it would, I think, have more accurately expressed just what was in the minds of the parties. Then it is stipulated that the terms of the agreement were not to prejudice the rights of Ramsay's trustees as against any party to the mortgage, and that, in case of default by Scholes, the trustees were at liberty to "proceed under the Judgment and Final Order of sale hereinbefore referred to in like manner as if these presents had not been executed." I do not think that the undertaking on the part of Scholes to pay interest upon interest can be construed as evidence of an intention to merge the principal and interest, due under the mortgage, into a new debt or obligation which was to extinguish or vacate the old mortgage debt. On the whole I think the agreement was not intended to mean or effect what is claimed here on behalf of the defendant; and I think that the agreement is the controlling factor in the controversy, and not particular words used in the Special Case, for example, the words " . . . . and that the interest and principal then owing to be consolidated for all purposes . . .", used in one paragraph of the Special Case. Whatever con-

1942

THE KING
v.
TORONTO GENERAL TRUSTS CORPN.

Maclean J.

struction is to be put on those words I do not think there was any warrant for their employment in the Special Case, particularly the words "for all purposes". I think the Court can look only to the agreement to ascertain what was the purpose and intent of the agreement between the parties.

The authorities to which I have referred, and others which I have not mentioned, indicate that the Courts have been astute in holding, in cases where a tax is imposed upon what are in substance and in fact interest payments, that an obligation to pay interest will not be deemed to have been extinguished and a new obligation substituted therefor, except upon the clearest of evidence, and that when principal and interest for some cause or other have become mixed up, any payments made may be disintegrated to ascertain what portion, if any, of such payments were on account of capital and what were on account of interest. Here, there can be no doubt but that some payment on account of interest was included in the quarterly payments made, and that fact cannot, I think, be altered or defeated in so far as the income tax here in question is concerned. And the trustees could lawfully have appropriated the whole of the payments made in liquidation of any overdue interest under the mortgage; but there is no evidence one way or the other how these payments were treated in the books of the trustees.

My conclusion is that the Crown must succeed and is entitled to the amounts claimed, and to the costs of this proceeding.

*Judgment accordingly.*