1958
Sept. 25
1959
Apr. 6

BETWEEN:

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

AND

THE PEOPLE'S THRIFT AND INVESTMENT COMPANY ... RESPONDENT.

Revenue—Income—Income tax—Purchase of shares of subsidiary—Whether interest deductible on loan made to repay money previously borrowed to purchase such shares—The Income Tax Act, 1948, S. of C. 1948, c. 52, ss. 11(1)(c) and 12(1)(c).

The respondent loan company in 1945 subscribed for shares in a wholly-owned subsidiary loan company at a cost of $500,000 and paid for the shares by instalments in 1945, 1946 and 1947 out of moneys borrowed for that purpose. In 1949 it borrowed $1,900,000 and in 1951 a further $400,000 and in its income tax return for the latter year claimed a deduction of $85,372.93 as interest in respect of monies borrowed for the purposes of its business. The Minister disallowed $20,704.15 of the claim as being an expense for the acquisition of the shares of its subsidiary, the income from which would be exempt under the *Income Tax Act*. The respondent appealed from the assessment to the Income Tax Appeal Board contending that the interest payments were deductible in full as having been made pursuant to its legal obligation to pay interest on borrowed money used for the purpose of earning income from its business. The appeal having been allowed, the Minister in his appeal to this Court submitted that the money he had disallowed was in respect of the purchase of property the income from which would be exempt under ss. 11(1)(*c*) and 12(1)(*c*) of the Act and that the said amount was not interest on borrowed money used for the purpose of earning income from the respondent's business within the meaning of s. 11(1)(*c*).

Held: That it was established that the sums borrowed by the respondent in 1949 and 1951 were not used to pay for stock of the respondent's subsidiary but, to a certain extent, to repay previously borrowed sums which were used to buy the subsidiary's stock and since ss. 11(1)(*c*) and 12(1)(*c*) do not expressly apply to a taxpayer who borrows money to repay borrowed money used to acquire property the income from which would be exempt, the respondent was entitled to the deduction claimed.

APPEAL under the *Income Tax Act*.

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

J. W. Long, Q.C. and *J. C. Couture* for appellant.

H. H. Stikeman, Q.C. for respondent.

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FOURNIER J. now (April 6, 1959) delivered the following judgment:

This is an appeal by the Minister of National Revenue from a decision of the Income Tax Appeal Board[1] dated June 20, 1956, allowing the appeal of the respondent from an assessment to income tax for its taxation year 1951.

The parties agree on the following facts. The respondent is a company incorporated in 1926 under the laws of the province of Quebec for the purpose of making loans in excess of $500 each. The Community Finance Corporation is a wholly-owned subsidiary of the respondent and was incorporated in 1930 under the laws of the Dominion of Canada for the purpose of making loans under $500 each. On March 1, 1945, the respondent subscribed for 5,000 shares of Community Finance Corporation at $100 per share, or a total consideration of $500,000. This subscription was paid off by the respondent in periodic instalments, namely, $160,000 in 1945, $190,000 in 1946 and $150,000 in 1947, the latter amount representing the balance of the subscription.

On September 12, 1949, the respondent borrowed a sum of $1,000,000 from The Prudential Insurance Company, on which a balance of $900,000 was still due on December 31, 1951. On the same date, it borrowed $840,000 from The Bank of Nova Scotia, which amount was still due on December 31, 1951. On May 23, 1951, it borrowed $400,000 from The Great-West Life on an issue of 4 3/4% debentures. This amount was still due at the end of 1951. The total amount borrowed is $2,240,000.

The respondent in its income tax return for its taxation year 1951 claimed a deduction of $85,372.93 as interest in respect of monies borrowed for the purposes of its business. On July 8, 1953, the appellant advised the respondent that $20,704.15 of the amount claimed as a deduction of interest had been disallowed as a deduction, it being an expense for the acquisition of shares of its subsidiary. The respondent objected to the assessment on the ground that the interest payments were deductible in full as having been made pursuant to a legal obligation to pay interest on borrowed money used for the purpose

[1] 15 Tax A.B.C. 257; 56 D.T.C. 332.

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of earning income from its business. On March 15, 1954, the appellant confirmed the assessment objected to, contending that the $20,704.15 was an expense for the purchase of property the income from which would be exempt within the meaning of the statute. The respondent appealed to the Income Tax Appeal Board from the appellant's assessment on the same grounds as alleged in its objection. The appeal was allowed and the matter referred back to the appellant for him to deduct from the respondent's income for the taxation year 1951 the sum of $20,704.15 and re-assess accordingly.

It is from this decision that the Minister of National Revenue appeals to this Court.

The sections of the *Income Tax Act* to be particularly considered in this matter are sections 11(1)(*c*) and 12(1)(*c*). The relevant parts read as follows:

11. (1) . . ., 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 . . ., 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), . . .

* * *

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 appellant bases his appeal on the ground that the interest amounting to $20,704.15 was in respect of the purchase of property the income from which would be exempt within the meaning of the above sections and that the said amount was not interest on borrowed money used for the purpose of earning income from the respondent's business within the meaning of section 11(1)(*c*) of the Act.

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On the other hand, the respondent contends that the interest payments it made in its taxation year 1951 were paid pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from its business; in other words, the interest paid was the cost of the moneys required for the purpose of earning income from its business of making loans and was deductible under the provisions of the above section 11(1)(*c*).

To arrive at the sum of $20,704.15 which the appellant states is not deductible in the computation of the respondent's taxable income, the Department of National Revenue devised the following formula:

$$\frac{\text{Average borrowings re stocks } \$\ 516{,}987.20}{\text{Average borrowings } \$2{,}045{,}000.00} \times \text{Int. exp. } \$81{,}897.54 = \$20{,}704.15$$

I will summarize the explanation given by the appellant with regard to the meaning of the formula. From its incorporation in 1926 up to the end of 1951, the respondent invested approximately $1,023,000 in stocks of its subsidiary and other companies. Its own capital stock and the surplus account which appear on its financial statements total $585,328.20. This represents the shareholders' equity or the amount of invested capital as distinct from borrowed capital. Had all the proceeds of its capital-stock and surplus been invested in the shares of its subsidiaries, the balance of the purchase price of these shares still would have had to come from other sources. As its financial statements show that a sum of $83,462.04 was expended for office furniture and equipment, this sum should be deducted from the possible amount which could have been invested in stocks.

Since its investments in the shares of the other companies totalled $1,023,000 and its own capital-stock and surplus amounted only to a little over $500,000, the balance of its investment in these stocks came from borrowed capital in the amount of, say, $522,133.84.

Instead of taking the above figures, the Department averaged those figures with similar figures for the year ended 1950 and arrived at $516,987.20 as representing borrowed funds invested in stocks. Then the borrowings of the respondent for the years 1950 and 1951 were averaged. The average borrowings amounted to $2,045,000,

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on which the total interest expense of the respondent amounted to $81,897.54. The final step was to divide up the interest expense in the ratio that the amount of borrowed funds invested in stocks bore to the total borrowed funds. The formula was the fraction $516,987.20 divided by $2,045,000 multiplied by $81,897.56, which gave $20,704.15, the interest paid in 1951 on borrowed monies, which amount was not deductible in computing the respondent's taxable income for the year 1951.

It is apparent that the facts and figures used in the formula were gathered from the financial statements of the respondent which are annexed to its income tax return and the documents filed as exhibits herein. The evidence establishes that the sum of $500,000 the respondent paid for the stock of its subsidiary company in the years 1945, 1946 and 1947 was borrowed monies. The appellant did not challenge the original claim to deduct interest on the $500,000 borrowed to pay for the shares bought in 1945 and paid for in the above years. Two years after the stock had been paid for, the respondent borrowed again, from two sources, sums amounting to $1,840,000. At the end of December 1951, only $100,000 had been reimbursed. In 1951, a further amount of $400,000 was borrowed. The appellant contends that part of these monies were to a certain extent used to replace the monies borrowed in 1945, 1946 and 1947. There is no evidence to this effect and both parties stated that it was impossible of proof without the creation of separate segregated bank accounts to keep the money distinct in terms of its real, physical self and that this was impracticable. That being so, the formula was based on the assumption that some proportion of the newly borrowed funds in 1949 and 1951 was subsequently used to replace monies borrowed two or three years earlier to take up the stock. The formula presupposes that some portion of the money borrowed in 1949 and thereafter was substituted for monies borrowed previously and which had been invested in shares. The above facts are in accordance with the evidence adduced.

The question to be determined is whether the statute as it read during the respondent's taxation year under review, to wit, 1951, authorized the appellant to disallow interest

on borrowed monies in 1949 and thereafter which were substituted for monies borrowed in 1945, 1946 and 1947 to pay for stocks purchased in 1945.

There are certain basic principles of income tax law which have to be kept in mind in deciding the question at issue. A person cannot be subject to a tax liability unless the facts of his case come within the express terms of the statute by which it is imposed. The letter of the law is supreme. This was laid down by the House of Lords in the authoritative case of *Partington v. The Attorney-General*[1], where Lord Cairns made the following statement (p. 122):

> . . . If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. . . .

The intention to tax cannot be assumed, it must be clearly expressed in the provisions of the law. The Court has to decide in conformity with the express words or terms of the statute. This rule was contained in the remarks of Lord Halsbury L.C. in the *Tennant v. Smith* case[2]:

> . . . And when I say "what is intended to be taxed," I mean what is the intention of the Act as expressed in its provisions, because in a taxing Act it is impossible, I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes. In various cases the principle of construction of a taxing Act has been referred to in various forms, but I believe they may be all reduced to this, that inasmuch as you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed by making such and such objects the intended subject for taxation, you must see whether a tax is expressly imposed.
>
> Cases, therefore, under the Taxing Acts always resolve themselves into a question whether or not the words of the Act have reached the alleged subject of taxation.

Reference was made before the Court to the ruling of the Supreme Court in the case of *Johnston v. The Minister of National Revenue*[3] that in an appeal from an assessment of taxable income under the *Income War Tax Act* the onus was on the taxpayer to demolish the basic fact on which the taxation rested.

[1] [1869] L.R. 4 H.L. 100. [2] [1892] A.C. 150, 154.
[3] [1948] S.C.R. 486.

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Here are some remarks of Rand J., who delivered the judgment of the Court, (p. 489):

> . . ., the proceeding is an appeal from the taxation; and since the taxation is on the basis of certain facts and certain provisions of law either those facts or the application of the law is challenged. Every such fact found or assumed by the assessor or the Minister must then be accepted as it was dealt with by these persons unless questioned by the appellant. If the taxpayer here intended to contest the fact that he supported his wife within the meaning of the Rules mentioned he should have raised that issue in his pleading, and the burden would have rested on him as on any appellant to show that the conclusion below was not warranted. For that purpose he might bring evidence before the Court notwithstanding that it had not been placed before the assessor or the Minister, but the onus was his to demolish the basic fact on which the taxation rested.

This decision established that an assessment carries with it a presumption of validity and legality and the onus of showing that it is erroneous in fact or in law is on the taxpayer appealing against it. In the case at bar, there does not seem to be any dispute as to the rule that the onus of proof rests on the taxpayer. The facts and the provisions of the statute on which the Minister relies for his assessment are challenged by the taxpayer.

Did the respondent establish that the facts of the case did not come within the express terms of the statute is the question to be answered.

This litigation arises from the fact that in 1945, 1946 and 1947 the respondent borrowed monies to pay for its subscription of shares of its subsidiary, or, in other words, to pay for property the income from which would be exempt, and that the appellant, in computing the respondent's income, did not disallow the interest paid on the said borrowings in the years they were made. For the year 1951, the assessors of the department devised the formula which has been dealt with *supra*. They assumed that the money borrowed in the years 1949 and 1951, or part thereof, was used to replace the money borrowed earlier, which money was used to pay for the stock of its subsidiary, though the actual tracing of the borrowed money and its disposition was impossible. It seems clear to me that the assessment in 1951 of the respondent's income is solely based on the fact that the purchase price of the subsidiary's stock cannot be accounted for out of the respondent's capital in 1945, 1946 and 1947 and has

to be accounted for out of something else. Well, the conclusion is that the purchase price is accounted for by the respondent's borrowings in the above years and not out of its capital. I believe this to have been the situation at the end of 1947.

But two years later and thereafter the respondent borrowed other monies which the appellant assumes to have been borrowed to replace the borrowed monies used to pay the stock of its subsidiary. For the sake of argument, I shall take for granted that the appellant's assumption is correct and that the sums borrowed from The Prudential Life, The Great-West Life and The Bank of Nova Scotia in 1949 and 1951 were used, to a certain extent, to repay the borrowings of 1945, 1946 and 1947.

The question then to be answered is whether or not the *Income Tax Act* in effect in 1951 empowered the Minister to disallow the deduction of the interest on the portion of the borrowed monies in 1949 and 1951 used to repay previous loans as established by the appellant's formula.

The amount of the tax in dispute is $9,441. It arises from the disallowance by the Minister of an amount of interest of $20,704.15 which is part of a larger sum of interest, to wit, $85,372.93. The entire sum of interest was claimed as a deduction by the respondent in 1951. This interest was paid on the bank loans which appear on Exhibit R^2 as being $1,000,000 from The Prudential, $400,000 from The Great-West Life and $840,000 from The Bank of Nova Scotia. The evidence shows that the respondent borrowed the above sums to produce stock-in-trade, to produce dollars which it loaned to its customers and to its subsidiary and some dollars with which it paid off the bank loan in part. There is no evidence that any portion of the above sums were used to buy shares of its subsidiary. The appellant's witness, Mr. Neil, could not say that the monies borrowed in 1949 and 1951 were used to pay for shares of the respondent's subsidiary. He did say that, though he made no attempt to trace the actual disposition of loans made in any one year, he had no doubt that the money necessary to invest in the subsidiary was derived from bank loans, subsequently reduced or repaid out of subsequent borrowings.

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I believe it well established that the above-mentioned borrowed sums of money were not used to pay for stock of the respondent's subsidiary; but it would seem that these sums of money, to a certain extent, were used to repay previous borrowed sums which were used to buy subsidiary stock. Then the formula would be to the effect that interest on monies borrowed in 1945, 1946 and 1947 could be deducted in computing the respondent's income for the year 1951 because they were substituted by monies borrowed in 1949 and 1951.

Is this the meaning of sections 11(1)(*c*) and 12(1)(*c*), as it existed in 1951, on which the appellant relies in this matter?

Section 11(1)(*c*), I repeat, states in essence that "in computing the income of a taxpayer for a taxation year there may be deducted the amount paid in the year pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property,—other than borrowed money used to acquire property the income from which would be exempt".

I am of the opinion that the section states clearly that it applies to borrowed monies used to acquire property for the purpose of earning income from that property. In that case, the interest on the borrowed monies paid or payable in the taxation year was deductible. On the other hand, if the borrowed monies were used to purchase property the income from which would be exempt, the interest would not be deductible. The language of the statute being clear, I cannot believe that another meaning could be given to its terms or that its wording would justify the inclusion of the words "interest on borrowed monies used to repay monies borrowed previously and used to acquire property the income from which would be exempt is not deductible". If this had been the intention, Parliament would have said so in express terms, as it did later on, in 1954. In that year the *Income Tax Act* was amended by adding subsection (3*b*) to section 11. Subsection (3*b*) reads:

For greater certainty it is hereby declared that, where a taxpayer has used borrowed money to repay money borrowed previously, the borrowed money shall, for the purpose of paragraph (*c*) or (*d*) of sub-

section (1), be deemed to have been used for the purpose for which the money borrowed previously was used or was deemed by this subsection to have been used.

In my view, the important terms of this amendment are not the opening words "For greater certainty" but the following: "borrowed money to repay money borrowed previously shall be deemed to have been used . . .". So it is apparent that "money borrowed to be used for a purpose" cannot mean "money borrowed to repay the money previously borrowed and used for another purpose". When the term "deemed" is applied, it is generally understood that it gives a meaning to the word or phrase considered which the word or phrase would not have otherwise.

The Court cannot assume the words "borrowed money to repay previously borrowed money to be used for a specified purpose" mean that the money so borrowed could have been used to acquire stock when it was borrowed to repay money borrowed to acquire the said stock. In my opinion, the terms of the section apply only to the money borrowed to acquire property the income from which would be exempt. In this case the monies borrowed to acquire property the income from which would be exempt were not borrowed in the 1951 taxation year.

Since sections 11(1)(*c*) and 12(1)(*c*) relied upon by the appellant do not expressly apply to a taxpayer who borrows money to repay borrowed money used to acquire property the income from which would be exempt, the respondent was entitled in his taxation year 1951 to claim a deduction of $20,704.15, interest on borrowed money, which the Minister disallowed.

For these reasons, the appeal is dismissed with costs.

Judgment accordingly.