1945
Feb. 19
1947
Sept. 12

BETWEEN:

LADY VIRGINIA KEMP,.....APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE, ... } RESPONDENT.

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3 (a), 3 (g) 4 (j), 49—Payments to beneficiary under will out of income exempt from income tax in hands of trustees does not change its income tax exempt character—Meaning of word "derived"—Court has no jurisdiction to relieve from interest or penalties.

The appellant was entitled to certain payments under the will of her deceased husband. Some of these payments were made out of accumulated revenue which at the time of its receipt by the trustees consisted of interest on bonds exempt from income tax. The amounts so paid were included in the assessments under appeal. Appeal allowed.

Held: That the whole accumulated revenue consisted of income received by the trustees as interest on income tax exempt bonds and was exempt from income tax under section 4 (*j*) of the Act. It lost none of that character on being lawfully transferred by the trustees to the appellant in partial discharge of the obligation to her under paragraph 4 of the will.

2. That the word "derived" in section 4 (*j*) must not be read as meaning "received in the first instance". The word cannot be limited to income from income tax exempt bonds immediately or directly received by the owners thereof as interest thereon, but must include income that has its source in such bonds even although there may be intervening channels through which it flows from such source to its final destination. It is wide enough to include the payments received by the appellant under paragraph 4 of the will to the extent

that they came out of the accumulated revenue made up of balances of interest on income tax exempt bonds received by the trustees. To such extent they are income derived from income tax exempt bonds within the meaning of section 4 (*j*) of the Act and not liable to taxation.

3. That the terms of section 49, as it stood at the time of the appellant's liability, are mandatory and leave no discretion as to relief from interest or penalties with the Court.

Appeal under the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Thorson, President of the Court, at Ottawa.

G. W. Mason K.C. and *D. M. Fleming K.C.* for suppliant.

R. Forsyth K.C. and *E. S. MacLatchy* for respondent.

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

THE PRESIDENT now (September 12, 1947) delivered the following judgment:

These appeals from the income tax assessments for the years 1938, 1939, 1940 and 1941 depend on whether certain sums received by the appellant in such years constituted income not liable to taxation as being derived from income tax exempt bonds within the meaning of section 4(*j*) of the Income War Tax Act, R.S.C. 1927, chap. 97, which provides:

> 4. The following incomes shall not be liable to taxation hereunder:—
>
> (*j*) The income derived from any bonds or other securities of the Dominion of Canada issued exempt from any income tax imposed in pursuance of any legislation enacted by the Parliament of Canada.

The facts are not in dispute. The appellant is the widow of Sir Albert Edward Kemp who died on August 12, 1929. By his last will and testament he appointed her together with Arthur B. Coleville and National Trust Company Limited as executors and trustees, and made substantial provision for her in a number of ways. Paragraph 3 provided in part as follows:

> 3. I GIVE AND DEVISE to my said Trustees my residence and lands in the City of Toronto, known as "Castle Frank", including houses, out-houses and other buildings thereon, and all the appurtenances used and enjoyed therewith (all of which are to be understood as being included in the term "Castle Frank") upon the following trusts:—

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(*a*) During the lifetime of my wife, Virginia, so long as she shall remain my widow, and so long as she desires to make use of the same as her residence, to keep up Castle Frank in a suitable condition for that purpose; and all costs and charges for the payment of taxes, insurance for the repairs, renewals and other like expenditures for the proper structural upkeep of the said houses and buildings shall be borne by my estate and be paid by my Trustees.

(*b*) To allow my said wife during her lifetime, and so long as she shall remain my widow, to occupy Castle Frank as her home and residence, free of rent.

(*d*) While my said wife shall occupy Castle Frank as her home and residence, my Trustees shall also bear the expense of the maintenance and management thereof; and to cover such cost, my Trustees shall pay to my wife the Sum of Two Thousand Two Hundred and Fifty Dollars ($2,250) each month in advance so long as she continues to reside in Castle Frank and to use it as her home.

and paragraph 4 further provided:

4. I DIRECT that the above provisions in favour of my wife shall be a first charge upon my estate, and shall be provided for and paid by my Trustees in priority to any other legacies payable under my said Will, and I further direct that any Succession Duties, and all income taxes which may be payable in respect of the above provisions for my wife shall be paid out of my estate by my Trustees.

Then under paragraph 16 the appellant is to receive one-sixteenth of the residuary estate outright and also the following income, namely, from one-sixteenth of the residuary estate during her life and also from one-eighth of the residuary estate as long as she remains the testator's widow. The appellant also had income from sources other than the will.

Under paragraph 4 of the will the amounts payable to the appellant under paragraph 3 were made a first charge on the estate with the result that there could be no payment of legacies and no distribution of any of the estate to other beneficiaries unless the appellant consented thereto. Not wishing to delay the payment of legacies or hold up the distribution to other beneficiaries the appellant agreed, although she was not obliged to do so, that the Trustees should set up trust funds out of the assets of the estate to provide for the payment of the obligations of the estate to her under the various paragraphs of the will. Three such funds were set up in the books of the Trustees, namely, Trust No. 1 for the payment of the income from one-sixteenth of the residuary estate, Trust No. 2 for the pay-

ment of the income from one-eighth of the residuary estate and Trust No. 3 for the payments under paragraphs 3 and 4. After these funds were set up a substantial distribution of the estate became possible. The funds were not evidenced by any documents but were merely set up in the books of the Trustees. The fact is that the appellant allowed the distribution of a part of the estate and was willing to have her charge upon the estate confined to what was left. The trust funds were not in separate bank accounts; the funds of the estate were in the one bank account, the various funds being kept separate only on the books of the Trustees.

We are concerned only with the trust fund known as Trust No. 3 which was set up early in 1930. At that time it amounted to $743,700, consisting of $738,200 in Dominion of Canada 5½ per cent bonds due December 1, 1937, and $5,500 in cash. With this cash other bonds of the same issue were bought on November 30, 1930. All these bonds were exempt from income tax within the meaning of section 4(*j*) of the Act. The annual income from them as received by the Trustees was credited as revenue of Trust No. 3 and drawn upon to make the payments to the appellant under paragraphs 3 and 4 of the will, and any balance not required for such payments was retained as revenue of the fund and accumulated from year to year. The amounts thus received during the years from 1930 to 1941, both inclusive, and their disposition including the accumulation of the balances above referred to are set out in a statement, Exhibit 2, filed by counsel for the appellant.

This fund, Trust No. 3, may be dealt with in two periods, the first being from its beginning until the end of 1937. In the first column of Exhibit 2 there is shown the gross income of the fund for each year during the period, consisting of the receipts by the Trustees of interest on the income tax exempt bonds that had been allocated to the fund. Then columns 2, 3 and 4 show the dispositions of such income, column 2 the annual amount of $27,000 paid to the appellant under paragraph 3 of the will, column 3 the amount paid to her under paragraph 4, and column 4 the amount remaining after the payments under paragraphs

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3 and 4 of the will had been made. This last amount was retained in the revenue account of the fund and allowed to accumulate. Up to the end of 1937 the gross income from the fund had been more than sufficient to provide the payments under paragraphs 3 and 4 of the will, and the balances retained and accumulated from year to year totalled $93,520.55. Out of such accumulated revenue $27,000 was reinvested in September, 1934, and a further $8,727.96 in February, 1935. There is no controversy in respect of this period. Neither the estate nor the appellant was taxed in respect of the interest on the income tax exempt bonds received by the Trustees or in respect of the payments received by the appellant under paragraphs 3 and 4 of the will.

The second period from the end of 1937 to the end of 1941 tells a different story. When the income tax exempt bonds matured on December 1, 1937, the proceeds were invested in securities the income from which was no longer exempt from income tax. Such income appears under column 1 of Exhibit 2. This was used to make the payments to the appellant under paragraphs 3 and 4 of the will, as shown by columns 2 and 3 respectively, as far as it would go. In 1938 the income was more than sufficient to make such payments, there being a balance remaining, as shown by column 4. But in respect of the years 1939, 1940 and 1941 the income was not sufficient to cover all the payments and the deficiency in making the payments under paragraph 4 was made up by drawing on the accumulated revenue of $93,520.55 above referred. The amounts so drawn were $3,995.98 in 1939, $6,333.36 in 1940 and $16,232.22 in 1941.

The simple issue in these appeals is whether such amounts, paid to the appellant under paragraph 4 of the will out of the said accumulated revenue of $93,520.55, were, when received by her, exempt from income tax as income derived from income tax exempt bonds under section 4(*j*) of the Act.

Counsel for the appellant contended that there had been no change in their income tax exempt nature; that the accumulated revenue out of which they were paid consisted

of amounts which at the time of their receipt constituted part of the income of the estate and, there being no power under the will to capitalize income, remained impressed with the character of income under the terms of the will, even although some of the accumulation had in fact been re-invested; that such amounts at the time of their receipt by the trustees were income that was exempt from income tax as being derived from income tax exempt bonds and, in the absence of legislation imposing tax thereon, retained that character until they reached the hands of beneficiaries under the will. The argument was that the Trustees were a conduit pipe between the testator and the beneficiaries under the will and that if amounts of income received by the Trustees were exempt from income tax in their hands they could not lose their income tax exempt character by passing from the Trustees into the hands of beneficiaries under the will, unless there was some legislation imposing tax thereon and there was no such legislation.

I have come to the conclusion that counsel's contention was well founded. He relied strongly on the judgment of the Appellate Division of the Supreme Court of Ontario in *Re Watkins and City of Toronto* (1). There the whole of the testator's property was devised to his executors upon trust. For a period of ten years from his death the duty of the trustees was to pay one-third of the income of the residuary estate to his son. By arrangement the rents of the testator's real estate were collected by agents and paid directly to the beneficiaries, including the son, without passing through the executors' hands. Under section 5 (21) of The Assessment Act, R.S.O. 1914, chap. 195, it was provided that "rent or other income derived from real estate" was exempt from liability for income tax and the question in issue was whether the son was entitled to the benefit of this exemption in respect of the amount which the agents collected as rents and paid directly to him. It was held that he was. At page 138, Middleton J. said of the amount received by the son:

> I think that it may be admitted that when it reaches the hands of the beneficiary it has ceased to be "rent", but the statute exempts not merely rent but "other income derived from real estate". This,

(1) [1923] 54 O.L.R. 136

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I think, is wide enough to cover the rental received by trustees and paid over to a beneficiary. It can be said to be "derived from real estate" within the meaning of the statute—the mere intervention of trustees, with no duty but to pay over, does not change its character.

It may be said that this case differs from the present one in that here there was no direction in the will to make the payments under paragraph 4 out of the tax exempt income of the estate. It is true that there was no such direction and that the said payments need not have been made out of such income but could have been made from other estate sources. But it is also true that there was nothing to prevent the Trustees from lawfully paying them out of the tax exempt income of the estate and they were, in fact, paid out of an accumulation of such income to the extent mentioned. That being so, I see no reason why that portion of the accumulated revenue that was paid by the Trustees to the appellant under paragraph 4 of the will, being exempt from income tax in their hands, should lose its income tax exempt character merely through being lawfully transferred by them to her. There is, I think, strong support for the view that there is no such change of character in the decision of the Judicial Committee of the Privy Council in *Syme* v. *Commissioners of Taxes* (1), an appeal from the Supreme Court of Victoria. In that case under a will the trustees carried on certain businesses in Victoria which had been owned by the testator and paid the appellant, one of the testator's sons, a fifth share of the annual profit thereof. Under the Income Tax Acts, 1895 and 1896, of Victoria, the rate of tax on income derived from personal exertion was very much less than on income derived from the produce of property. In respect of the fifth share of the annual profit the Commissioners assessed the appellant on the latter basis, whereas he claimed that he was entitled to be assessed on the former. The Commissioners succeeded in the Supreme Court of Victoria, but this decision was reversed by the Judicial Committee. It was clear that the income received by the trustees from carrying on the businesses was income derived from personal exertion within the meaning of the taxing Acts and the issue was whether it maintained such character when it was passed on to the

(1) [1914] A.C. 1013

beneficiary under the will as a share of the profits. It was argued for the respondent that the income so received by the appellant was a different income from that derived by the trustees from the businesses, being paid out of a fund arrived at by the trustees after setting off profits and losses and deducting prior charges but this argument did not succeed. It was held by Lord Summer, delivering the judgment of the Committee, that the sum received by the appellant from the trustees as his share of the profits of the businesses was not different in character from the income received by the trustees from carrying them on. If in their hands it was derived from personal exertion, so also in his hands it was also so derived. At page 1021, Lord Summer put his conclusion briefly as follows:

> What was the produce of personal exertion in the trustees' hands till they part with it does not, in the instant of transfer, suffer a change, and become the produce of property and not of personal exertion, as it passes to the hands of the cestui que trust.

The whole accumulated revenue consisted of income received by the Trustees as interest on income tax exempt bonds and was exempt from income tax under section 4(*j*) of the Act. In my view, it lost none of that character on being lawfully transferred by the Trustees to the appellant in partial discharge of the obligations to her under paragraph 4 of the will.

But even if the income received by the appellant under paragraph 4 of the will were not the same as that received by the Trustees as interest on income tax exempt bonds, it does not follow that it would be subject to income tax, for proper regard must be had to the meaning of the word "derived" in section 4(*j*). Counsel for the appellant contended that it must not be read as meaning "received in the first instance". I agree. In a taxing Act words must, generally speaking, be given their plain and ordinary meaning, and, according to such meaning, the word "derived" covers a wider field than the word "received", and when applied to the word "income" it connotes the source or origin of such income rather than its immediate receipt. In the New English Dictionary, Vol. III, page 230, its meaning is given as "Drawn, obtained, descended, or

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deduced from a source;" and in Webster's New International Dictionary, Second Edition, "Formed or developed out of something else; derivative; not primary;"

The word was recently carefully construed by this Court in *Gilhooly* v. *Minister of National Revenue* (1) by Cameron J., then Deputy Judge, when he had to consider whether the moneys received by the executors of an estate as dividends on shares held by it in a mining company and paid to a beneficiary entitled to a share of the income of the estate constituted in the hands of such beneficiary "income derived from mining" within the meaning of section 5 (a) of the Act, so as to entitle her to a depletion allowance. He came to the conclusion that they did. In arriving at such conclusion Cameron J. referred to a number of cases, namely, *In re Income Tax Acts 1895 and 1896* (2); *In re Income Tax Acts (No. 2)* (3); *Syme* v. *Commissioner of Taxes (Supra)*, *In re Income Tax Acts, 1924-1928 (No. 2)* (4); and *Armstrong* v. *Commissioner for Inland Revenue* (5). I need not here repeat his discussion of the cases or his citations from them. In my view, they support his opinion that income "derived from mining" meant "income originating from mining or coming from mining as its source", and his finding that the moneys received by the appellant beneficiary as a share of the income from the estate were "income derived from mining", notwithstanding the intervention, first, of the mining company paying dividends to the executors of the estate as shareholders in the company and, secondly, of the executors paying a share of the income of the estate to the appellant beneficiary. Whether the moneys were received by the executors as dividends on shares or by the beneficiary as her share of the income of the estate, they had their source or origin in the mining operations that made their payment possible and were, therefore, "income derived from mining", within the meaning of section 5 (*a*).

Similarly, it seems to me that the word "derived" in section 4 (*j*) of the Act as applied to the income there referred to cannot be limited to income from income tax

(1) [1945] Ex. C.R. 141
(2) (1897) 22 V.L.R. 539.
(3) (1903) 29 V.L.R. 525.
(4) (1929) St. R. Qd. 276.
(5) (1938) 10 S.A. Tax Cases 1.

exempt bonds immediately or directly received by the owners thereof as interest thereon, but must include income that has its source in such bonds even although there may be intervening channels through which it flows from such source to its final destination. The word, in my opinion, is wide enough to include the payments received by the appellant under paragraph 4 of the will, to the extent that they came out of the accumulated revenue of $93,520.55 made up of balances of interest on income tax exempt bonds received by the Trustees. To such extent they were, in my judgment, income derived from income tax exempt bonds within the meaning of section 4 (*j*) of the Act and not liable to taxation. To the extent of such payments, namely, $3,995.98 in 1939, $6,333.36 in 1940, and $16,232.22 in 1941, the appeals from the assessments for such years must be allowed and the assessments set aside for amendment accordingly. There being no evidence that any sum was paid to the appellant out of tax exempt income in 1938, the appeal from the assessment for that year must be dismissed.

In view of this result there is no object in considering whether the payments in question could be considered as annuities under section 3 (*g*) of the Act, or free from liability under section 3 (*a*).

This leaves only the question of interest and penalties on the unpaid amounts of income tax as from the date at which they ought to have been paid. Counsel for the appellant urged that it had been necessary to go to the Court for interpretation of the testator's will on a number of points including questions affecting the amount of the appellant's income tax liability and that in view of the difficulties involved in determining such liability interest and penalties, or at any rate the latter, should be computed only as from the date of assessment, namely, November 29, 1943. It is true that the aid of the Court in interpreting the testator's will was sought and the amount of the appellant's tax liability was not determined until just before the date of the assessment, but I have come to the conclusion that under the state of the law governing the matter the Court is powerless to grant relief sought and that if any relief is to be afforded it must come pursuant to an Order in Council under the appropriate legislation dealing with

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such matters as the remission of penalties and the like. At the time of the appellant's liability for income tax for the years in dispute section 49 of the Act read as follows:

> 49. If any person liable to pay any tax under this Act (except any tax payable under section eighty-eight hereof) pays less than one-third of the tax as estimated by him, or should he fail to make any payment at the time when the filing of his return is due, or fail to pay the balance of the tax as estimated by him within four months therefrom, he shall pay, in addition to the interest of five per centum per annum provided for by the last preceding section, additional interest at the rate of three per centum per annum from the date of default to the date of payment.

Counsel for the respondent pointed out that, although this section, as later amended, was repealed in 1944, the repeal could not help the appellant; and that its terms are mandatory and leave no discretion as to relief from it with the Court. I agree. He also suggested that any hardship caused in this case was not due to the respondent but to the fact that the testator had made a difficult will that required interpretation by the Court and that the appellant could have protected herself against interest and penalties by making an adequate payment subject to refund of any excess payment if necessary. The adequacy of this suggested answer to this branch of the claim may be open to question but, be that as it may, in any event, I think it is clear that the Court cannot grant the relief sought by the appellant as to interest or penalties other than as consequential to the amendments of the assessments in respect of which there are successful appeals: *Minister of National Revenue* v. *Trusts and Guarantee Co.* (1).

In the result the appeal from the assessment for the year 1938 is dismissed with costs and the appeals from the assessments for the years 1939, 1940 and 1941 are to the extent indicated, allowed with costs.

Judgment accordingly.

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(1) (1940) A.C. 138 at 151.