BETWEEN:

INTERIOR BREWERIES LIMITED .....APPELLANT;

AND

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

1954
Nov. 9
1955
May 5

Revenue—The Income Tax Act, 1948, S. of C. 1948, c. 52, as amended, s. 3, s. 11(1)(c) and s. 12(1)(c)—Interest paid on borrowed money to be deductible from income must be paid on money used to earn the income from the business or property—Not sufficient that such borrowed money be used to open up other lines of credit—Appeal dismissed.

Appellant borrowed money from subsidiary companies controlled by it and used such money for the purpose of paying off certain bank loans. Appellant contends that interest paid on the borrowed money was deductible from income as being money used for the purpose of earning the income from the business and not for the purpose of gaining income from property.

Held: That the appeal must be dismissed as the borrowed monies were not used for the purpose of earning income from the business or property.

2. That it is not sufficient that by the use of the borrowed monies in some way other than for the purpose of earning income in the business, other lines of credit are opened up or other monies are received which might be used for the purpose of earning income in the business.

3. That the provisions of s. 11(1)(c) of the Income Tax Act are not to be construed by themselves but must be read in connection with the provisions of s. 12(1)(c) of the Act and on the facts the whole of the outlays here in question may reasonably be regarded as having been incurred in connection with property the income of which would be exempt and they are therefore not deductible.

1955

INTERIOR BREWERIES LTD. v. MINISTER OF NATIONAL REVENUE

APPEAL under the Income Tax Act.

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

Hon. J. W. De B. Farris, Q.C. and *C. H. Wills* for appellant.

A. H. J. Swencisky and *E. S. MacLatchy* for respondent.

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

CAMERON J. now (May 5, 1955) delivered the following judgment:

In its income tax return for the fiscal year ending March 31, 1951, the appellant deducted certain items of interest said to have been paid or payable on bonds, debentures and notes in that year. In assessing the appellant, the respondent disallowed these deductions in full and added them to its taxable income. From that assessment the appellant now appeals to this Court.

The main facts are not in dispute. The appellant was incorporated under the British Columbia Companies Act (originally under the name of Interior Holdings Limited) on February 10, 1950. It was then a private company but on May 29, 1950, it became a public corporation. On June 8, 1950, it purchased all the outstanding shares of Kootenay Breweries Limited and thereby obtained control of Kettle Valley Investment Company which was a wholly owned subsidiary of Kootenay Breweries. On the same date it purchased 97·2 per cent. of the outstanding shares of Fernie Brewing Company, Ltd. (the remaining shares were acquired in August, 1950) and thereby obtained control of its two subsidiaries, Cranbrook Brewing Company, Ltd. and Brewery Investments Ltd. The consideration for the shares in Kootenay Breweries and Fernie Brewing thus acquired was the issue of certain Class "A" and Class "B" shares of the appellant company and $1,634,730. in cash. The funds for the cash payment were obtained to the extent of $1,500,000 from the Canadian Bank of Commerce in a form of a demand loan (Exhibit 9 dated June 8, 1950) and the balance from within the resources of the appellant company. As collateral security for the bank loan, all the shares

in Fernie Brewing and Kootenay Breweries were hypothecated to the bank. Subsequent to the acquisition of these shares on June 8, 1950, the appellant alleges that it effected certain borrowings in the form and on the dates as follows:

(*a*) $40,000 from the Cranbrook Brewing Company Limited by means of a demand note bearing interest at 5% per annum, dated June 9, 1950;

(*b*) $150,000 borrowed from Brewery Investments Limited by means of a demand note bearing interest at 5% per annum, dated June 13, 1950;

(*c*) On June 15, 1950, Interior Breweries Limited issued 4½% First Mortgage and Collateral Trust Bonds of a principal amount of $400,000 and 5½% Convertible Debentures of a principal amount of $400,000; said bonds and debentures were sold to Lauder, Mercer and Company, Vancouver, B.C. pursuant to an underwriting agreement, and the Company received as consideration therefor, the sum of $760,000 on the same day;

(*d*) $35,000 from the Cranbrook Brewing Company Limited by means of a demand note bearing interest at 5% per annum, dated August 25, 1950.

In its tax return the appellant included in its expenses for the fiscal year the sum of $31,616.84, representing interest paid or accrued on its said outstanding bonds and debentures, the sum of $6,184.93 being interest paid or accrued on the note due Brewery Investments Limited, and the sum of $2,661.65 being the amount of interest paid or accrued upon the notes due the Cranbrook Brewing Company, Ltd.

It is these interest payments totalling $40,463.42 which are now in dispute. I should note at once that after a careful reading of the record, I can find no evidence whatever relating to Item (*d*) above—namely—the note for $35,000 to Cranbrook Brewing Company dated August 25, 1950. In the Minister's reply to the Notice of Appeal it was not admitted that the appellant had effected any borrowings whatever. In the absence of any evidence that the sum of $35,000 was actually borrowed, or, if borrowed, the use to which it was put, the appeal as to interest on that note must be dismissed. It will be understood, therefore, that what is said hereafter has no reference to that particular item.

Certain other facts which have been fully established by the evidence may now be stated. Mr. Lauder, who gave evidence for the appellant and who was responsible for the formation of the company and the carrying out of its plans (but who is not now connected in any way with it), stated that it was formed for the sole purpose of buying the shares

1955

INTERIOR BREWERIES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

in the two brewing companies. The entire plan as it was eventually carried out, was conceived and provided for before any offer to purchase was made to the shareholders of the brewing companies. It was fully realized that the company's own assets were insufficient to pay for the shares and that until actual title to them was secured, it would not be feasible to sell its stock, bonds and debentures, or arrange for the loans from the subsidiaries of the two brewing companies to be acquired; and that as a very substantial amount of cash was required in part payment of the shares to be purchased, it would be necessary to secure a temporary loan from its banker. It was at all times contemplated that the bank loan would be paid off as soon as the bonds, debentures and stock were sold, and the dividends and loans made by the subsidiaries. The agreement with Mercer, Lauder & Company to purchase the bonds, debentures and stock of the appellant was actually entered into on May 31, 1950. The bank loan was made on June 8 and used on that day solely for the purpose of paying for the shares in the brewing companies. Within one week of that date the bank loan had been repaid in full and it is proven that the monies derived by the appellant from the sale of the bonds and debentures and from the loans from the Crankbrook Brewing Company and from Brewery Investments, Ltd. for $40,000 and $150,000 respectively (along with certain other funds), were used entirely to retire the bank loan.

The first section of the Income Tax Act which must be considered is section 11(1) (*c*), which was then as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, 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 (depending upon the method regularly followed by the taxpayer in computing his income), 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),

or a reasonable amount in respect thereof, whichever is the lesser.

It is not disputed that the several items claimed as deductions were paid or payable under a legal obligation to pay interest, and that the amounts in respect thereof were reasonable.

While the onus is on the appellant to establish the existence of facts or law showing an error in relation to the assessment imposed upon him (*Johnston* v. *Minister of National Revenue* (1)), it will be convenient to state briefly the grounds on which the deductions were disallowed by the Minister. It was considered that in substance, if not in form, the borrowings (the interest on which is here in question) were made to acquire shares in the brewing companies for the purpose of gaining income therefrom and that as such income would be exempt under section 27 of the Act (as being dividends paid by a taxable Canadian corporation to another), the deductions now claimed were barred under the provisions of subsection (1)(*c*)(ii) of section 11 (*supra*) and of section 12(1)(*c*).

For the appellant it is submitted that it is entitled to the deductions under subsection (1)(*c*)(i) of section 11 as being "interest on borrowed money used for the purpose of earning income from a business". While admitting that all of the proceeds of the borrowings were paid to the bank, it is said that the entire scheme of financing which was carried out (inclusive of the borrowings) enabled the company not only to acquire the shares, but also to carry out certain management contracts which resulted in producing earned income. These management contracts (Exhibits 10, 11 and 12, and all dated June 8, 1950) are with Fernie Brewing Company, Kootenay Breweries Limited, and Cranbrook Brewing Company, Ltd., and are said to be in similar terms. Thereby the appellant company undertook to supply management to the other contracting parties "on such terms as may from time to time be arranged", and to assist in furnishing materials and supplies. Provision was also made for mutual assistance and co-operation in financial matters affecting one or other of the parties and for the supply, or assistance in supplying, of working capital to the subsidiary companies by the appellant. The evidence indicates that the management fees received by the appellant from its subsidiaries thereafter were based on a charge of fifty cents

(1) [1948] S.C.R. 486.

1955

INTERIOR BREWERIES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

per barrel of beer manufactured and that very considerable amounts were received thereunder; such income, of course, would be taxable in the hands of the appellant. Mr. Lauder stated that with the very large bank loan outstanding, the appellant's credit was strained to the limit and that it was unable to carry out its contractual obligations under the management contracts to provide the subsidiary companies with working capital. In order to re-establish its credit, therefore, it was necessary to pay off the bank loan, extend its debts by means of long-term bonds and debentures, and thereby provide it with working capital and thus enable it to carry out the management contracts. The fact is that on the completion of the financing program, the appellant had only about $15,000 working capital and was itself indebted to several of its subsidiaries; taking all the companies into consideration, the consolidated working capital was about $480,000, mostly in inventories, receivables and the like.

In my view, this interesting submission cannot be supported. To be entitled to the deductions of interest under subsection (1)(*c*)(i) of section 11, a taxpayer must first establish that the borrowed money on which interest is payable is used for the purpose of earning income from a business or property. Counsel for the appellant submits that it was used for the purpose of gaining income from the *business* and insists that it was not for the purpose of gaining income from property.

In view of the facts which I have stated, I consider it impossible to find that in any real sense the borrowed monies were used for the purpose of earning income from a business. They were used entirely to pay off the bank loan as soon as they were received and were used in no other way. It is not possible to earn income merely by paying off an existing liability and no one could have had such a purpose in mind. The requirements of the subsection are fulfilled only if the borrowed monies themselves are used for the purpose of earning income from the business (or property), and it is not sufficient to say that by the use of the borrowed monies in some way other than for the purpose of earning income in the business, other lines of credit are opened up or other monies are received which might be used for the purpose of earning income in the business. My

conclusion on this point is that the borrowed monies were not used for the purpose of earning income from a business and the appellant therefore fails on that point.

A further point taken by counsel for the appellant is that subsection (ii) of section 11(1)(*c*) does not apply to the facts of this case and that the Minister was not empowered to disallow the deductions by virtue of that paragraph. He says that the interest deductions now claimed were not interest on amounts payable for property—that is, for the shares in the brewing companies. He points out that the shares were acquired and fully paid for by the proceeds of the bank loan *before* the borrowings now in question were made and that the share purchases were then at an end. In its tax return, the appellant had claimed the right to deduct interest paid to the bank on the temporary loan, but that item was disallowed and it is now admitted that as the proceeds of the bank loan were used to acquire shares, the income from which would be exempt, the disallowance was properly made. Reliance is placed on a decision of the Income Tax Appeal Board reported as *No. 108* v. *Minister of National Revenue* (1). In some respects that case is similar to the present one, but in others the facts are quite different. There the Board stated that it was questionable whether it could be said that even the call loan was used to obtain property the income from which would be exempt. In the instant case Mr. Lauder stated that the loan from the bank was negotiated for the sole purpose of acquiring title to the shares of the brewing company. In that case, also, the Board's decision states that the debentures were issued in the year following the bank loan which was used to pay for the shares, and there is nothing in the decision to indicate that at the time the shares were purchased there was any intention of issuing debentures to retire the bank loan. The Board was able to find, therefore, that the transactions were quite separate. It also came to the conclusion that notwithstanding the provisions of section 12(1)(*c*), on which the Minister now relies, section 11(1)(*c*) gave a taxpayer a positive right to the deductions stated therein, subject only to the exceptions contained in the words "other

(1) 8 T.A.B.C. 358.

1955

INTERIOR BREWERIES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.

than property the income from which would be exempt". Section 12(1)(*c*) is as follows:

> 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,

It will be noted that this subsection is not referred to in the opening words of section 11(1):

> 11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year.

It seems to me, therefore, that the statutory provisions of section 11(1)(*c*) are not to be construed by themselves but must be read in connection with the provisions of section 12(1)(*c*) thereof, which relates to deductions affecting exempt income as does section 11(1)(*c*). On the facts of this case I think I must find that the whole of the outlays here in question may reasonably be regarded as having been incurred *in connection* with property the income from which would be exempt, and that they are therefore barred from deduction. On page 49 of the record the following appears:

> Q. And was it the primary purpose of this parent company, the appellant company, to acquire the shares of subsidiary companies?
> A. Yes. Certainly that is what it was formed for.

While the borrowings in question were actually made within a few days after the shares were acquired and paid for, the entire scheme of operations was planned as a whole before the shares were purchased. There is therefore a direct and distinct connection between these borrowings and the property (the brewing company shares) which it was the sole purpose of the appellant to acquire.

If, however, I am wrong in this conclusion, I think the appeal would still fail. By section 3 of the Act, the income of a taxpayer for a taxation year is his income for the year from all sources. So far as I am aware, the only section which permits the deduction therefrom of interest on borrowed money or on amounts payable for property acquired, is section 11(1)(*c*). Counsel for the appellant relied entirely on Clause (i) thereof and as I have found that it is not

applicable to the facts of this case and as there is no other section which permits these deductions from income, the assessment must stand.

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

Judgment accordingly.

1955

INTERIOR BREWERIES LTD. v. MINISTER OF NATIONAL REVENUE

Cameron J.