BETWEEN:

1945
Feb. 28
Mar. 2

BAYMOND CORPORATION LIMITED ..... APPELLANT;

AND

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

Revenue—Income—Income War Tax Act, R.S.C. 1927, c. 97, Sec. 5 (b)—Exemption provisions of a taxing Act must be construed strictly—Claim for deduction of interest on borrowed capital—Meaning of capital—Difference between borrowed and other capital—Restricting effect of expression "used in the business to earn the income" on taxpayer's right to deduct interest on borrowed capital—Appeal from assessment dismissed.

In 1936 the appellant purchased property on which there was an uncompleted building, finished the building and then, having tried unsuccessfully to borrow on a second mortgage money with which to discharge liabilities incurred in connection with completion of the building, decided to obtain the necessary funds by the issue of second mortgage bonds. It was unable to dispose of them except at a discount. On October 15, 1937, it issued second mortgage bonds of the face value of $600,000 bearing interest at 6 per cent per annum and maturing on October 15, 1952, but all that it realized on the sale of the bonds was $157,500. In 1938 the appellant sold the property and acquired for cancellation the outstanding bonds for the sum of $341,000 but was required to pay and did pay interest on $600,000 at 6 per cent per annum from the date of issue to September 15, 1938. In its income tax return for 1938 it claimed a deduction of $25,545.50 being interest at 6 per cent per annum from January 1, 1938, to September 15, 1938, on $600,000, but on the assessment only a deduction of $6,679.73, being interest at 6 per cent per annum for the period claimed, on $157,500 was allowed. On appeal to the Minister the assessment was affirmed and an appeal to this Court was then brought.

Held, That section (*f*) of the Income War Tax Act does not necessarily allow the deduction of interest at the contract rate. The rate is restricted to such reasonable rate as the Minister in his discretion may allow.

2. That the discretion of the Minister relates only to the allowance of a reasonable rate of interest.

3. That the exemption provision of a taxing Act must be construed strictly. *Lumbers* v. *Minister of National Revenue* (1943) Ex. C.R. 202 at 211 referred to.

4. That it is inherent in the idea of capital, whether of a company or of an individual, that there is an asset in the form of money or a fund or other property capable of being or becoming a source of income to its owner. Its amount must be distinguished from the obligation or liability incidental to it.

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5. That the expression "used in the business to earn the income" contained in Section 5 (*b*) of the Income War Tax Act shows in clear and explicit terms that the right of a taxpayer to deduct from what would otherwise be his taxable income interest on borrowed capital is not to be measured by the extent of his obligation in respect thereof but is restricted to only such borrowed capital as has actually been used in his business to earn the income.

APPEAL under the provisions of the Income War Tax Act.

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

D. M. Fleming K.C. for the appellant.

R. Forsyth K.C. and H. M. Lehrer K.C. for the respondent.

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

THE PRESIDENT now (March 2, 1945) delivered the following judgment:

The issue in this appeal depends upon the construction of section 5 (*b*) of the Income War Tax Act, R.S.C. 1927, chap. 97. In September, 1936, the appellant purchased property in the City of Toronto on which there was an uncompleted building known as the Victory Building. It finished the building in 1937 and started to lease office space in it. Then, having tried unsuccessfully to borrow on a second mortage money with which to discharge liabilities incurred in connection with completion of the building, it decided to obtain the necessary funds by the issue of second mortgage bonds. Because the bonds were the issue of a new company with no previous operating experience it was found impossible to dispose of them except at a discount. A purchaser was finally found and on October 15, 1937, the appellant issued second mortgage bonds of the face value of $600,000, bearing interest at the rate of six per cent per annum and maturing on October 15, 1952, but all that it realized on the sale of the whole issue was the sum of $157,500. In September, 1938, the appellant sold the Victory Building and at the same time acquired for cancellation the

outstanding bonds for the sum of $341,000, but was required to pay and did pay interest at six per cent per annum on $600,000 from the date of issue to September 15, 1938.

In its income tax return for 1938 the appellant claimed as a deduction the sum of $25,405.50, being interest at six per cent per annum from January 1, 1938, to September 15, 1938, on $600,000. The income tax assessment for 1938, as appears from the notice, dated May 5, 1943, allowed a deduction of only $6,679.73, being interest at six per cent per annum for the period claimed, on $157,500 and disallowed the claim in respect of the remainder. An appeal was taken to the Minister who affirmed the assessment, and an appeal to this Court was then brought. No question arises with respect to the interest paid for the period from the date of issue to December 31, 1937, since the operations of the appellant during 1937 did not result in taxable income.

The issue in the appeal is a narrow one. The appellant bases its right to deduct interest on section 5 (*b*) of the Income War Tax Act, which provides as follows:

> 5. "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—
>
> (*b*) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable;

The section does not necessarily allow the deduction of interest at the contract rate. The rate is restricted to such reasonable rate as the Minister in his discretion may allow. There is, therefore, no substance in the appellant's argument in its notice of appeal that if it had not been able to discount the bonds it might have been forced to borrow on a second mortgage at an interest rate substantially higher than that actually paid on the net amount received from the sale of the bonds.

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It is, I think, clear that the discretion of the Minister relates only to the allowance of a reasonable rate of interest. The rate has been allowed at six per cent per annum and in allowing such rate the Minister has fully exercised the discretion vested in him. This leaves the amount to which the rate should be applied to be determined quite apart from any exercise of ministerial discretion. The question to be answered is whether the expression "borrowed capital used in the business to earn the income" means $600,000, the face value of the bonds or $157,500, the sum realized on their sale.

The appellant claims a deduction from what would otherwise be its taxable income. It is well established that the exception provisions of a taxing Act must be construed strictly, since "taxation is the rule and exemption the exception". *Wylie* v. *City of Montreal* (1). In *Lumbers* v. *Minister of National Revenue* (2), I expressed the rule with reference to the exemption provisions of the Income War Tax Act as follows:

> in respect of what would otherwise be taxable income in his hands a taxpayer cannot succeed in claiming an exemption from income tax unless his claim comes clearly within the provisions of some exempting section of the Income War Tax Act: he must show that every constituent element necessary to the exemption is present in his case and that every condition required by the exempting section has been complied with.

There are, in my opinion, two reasons why the appellant cannot succeed in its claim to deduct interest except to the extent allowed on the assessment. One relates to the word "capital" as used in the section and the other to the expression "used in the business to earn the income".

Lindley's Law of Companies, 6th Edition, points out, at p. 543, that the word "capital" is used in many senses and, after specifying a number of them, states:

> The idea underlying the various meanings of the word capital in connection with a company is that of money obtained or to be obtained for the purpose of commencing or extending a company's business as distinguished from money earned in carrying on its business.

A similar idea is involved in the meaning of the capital of an individual in his business. Wharton's Law Lexicon, 14th Edition, defines, capital as:

(1) (1885) 12 Can. S.C.R. 384 at 386.

(2) (1943) Ex. C.R. 202 at 211.

The corpus of property of any description which may or may not be the source of a periodical or other return (fructus, produce or income).

and also states:

In commerce, and as applied to individuals, it is understood to mean the sum of money which a merchant, banker, or trader adventures in any undertaking, or which he contributes to the common stock of a partnership.

This latter definition appears also in Bouvier's Law Dictionary.

A company may raise capital either by the sale of its shares or by borrowing on the issue of debentures or bonds. *Kennedy* v. *Acadia Pulp & Paper Mills Co.* (1). But there is an important difference between the share capital of a company and its borrowed capital; in respect of the latter the company owes a debt to its debenture or bond holders, whereas, in respect of the former, the liability of the company to its shareholders, whatever its nature may be, is clearly not that of debt.

This difference is the basis of section 5 (*b*) of the Act, which allows a deduction of interest only on borrowed capital. The borrowed capital may be that of a company or of an individual. No deduction is allowed in respect of the share capital of a company or the capital which an individual adventures out of his own resources, for no interest is owing in respect of it. This distinction between share and borrowed capital was clearly emphasized by Audette J. in *Dupuis Frères Limited* v. *Minister of Customs and Excise* (2), when he held that preference shares were not "borrowed capital" and that the dividends paid on them were not exempt from income tax.

It was argued that the appellant had incurred an obligation to pay $600,000 together with interest thereon at six per cent per annum and had paid such interest; that all the proceeds of the borrowing had gone into the exchequer of the appellant and that the amount of its borrowed capital was $600,000. Some support for this contention may perhaps be found in Lindley's Law of Companies, 6th Edition, at p. 543, where the author says:

A company's co-called borrowed capital or loan capital is neither more nor less than a debt; it is money borrowed by a company on certain terms, and is repayable by the company according to the terms on which the money has been lent.

(1) (1905) 38 N.S.R. 291 at 307. (2) (1927) Ex. C.R. 207.

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It seems to me that in the first part of this statement the author has failed to distinguish between the capital obtained by the borrowing and the obligation incurred in respect of it. It is, I think, inherent in the idea of capital, whether of a company or of an individual, that there is an asset in the form of money or a fund or other property capable of being or becoming a source of income to its owner. Its amount must be distinguished from the obligation or liability incidental to it. The capital is one thing, the liability or obligation in respect of it, whatever its nature or exent, is quite a different thing. What the appellant really did was to incur an obligation to pay $600,000 in 1952 together with interest thereon at six per cent per annum in consideration of receiving the present sum of $157,500. This was the only asset it obtained by borrowing and this was the amount of its borrowed capital. The difference between such amount and the amount of the obligation incurred, even although a capital obligation, never became part of the capital of the appellant, borrowed or otherwise. In this view of the matter, it is unnecessary to determine what the difference was.

There is a second reason why the appellant cannot succeed. The expression "used in the business to earn the income" contained in section 5 (*b*) of the Income War Tax Act shows in clear and explicit terms that the right of a taxpayer to deduct from what would otherwise be his taxable income interest on borrowed capital is not to be measured by the extent of his obligations in respect thereof but is restricted to only such borrowed capital as has actually been used in his business to earn the income. It is not the obligation incurred through the borrowing but the asset in the form of money or other property received from it and actually put into the business to earn the income that is the measure of the taxpayer's right, once the rate of interest has been allowed. The taxpayer is entitled only to such deduction as the section clearly permits and the expression referred to expressly limits his right in the manner specified. Consequently, whatever the appellant's borrowed capital was, it is clear that all that was used in the business to earn the income was the sum of $157,500. That was all that

could have been so used for that was all that the appellant ever received. That is the limit of the amount in respect of which it is entitled to deduct interest. The assessment allowing only such a deduction was in accordance with the Act and the appeal must be dismissed with costs.

Judgment accordingly.