BETWEEN:

1943 Sept. 28 — 1946 Jan. 10

THOMAS D. TRAPP.............. APPELLANT.

AND

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

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 5(b), 6(a), 6(b), 6(d), 9, 11, 47—Basis of taxability is income received—Taxpayer has no right to file returns and be assessed on accrual basis—Minister has no authority to permit taxpayer to file returns on accrual basis or to assess on such basis—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—Unpaid interest on mortgage not deductible under s. 6(a)—Payment on account of capital—S. 5(b) an exception to s. 6(b)—Onus on taxpayer to show that this case comes within an exempting provision—Interest on borrowed capital used in the business to earn the income deductible only if paid.

The appellant owned property subject to a mortgage on which there was a garage building. He leased the building, and included the rental from it in his income tax return, but sought to deduct interest on the mortgage which was payable but had not been paid. The Minister disallowed the deduction of the unpaid interest.

Held: That the basis of taxability under the Income War Tax Act is that of income received. *Capital Trust Corporation Limited* v. *Minister of National Revenue* (1936) Ex. C.R. 163; (1937) S.C.R. 192 followed.

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2 That a taxpayer is not entitled, as a matter of right, under the Income War Tax Act as it stands to elect whether he shall file his income tax returns on an accrual rather than on a cash basis and be assessed for income tax accordingly. He is liable to tax only on the net profit or gain or gratuity that he has received, either directly or indirectly, ascertained by deducting only disbursements or expenses made or paid out from gross income received and has no legal right to be taxed on any other basis.

3. That there is no authority, under the Act as it stands, for the practice of the taxing authority to permit taxpayers in certain classes of cases to file their income tax returns on an accrual rather than a cash basis if they so elect and indicate such election and to assess them for income tax on such basis and that the Minister has no power under section 47 to permit such practice.

4. That section 5(*b*) allows the deduction of interest on borrowed capital used in the business to earn the income only when the interest has been paid; and that no deduction is allowed in respect of unpaid interest, even although it has become payable or is accruing from day to day.

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 Vancouver.

Hon. J. W. de B. Farris K.C. and *J. L. Lawrence* for appellant.

Dugald Donaghy K.C. and *H. H. Stikeman* for respondent.

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

THE PRESIDENT, now (January 10, 1946) delivered the following judgment:

This appeal raises two important related questions; one, whether a taxpayer is entitled, as a matter of right, under the Income War Tax Act, R.S.C. 1927, chap. 97, to file his income tax returns on an accrual rather than a cash basis of accounting, if he so elects, and to be assessed for income tax thereon; and the other, whether the Minister has power to permit a taxpayer to file his returns on such basis and assess him accordingly.

The appellant resides in New Westminster, British Columbia. On February 13, 1931, he purchased certain lands and premises in that city from The T. J. Trapp Company, Limited, which had gone into voluntary liquidation, and on the same day executed a mortgage of $106,000 in favour of the liquidator to secure the amount of the purchase price and interest thereon at the rate of 5 per cent per annum. On February 28, 1931, the liquidator assigned this mortgage to the shareholders of The T. J. Trapp Company, Limited, in proportion to their holdings of shares in it, the amount to which the appellant was entitled being $30,000. This was applied on the principal of the mortgage, leaving the appellant the registered owner of the property subject to a mortgage of $76,000. On the premises there was a garage building which was rented to Trapp Motors Limited. The appellant was entitled to the rentals from this building and liable for payment of the mortgage and the interest thereon. In his income tax return for the year ending December 31, 1940, he included the rental income from the garage building but claimed as an item of expense the sum of $3,800 as one year's interest on the mortgage, although as a matter of fact he had not paid it. At the trial he stated that the last payment of interest made by him was on January 10, 1938, and explained that his reason for not paying the interest was that he did not have it and that he was working out a plan of settlement for cash and kind with the shareholders of The T. J. Trapp Company, Limited, who were entitled to the mortgage. On the assessment this sum of $3,800 was disallowed and added to his stated income.

An appeal from this assessment, confined to the question of disallowance of the unpaid interest, was taken to the Minister. In his notice of appeal the appellant claimed that the sum of $3,800 was the mortgage interest which accrued during the taxation year in respect of property, the income of which was taxed under the Act, and was an expense, wholly, exclusively and necessarily provided for the purpose of earning the income; that his return of income for the taxation year 1940 was on an accrual basis; that he had always made his return of income on an

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accrual basis and elected to continue on that basis; that the disallowance of the sum of $3,800 was unreasonable and not in accordance with the Income War Tax Act, and not in the discretion of the Minister, or, alternatively, an improper exercise of discretion by him. In his decision on the appeal the Minister affirmed the assessment on the grounds that the mortgage interest was not actually laid out or expended for the purpose of earning the income within the meaning of section 6 (*a*) of the Act; that there is no provision in the Act permitting the taxpayer to elect to be taxed on an accrual basis; and that under section 47 of the Act the Minister shall not be bound by any return or information supplied by or on behalf of a taxpayer and, notwithstanding such return or information, the Minister may determine the amount of tax to be paid by any person.

In his notice of dissatisfaction, the appellant set forth further grounds of appeal, namely, that having adopted a return of income on an accrual basis he was justified in continuing that system and was not prohibited from so doing; that the sum of $3,800 was properly deductible on an accrual basis; that it was deductible under section 5 (*b*) as interest on borrowed capital used in his business to earn the income; and that section 47 did not authorize the Minister to determine the amount of the tax payable by the appellant on any basis other than as set forth in the Income War Tax Act.

In his statement of claim the appellant put forward still another claim, namely, that his return of income for the taxation years previous to 1940 was on an accrual basis and such method was accepted and ratified by the Minister. This was denied by counsel for the respondent. At the trial, evidence was given that the income tax returns of the appellant for 1938, 1939 and 1940 had in fact been made on an accrual basis, and I accept this evidence. But there is nothing to justify the allegation that this method was accepted and ratified by the Minister. In the return for 1940, which was the only one before the Court, there is nothing to indicate that it was made on an accrual basis. Indeed, quite the reverse is the case. Item No. 23 on page 2 is headed "Gross Income from Rentals (give amount received from and

address of each property" and under this there is entered "net—as per statement attached" $2,179.42). This is a clear statement that the net income had been "received" and there is nothing on the statement attached to show that it is made on an accrual basis and that the interest was not paid. In my opinion, any one looking at the return by itself would certainly conclude that it had been made on a cash basis, and there was nothing in it to lead the Minister to think otherwise.

It was argued for the appellant that section 3 of the Income War Tax Act defines income for the purposes of the Act as meaning "annual net profit or gain or gratuity"; that what is "net" profit or gain must be ascertained by the application of the recognized principles of good business and accountancy practice; and that the deduction of the interest on the mortgage, although it had not been paid, was justified by such principles. It may well be that the deduction of the interest, although unpaid, was in accord with good business and accountancy practice on the ground that the interest accrues from day to day and that accounting on an accrual basis in such a case as this more clearly reflects the true net profit or gain position of the appellant than accounting on a cash basis would do. But it is well established that for income tax purposes accountancy practice, however sound it may be, must give way before the provisions of the Income War Tax Act, and that if there is any conflict between them the provisions of the Act must prevail. The Act makes no reference either to the cash or to the accrual method of accounting and gives the taxpayer no right of election between them. Nor can it be said that the Act is a scientific document or that what is truly net profit or gain from an accountant's point of view is necessarily the same as taxable income under the Act. The Court is concerned only with the latter and the question for it to determine in the present case is, not whether the deduction of the unpaid interest was in accord with the principles of good business and accountancy practice, but rather whether the appellant was entitled to it under the Act. If he was not, that is the end of the matter and the appeal must be dismissed.

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Section 9 is the primary charging section of the Act, and subsection 1 provides for the assessment, levy and payment of the tax upon "the income during the preceding year" of every person, other than a corporation or joint stock company. The income is defined by section 3 as meaning "the annual net profit or gain or gratuity * * * * * directly or indirectly received by a person * * * *". The income thus defined is made subject to the exemptions and deductions specified in section 5 and section 6 lays down the deductions that shall not be allowed in computing the amount of the profits or gains to be assessed. The taxpayer is, therefore, taxable not on his "net profit or gain" as it might appear to an accountant on an accrual basis of accounting, but on the net profit or gain that he has "received" during the preceding year.

In *Robertson Limited v. Minister of National Revenue* (1) this Court held that the test of taxability of the income of a taxpayer in any year is not whether he earned or became entitled to such income in that year but whether he received it in such year, and the taxpayer has no right to have income received by him during a taxation year distributed for taxation purposes over the years in respect of which he may have earned or become entitled to such income. This means that he has no right to have his income taxed on an income receivable basis, but only on an income received basis, and it must, I think, follow that he is liable to tax only on such a basis and not on an income receivable basis. This was clearly settled in *Capital Trust Corporation Limited et al* v. *Minister of National Revenue* (2). In that case, a testator by a codicil to his will had directed that his son, who was one of his executors, should be paid "the sum of $500 per month in addition to any sum which the Courts or other proper authorities may allow him in common with the other executors". The testator died on December 5, 1923, but the son did not receive any of the monthly payments of $500 until March 10, 1927; on that date, he received the sum of $19,500, representing 39 payments of $500 each from December 5, 1923, to March 5, 1927, and, subsequently, he received the monthly payment regularly until his

(1) (1944) Ex. C.R. 170 at 180.
(2) (1936) Ex. C.R. 163; (1937) S.C.R. 192.

death on July 16, 1932. His income tax returns for the years 1927 to 1932, filed by him or his executor, made no mention of these monthly payments of $500. Subsequently, his estate was assessed in respect of them in addition to the amounts mentioned in the returns made and for the year 1927 the assessments included the $19,500 received on March 10, 1927, as well as the monthly payments received during the balance of that year. An appeal was taken to this Court on the ground that the amounts of $500 per month were a bequest under a will under subsection (*a*) of section 3 of the Income War Tax Act, and that, in any event, the assessment in respect of the year 1927 should not be for more than the amount payable for that year. Angers J. held that the amounts in question were not a gift or bequest under section 3 (*a*) of the Act but constituted additional remuneration to the son for his services as executor and, as such, were taxable income. He also held that it was the intention of the legislature to assess income for the year in which it was received, irrespective of the period during which it was earned or accrued due, and pointed out that there was no stipulation in the Income War Tax Act providing for the apportionment of accumulated income, paid in one sum, over the period in respect of which it became receivable. The appeal to this Court was, therefore, dismissed. On appeal to the Supreme Court of Canada, the judgment of Angers J. was affirmed. It was argued before the Supreme Court that if the payments were to be treated as additional remuneration, then the assessments should be revised so as to allocate $6,000 to each of the years in respect of which the amounts were payable, and the tax levied accordingly. The Supreme Court held that the appellant had no right to have this done. Davis J., delivering the judgment of the Court, said, at page 195:

> The statute here by section 3 defines income as "income received" and by section 9 imposes the tax upon "the income during the preceding year". Unfortunately in this case the taxpayer is bound to pay a larger amount than could have been levied and collected upon the same income had it been paid in instalments month by month as it became due and payable, but that cannot affect the liability plainly imposed by the statute.

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If the taxpayer is not entitled to have his income assessed as it is receivable, then it follows, I think, that there is no authority to tax him on income that has accrued or is accruing but has not been received by him, either directly or indirectly. What is taxable is the income "received", not the income receivable, whether accrued or accruing.

The decision in the *Capital Trust Corporation* case (*supra*) is, I think, conclusive against reading the word "received" in section 3 of the Act as meaning or including "receivable". Since the taxpayer is not entitled to be taxed on the basis of the income receivable by him, whether accrued or accruing, and is liable to tax in respect of the income received by him during the year, regardless of when it accrued to or was receivable by him, it seems to me that the conclusion is inescapable, as long as the authority of the *Capital Trust Corporation case* (*supra*) remains unchallenged, that, under the Act as it stands, so far as receipts are concerned, a taxpayer is not entitled, as a matter of right, to be taxed on an income computed according to an accounting on an accrual basis.

Now we come to the question of deductible expenditures. Section 6 (*a*) provides:

6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income.

This is put in double negative form. While there is no positive statement anywhere in the Act as to what disbursements or expenses may be deducted, it follows by necessary implication that if disbursements or expenses have been wholly, exclusively and necessarily laid out or expended for the purpose of earning the income, and are not otherwise excluded from deduction, they are deductible, for in such case they fall outside the excluding provisions of the section.

Counsel for the appellant contended that the words "laid out or expended" were referable to each of the words "disbursements" and "expenses". In my view, the words "laid out" are referrable to the word "disbursements" and the word "expended" to the word "expenses". A person "lays out" disbursements; they

are not ordinarily spoken of as "expended"; and the term "expended" is, I think, referable only to the word "expenses". The contention of counsel was necessary to his further argument that the distinction between disbursements and expenses is that one is paid while the other is only incurred, and that the term "laid out" in the context necessarily includes "incurred". "Laid out or expended" would then mean "incurred or expended". I am quite unable to give effect to this argument and agree with the contention of counsel for the respondent that the words "laid out" and "expended" mean "actually paid out" and that if it had been intended to allow expenses that had merely been incurred but not paid, the terms used would have been "laid out, expended or incurred", or terms to the like effect. The term "incurred" is frequently used with regard to expenses and, in ordinary use, is sometimes equivocal in meaning; it may mean either that the expenses have been paid or that an obligation to pay them has been assumed. The fact that the word "incurred" is not used in the section strongly indicates that the expenses referred to are those that have been paid out. Nor can I think that the words "laid out" can include "incurred". Disbursements that have been laid out are those that have been made, not those that are to be made. Nor can the word "expended" be read as meaning or including "expendible". The words must be given their plain ordinary meaning and should not receive the meaning urged on behalf of the appellant. As I read section 6 (*a*) disbursements that have not been made and expenses that have not been paid out do not fall outside the excluding provisions of the section or within the class of deductions allowed by the necessary implication from it. So that, as far as disbursements or expenses are concerned, it seems to me that a taxpayer has no right to deduct them in computing his taxable income unless they have been made or paid out.

It is obviously essential to the keeping of accounts on an accrual basis that in preparing the statement of receipts and expenditures from which the net profit or gain during the year is to be ascertained account should be taken of amounts receivable on the one hand and

amounts payable on the other. But since only income "received" is taxable and only disbursements or expenses that have been made or paid out can be deducted in computing the amount of profits or gains to be assessed, it follows that a taxpayer is not entitled, as a matter of right, under the Income War Tax Act as it stands, to elect whether he shall file his income tax returns on an accrual rather than on a cash basis and be assessed for income tax accordingly. He is liable to tax only on the net profit or gain or gratuity that he has received, either directly or indirectly, ascertained by deducting only disbursements or expenses made or paid out from gross income received and has no legal right to be taxed on any other basis.

This conclusion finds further support in section 6 (*d*) which provides as follows:

> 6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
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> (*d*) amounts transferred or credited to a reserve, contingent account or sinking fund, except such an amount for bad debts as the Minister may allow and except as otherwise provided in this Act;

This was introduced in 1923. The reason for its introduction is not clear. Obviously if income tax returns are to be made on a cash basis and the taxpayer is taxable only on such basis there is no need for any allowance for bad debts. It is, I think, equally clear that if the taxpayer is entitled, as a matter of right, to make his returns on an accrual basis and to be taxed thereon he is entitled to an allowance for bad debts, for such an allowance is essential to a proper accounting on an accrual basis. But the taxpayer is not given any legal entitlement to an allowance for bad debts. The provision for the allowance appears in the section which specifies the deductions that "shall not" be allowed and is an exception to it. The taxpayer gets the benefit of an amount for bad debts only if the Minister allows it and not otherwise. As I see it, section 6 (*d*) confirms the view that the taxpayer is not entitled, as a matter of right, to make his returns and to be assessed thereon except

on a cash basis, and that if he files his returns on an accrual basis and is assessed accordingly, this can happen only as the result of permission by the taxing authority.

This leads to the question whether there is any authority in the Act for such permission. It was argued by counsel for the respondent that a taxpayer has no right to file his income tax returns or to be assessed for income tax on an accrual basis unless the Minister so permits, and that in the present case no such permission had been given. While I have found that in fact the appellant's return was made on an accrual basis, I have also found that there is nothing in the return itself to indicate that it was made on such basis and I find further that there is no evidence to establish that any permission to make his return on such basis was ever given to the appellant by the taxing authority. Moreover, even if such permission had been given, it would not, in my opinion, help him.

It has been the practice of the taxing authority for a great many years to permit taxpayers in certain classes of cases to file their income tax return on an accrual rather than a cash basis if they so elect and indicate such election and to assess them for income tax on such basis. I have come to the conclusion that there is no authority, under the Act as it stands, for this practice. Counsel for the respondent contended that the Minister's powers under section 47 of the Act were wide enough to authorize the practice; it reads as follows:

> 47. The Minister shall not be bound by any return or information supplied by or on behalf of a taxpayer, and notwithstanding such return or information, or if no return has been made the Minister may determine the amount of the tax to be paid by any person.

While the Minister has the power to determine the amount of the tax to be paid by any person, his power to do so is subject to the Act and is governed by it. The Act lays down a specific basis for taxation and the Minister has no right to use a different basis in determining the amount of the tax that a person is to pay. Parliament has decreed by section 3 that the basis of taxability of income is that of income received, as was held in the *Capital Trust Corporation case* (*supra*), and the Minister has no right to tax on the basis of income that has not been received; Par-

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liament has also laid down that disbursements or expenses shall not be deductible if they have not been made or paid out, and the Minister has no right to allow their deduction. It cannot have been intended by Parliament that, although it had fixed the basis of taxation, the Minister should have the right to change it, if in any case he should decide to do so. The basis of taxability is fixed by the Act, and section 47 does not, in my judgment, give the Minister any power to depart from it. Such a power would have to be conferred in clear and explicit terms before effect could be given to it and no such terms can be found in section 47. The view that the Minister may, under such section, permit a taxpayer to file his income tax returns on an accrual basis and assess him for income tax accordingly, notwithstanding the specific provisions of section 3 and section 6 (*a*), is, in my opinion, quite untenable.

This leaves the case for permitting the filing of income tax returns on an accrual basis and assessing taxpayers accordingly dependent solely upon the implication involved in the exceptional provision in section 6 (*d*) that an amount for bad debts may be allowed by the Minister. It might be argued from the inclusion of this provision in the Act for an allowance, which would be necessary only when a taxpayer had included items of receivable income in his receipts, that the filing of returns on an accrual basis and assessment accordingly might be permitted, but if that were so, there would surely be some clear authority in the Act for such permission. I have been unable to find any such authority; it is, in my opinion, not contained in section 47; and no other source of authority was suggested by counsel. In view of the express provisions in the Act fixing the basis of taxability, it is, I think, inconceivable that Parliament should have intended a different basis, dependent upon the Minister's permission, to be discovered in the indirect implication involved in the exceptional provision in section 6 (*d*) to which I have referred. The only explanation I can think of for the inclusion in the Act of the

provision in section 6 (*d*) for a permissive allowance of an amount for bed debts is that the draughtsman assumed that such a provision was desirable in view of the permissive practice that had been followed by the taxing authority and that Parliament adopted it on such assumption without making any amendment of the basis of taxability as fixed by the Act.

The basis of taxability under the Income War Tax Act is different from that which exists under the Income Tax Act, 1918, of the United Kingdom. For example, Schedule D of that Act includes the following provision:

> 1. Tax under this Schedule shall be charged in respect of—
> (*a*) The annual profits or gains arising or accruing—
> (i) to any person residing in the United Kingdom from any kind of property whatever, whether situate in the United Kingdom or elsewhere; and
> (ii) to any person residing in the United Kingdom from any trade, profession, employment, or vocation, whether the same be respectively carried on in the United Kingdom or elsewhere; and
> (iii) to any person, whether a British subject or not, although not resident in the United Kingdom, from any property whatever in the United Kingdom, or from any trade, profession, employment, or vocation exercised within the United Kingdom;

In the cases that come under this part of Schedule D the basis of taxability is not "net annual profit or gain or gratuity received", as is the case in Canada, but "annual profits or gains arising or accruing". The difference is fundamental. Because of this difference it is quite unsound to apply English decisions on the subject of taxable income in the United Kingdom in the determination of taxable income in Canada under the Income War Tax Act. It might be quite proper to say in the United Kingdom, as Rowlatt J. did in *The Naval Colliery Co., Ltd.* v. *The Commissioners of Inland Revenue* (1), to which counsel for the appellant referred, that "receipts include debts due" and "expenditure includes debts payable", but such a statement is not applicable in Canada under the Income War Tax Act and in view of the decision in the *Capital Trust Corporation* case (*supra*).

(1) (1926) 12 T.C. 1016 at 1027.

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The law in the United States on this matter is also very different from that in Canada. Section 41 of the United States Revenue Act of 1938 provides as follows:

41. The net income shall be computed * * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income * * * *

In the United States, while the taxpayer may keep his accounts and file his returns on a cash or on an accrual basis of accounting, as he elects, the essential requirement is that the method of accounting used by him shall clearly reflect his true net income. If it does, the Commissioner cannot change it, but if it does not, he may do so. The essential thing in the United States law is to ascertain what is truly the net income. There is a constitutional reason for this, for the Sixteenth Amendment prevents Congress from taxing as income what is not in fact income. The result is that, while net income from an accounting point of view may differ from taxable income under the Revenue Acts, sound accounting practice plays a much more dominant role in United States income tax law than it does in the Canadian law. If in any case the method of accounting on an accrual basis clearly reflects the net income of the taxpayer, and the method of accounting on a cash basis does not do so, the accrual basis method governs.

It is generally conceded that in many cases, if not in most, the true net profit or gain position of a taxpayer, particularly if he is in business, cannot be ascertained otherwise than by an accounting method on the accrual basis. A person who has accounts receivable at the end of the year that are attributable to the earnings of such year and owes accounts payable for debts relating to the earnings of such year but keeps his accounts only on a basis of cash received and cash expended will frequently arrive at an amount of income "received" during the year that is not a reflection of his true net profit or gain for such year. But under the Income War Tax Act, as it stands, there is no place, as a matter of right, for the accounting method on an accrual basis, even if it does reflect the

true net profit or gain of the taxpayer, and it must give way to the express provisions of the Act. Income tax law in Canada in this respect lags far behind that of the United Kingdom and the United States and runs counter to well recognized principles of sound business and accountancy practice.

The administrative practice of permitting certain classes of taxpayers to file their income tax returns on an accrual basis and assessing them for income tax accordingly, for that is all I think it is, has, no doubt, in many cases resulted in taxation on a more equitable and sounder basis than would otherwise be the case. It was, in effect, a needed income tax law reform by administrative action in the cases where such action was taken. But income tax law reform is not a matter for administrative action; it is a function that belongs exclusively to the appropriate legislative authority. It is, perhaps, not beyond the scope of the judicial function to suggest, under the circumstances, that the Act be amended with a view to coming nearer the objective of taxing what is truly net profit or gain than the Act as it stands now does; that the present basis of taxability be broadened to include income accrued or accruing as well as that received; that the taxpayer be entitled, as a matter of right, to elect under what method of accounting he shall keep his accounts and file his income tax returns and that he be assessed for income tax accordingly, with the necessary provision that the accounting method used must in each taxpayer's case be such as will clearly reflect his true net profit or gain, as is the case in the United States. In this connection it might be again pointed out as I did in *Robertson Limited* v. *Minister of National Revenue* (*supra*) that in the *Capital Trust Corporation* case (*supra*) *both* Angers J. in this Court and Davis J. in the Supreme Court of Canada commented upon the harshness and injustice of the result of the decision from which there was no escape in view of "the liability plainly imposed by the statute". If the appellant in that case had had the right of being assessed on the basis of the income as it accrued or became payable to him in each

of the years in which he earned it, he would not have suffered the inequity that the state of the law imposed upon him.

Under the law as it stands, so far as this appeal rests on the ground that the income tax return of the appellant was properly made on an accrual basis of accounting and that he was entitled to be assessed for income tax accordingly, it cannot succeed.

I have not overlooked the fact that the Act contains some specific provisions in respect of amounts that have not been received or paid by the taxpayer; for example, section 11 puts certain amounts into the category of taxable income although they have not been received, and section 5 allows the deduction of certain amounts although they have not been paid. In all of such cases the matter is covered by specific statutory authority. Such specific provisions do not disturb the conclusions I have reached; indeed, they tend to confirm them.

There are also other grounds on which the appeal must fail. The appellant cannot show that the unpaid interest on the mortgage falls outside the excluding provisions of section 6 (*a*), which I have already cited. There are two reasons why the deduction cannot be allowed. I have already mentioned one, namely, that the interest on the mortgage was not a disbursement or expense that was either "laid out" or "expended". That would be enough to prevent it from falling outside the exclusions of the section but there is also a further reason. Even on the assumption that the appellant was in the business of renting the garage and earning the rentals as the income from such business, and even if he had actually paid the interest, payment of it would not be part of the appellant's working expenses in the business of renting the garage nor would it be an expenditure "laid out as part of the process of profit earning" in the garage renting business, within the meaning of the test laid down by the Lord President (Clyde) in *Robert Addie & Sons' Collieries, Limited* v. *Commissioner of Inland Revenue* (1), as adopted by the Supreme Court of Canada in *Min-*

(1) (1924) S.C. 231 at 235.

ister of National Revenue v. *Dominion Natural Gas Co. Ltd.* (1). The interest would be payable even if the appellant did not rent the garage at all. The payment of the interest has nothing to do with the business of renting the garage. It becomes payable because of the covenant in the mortgage and this is not an obligation assumed in the course of or as part of the business of renting the garage. Nor would the payment of the interest, if it had been made, have been "directly related to the earning of the income" from the garage renting business within the meaning of the judgment delivered by Lord MacMillan in *Montreal Coke and Manufacturing Co.* v. *Minister of National Revenue* (2); *vide* also, *Siscoe Gold Mines Limited* v. *Minister of National Revenue* (3).

Moreover, if the payment had been made it would, in my opinion, clearly have been a payment on account of capital within the meaning of section 6 (*b*) which reads:

6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence except as otherwise provided in this Act;

The payment of the interest would be the result of an obligation not of a current or business or revenue nature, but of a capital one, and it would have to be made to save the appellant's property from foreclosure. Such foreclosure would have extinguished the appellant's capital asset. The payment would be for the purpose of maintaining or preserving such capital asset. In the *Dominion Natural Gas Co. Ltd. case* (*supra*) the Supreme Court of Canada held that certain legal expenses of the company incurred and paid in defending its right to supply gas in the City of Hamilton were not deductible and one of the grounds for so holding was that they were a capital expenditure: *vide* also *Siscoe Gold Mines Limited* v. *Minister of National Revenue* (*supra*). Indeed, the argument of counsel for the appellant that it was interest on borrowed capital used in the business, within the meaning of section 5 (*b*) of the Act, admits that, if it had

(1) (1941) S.C.R. 19.
(2) (1944) A.C. 130.
(3) (1945) Ex. C.R. 257.

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been paid, it would have been a payment on account of capital. As such it would be excluded from deduction by section 6 (*b*) unless it were excepted from such exclusion by the concluding words of the section "except as otherwise provided in this Act".

There remains only the question whether the appellant is entitled to have the unpaid interest deducted under section 5 (*b*) which reads 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 draftsmanship of the section is careless. What is said to be exempted or deducted is "such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow * * * ", whereas it is obvious that what is meant is "interest on borrowed capital used in the business to earn the income at such reasonable rate as the Minister in his discretion may allow * * * * ". It is interest, not a rate of interest, that is to be exempted or deducted.

Section 5 (*b*) must be interpreted in the light of its complete and true context. It is not sound construction, in my opinion, to consider it solely from the point of view of its inclusion in section 5, as a statement of one of the exemptions and deductions to which "income" as defined in section 3 shall be subject. It must also be considered in the light of its context as an exception to the excluding provisions of section 6 (*b*), which I have already cited. It is obvious that section 5 (*b*) is one of the provisions of the Act that comes within the concluding words of section 6 (*b*), "except as otherwise provided in this Act", and its place as such in the scheme of the Act must not be overlooked. It is by reason of such exception that interest on borrowed capital used in the business to earn the income

falls outside the exclusions of section 6 (*b*). It would have been just as easy to specify "interest on borrowed capital used in the business to earn the income" as an exception to the exclusions of section 6 (*b*) in section 6 (*b*) itself as to provide for it otherwise in the Act, either in a substantive section or in one of the paragraphs of section 5; and the effect of the provision must be the same, wherever it is placed. The essence of the matter is that section 5 (*b*) is an exception to section 6 (*b*) and that without it, section 6 (*b*) would be the governing section.

The onus is on the appellant to show that his case comes within the terms of section 5 (*b*); he seeks the benefits of an exceptional provision in the Act and must comply with its conditions. The principles of construction to be applied are well established. In *Wylie* v. *City of Montreal* (1) Sir W. J. Ritchie C.J. said:

> I am quite willing to admit that the intention to exempt must be expressed in clear unambiguous language; that taxation is the rule and exemption the exception, and therefore to be strictly construed;

And this Court, in construing another paragraph of section 5, namely, paragraph (*k*), in *Lumbers* v. *Minister of National Revenue* (2), stated the rule to be applied 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.

The judgment of the Supreme Court of Canada in the same case (3) while not referring to this statement of the rule fully supports it.

If the appellant is to succeed he must be able to show that section 5 (*b*) allows the deduction of the interest when it is payable but has not been paid. As I read the section by itself, there is nothing in it that will help the appellant. It is not specified in the section whether the interest must have been paid in order to be deductible or whether it is deductible when it has become payable but has not been paid. If the case were to rest there

(1) (1885) 12 Can. S.C.R. 384 at 386.
(2) (1943) Ex. C.R. 202 at 211.
(3) (1944) S.C.R. 167.

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and no other clue were available the appellant's claim would fail, for the general scheme of the Act, taxing income on the basis of income "received", would govern. The amount of the interest having been received by the appellant and not yet laid out or expended would have to be regarded as income "received" by him during the year and, therefore, taxable in his hands. Under the circumstances, it would not be proper to construe section 5 (*b*) as allowing the deduction of unpaid interest, for such a construction would be an enlargement of an exemption provision beyond the scheme of the Act. No such enlargement is permissible in the absence of clear terms authorizing it, and there are no such terms.

Moreover, no light is shed on the question by the other paragraphs of section 5. The statutory requirements for the deductibility of the amounts specified in its paragraphs are not uniform; in most cases it is a condition that the amount to be deducted must have been paid, but in some it is deductible if payable or accruing. The statutory conditions for deductibility are specified in each of the paragraphs of section 5, except in paragraph (*b*).

Since section 5 (*b*), considered by itself, does not answer the question whether interest on borrowed capital used in the business to earn the income can be deducted if it is payable but has not been paid, the answer must be sought elsewhere. It will be found, I think, if section 5 (*b*), is read in its true light as an exception to the excluding provisions of section 6 (*b*). If section 5 (*b*) were not in the Act, it is clear, I think, that even if the appellant had paid the interest on the mortgage he would not have been entitled to deduct it. It would not have fallen outside the exclusions of section 6 (*a*) for the two reasons already mentioned and it would have fallen squarely within the exclusions of section 6 (*b*) as being a "payment on account of capital". It is also clear that section 6 (*b*) in excluding "any payment on account of capital" must *a fortiori* also exclude any amount payable on account of capital. If the appellant could not have deducted the interest even if it had been paid, there was no possible right by which he could have deducted un-

paid interest. It is only by virtue of the exception that he can have any right of deduction at all. How far does the exception extend? Does it include interest payable or is it confined to interest that has been paid? The answer, in my opinion, is to be found in the words "any payment on account of capital", contained in section 6 (*b*). If the exception with which we are concerned had been set out in section 6 (*b*) itself immediately after the words mentioned the exclusion and the exception to it would have been stated as follows, namely, "any payment on account of capital except interest on borrowed capital used in the business to earn the income at such reasonable rate as the Minister in his discretion may allow * * *". Read in that light, as I think it should be, the meaning of section 5 (*b*) becomes quite clear. Section 6 (*b*) excludes from deduction "any payment on account of capital" but provides for an exception to such exclusion by the words "except as otherwise provided in this Act". These words contemplate only exceptions of the same kind as the specific exclusions set out in the section. The exception carved out by section 5 (*b*) is, therefore, of the same kind as the exclusion to which it is an exception, that is to say, it must be some kind of a "payment on account of capital". These words govern the kind of exception that is otherwise provided for in the Act. The exception extends only to interest that amounts to a payment on account of capital; it is, therefore, confined to interest that has been paid; and does not include interest that is payable but has not been paid, for such interest cannot be a "payment" on account of capital. Such a construction of section 5 (*b*) is necessary in order to bring its subject matter outside the exclusion of section 6 (*b*) and within the exception contemplated by it, and there is nothing in section 5 (*b*) itself that is inconsistent with it. It was, therefore, not necessary to specify in section 5 (*b*) that the interest mentioned in it must have been paid in order to be deductible; that was a condition precedent to its deductibility inherent, in the absence of clear terms to the contrary, in section 5 (*b*) as one of the exceptions referred to in the concluding words of section 6 (*b*). It is, in my opinion,

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clear that section 5 (*b*) allows the deduction of interest on borrowed capital used in the business to earn the income only when the interest has been paid; and that no deduction is allowed in respect of unpaid interest, even although it has become payable or is accruing from day to day.

That being so, since the appellant did not pay the interest on the mortgage, he cannot show compliance with the conditions required by section 5 (*b*) and is not entitled to the benefit of its provisions. On this ground as well as on the others mentioned the appellant fails. The Minister was right in disallowing the deduction of the unpaid interest on the mortgage and the appeal must be dismissed with costs.

Judgment accordingly.