BETWEEN:

ALUMINIUM UNION LIMITED .....APPELLANT;

AND

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

1959
Sept. 25

1960
June 21

Revenue—Income Tax Act R.S.C. 1952, c. 148, s. 4—Income or capital—Profit on foreign exchange—Money used in operation of business—Buying and selling of foreign exchange necessary for purpose of business transactions—Profit realized on settlement of indebtedness is taxable as income—Appeal dismissed.

Appellant, a Canadian company, carried on the business of selling aluminium and related products in foreign countries. It commenced trading operations in these commodities in Japan in 1934 and through this branch office promoted the market for its goods, served its customers and made its sales. The office was closed in April 1942. To finance the trading operations of its Japan branch it obtained through that branch loans and advances in Japanese currency from the National City Bank of New York through the branches of that bank maintained in Japan. The borrowings were for payment of import duties and for general purposes. A final settlement of indebtedness was effected in 1952 by the purchase by appellant of the necessary Japanese money. As a result the appellant made a profit of $172,927 which was shown in its income tax return for 1952 but which appellant claims to not be taxable income within the provisions of the *Income Tax Act* or the *Income War Tax Act*. The respondent assessed the appellant for income tax on this amount and an appeal to the Income Tax Appeal Board was dismissed from which decision the appellant now appeals to this Court.

Held: That the profit realized from the use of the funds was income within the meaning of s. 4 of the *Income Tax Act* since the money borrowed from the bank was not borrowed for capital purposes but to pay the current expenses of carrying on the business, it was not borrowed for investment purposes but to meet the expenditures incurred in the operation of appellant's business activities and was circulating capital used in its trade.

2. That the amount of indebtedness of the appellant to the bank at the time of the settlement of the debt consisted of sums borrowed on demand loans and on advances by way of overdraft on its current account which sums had been used by appellant to finance its trading operations and was circulating capital used in the trade and the profit made on the exchange of dollars for Japanese yen when it settled its account with the bank in Japan was made on funds which had been borrowed and used to pay expenses of its trading operations.

3. That though the buying and selling or the exchanging of dollars for yen was not the primary business of the appellant that operation was necessary for the purpose of its transactions on revenue account and the settlement of its debt with the bank in Japan was a part of its trading operations.

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APPEAL under the *Income Tax Act.*

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

C. Antoine Geoffrion and *Raymond Y. Décarie* for appellant.

Lovell C. Carroll, Q.C. and *Maurice Regnier* for respondent.

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

FOURNIER J. now (June 21, 1960) delivered the following judgment:

In this case the Minister of National Revenue in his assessment of the income tax of Aluminium Union Limited for the taxation year 1952 included as taxable income the sum of $172,927 on the ground that it was profit on settlement of pre-war Japanese yen loans. The Income Tax Appeal Board in a decision dated February 18, 1957 confirmed the Minister's assessment. The taxpayer now appeals to this Court from the above decision.

The appellant claims that the aforesaid amount was not profit from its business and was not taxable income within the meaning of and for the purposes of any part of the *Income Tax Act* or the *Income War Tax Act* for the 1952 taxation year or any other year.

At the hearing of the appeal it was agreed that the evidence set out in the transcript of proceedings before the Income Tax Appeal Board and the supporting documents should be evidence before this Court. I shall summarize the important and material facts constituting the basis of the litigation.

The appellant, a company incorporated under the laws of Canada with head office in Montreal, since its inception has carried on the business of selling aluminium and related products in foreign countries. It commenced its trading operations in those commodities in Japan during the year 1934 and opened a branch office at Osaka, Japan, headed by its representative. Through this branch office, it promoted the market for its goods, served its customers

and made its sales. These trading operations went on from 1934 until shortly after the outbreak of war with Japan. The office was finally closed in April 1942.

To a large extent, the appellant's trading activity is limited to placing the production of associated companies in the export market through the medium of branch offices and agents or representatives. The trading operation involves the obtainment of orders, the placement of these with suppliers and the sale to customers. The financing of such transactions is made largely by arrangement of credit terms with suppliers to meet the credit terms extended to the customers. The branch offices receive credit for profits resulting from their activities. It appears that the appellant to finance the trading operations of its Osaka (Japan) branch office, obtained through the said branch office loans and advances in Japanese currency from the National City Bank of New York through the branches maintained in Japan by this bank. The financial statements of the Osaka office show the initial loan to be of June 1936 with continuance at varying amounts until November 1938. The borrowing on overdraft account began in July 1938 and continued in varying amounts until closure of its operations. The appellant's business activities in Japan consisted of trading operations. Its borrowings were for the payment of import duties and for general purposes.

In November 1938, the balance due on the bank loan was ¥575,000; at the outbreak of war with Japan and at the date of settlement it stood at the same amount.

The borrowings on overdraft account started in July 1938. In November and December of the same year, an amount of ¥300,000 was drawn on that account to meet a call on Aluminium Sumitomo Limited shares held in the name of Aluminium Limited. The payment was made by the Osaka branch office at the request of the appellant on behalf of its parent company Aluminium Limited and charged by the appellant to Aluminium Limited in March 1939 (Exhibit 1) in the amount of $86,437.50. This dollar equivalent was recovered by the appellant by being credited for same by its parent company Aluminium Limited, to which the appellant was indebted. So the appellant instead

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of receiving dollars reduced its liability to Aluminium Limited by so many dollars. To complete the picture, at the outbreak of hostilities the balance due by the appellant to the bank was ¥575,000, acknowledged by a promissory note dated September 22, 1941 and ¥122,000 on the current account, which in May 1942 was reduced to ¥118,989. These loans were recorded and carried in its accounts as liabilities every year, from 1941 up to the date of settlement, at the Canadian currency rate, at a sum of $175,635 and later at $174,805. Attempts were made by the appellant after the war to repay the balance still owing, but without success until the year 1952. The settlement at that time was effected by purchasing the necessary yen at the prevailing Canadian currency rate. The amount of the purchase for the foreign currency was $1,878. Copy of the certificate of receipt for ¥713,014.05 is annexed to the appellant's notice of appeal.

In its income tax return for 1952, the appellant's statement of "Profit and Loss" for the year ended December 31, 1952 adds to its net profit, after deduction of certain expenses, the item "As exchange profit on settlement of bank loans in Japan, the sum of $172,927" but claims that it was not taxable income within the meaning of the provisions of the Act.

The tests to be applied in determining if a gain resulting from the variations in foreign exchange rates is taxable income are the same as those applicable to other profits. If the exchange profit is derived from funds forming part of capital assets, it is not taxable; but if it results in respect of funds received on revenue account, the profit is income.

In this instance the appellant's business is the promotion and sale of aluminium and other related products in foreign countries. In Japan it carried on its trading operations through a representative at its branch office in Osaka. To finance its Japanese business activities it borrowed money from a bank. It had no other funds at its disposal. The borrowed monies were in Japanese currency and were used to pay duties on the goods imported in Japan from Canada and elsewhere. The duties were added to the sale price of the goods sold to the clientele. The loans were also used for business purposes, such as general administration, salaries,

travelling expenses and office furnishings. At the outset, the appellant made time loans through its branch office. This method of borrowing was discontinued in November 1938. The balance due on these loans remained the same from that time until the outbreak of war. It then gave its promissory note to cover this liability. In July 1938, it opened an overdraft current account to meet its expenses. As all such current accounts, it showed the deposits and the withdrawals made during each month. The sum of ¥300,000 to pay for the call on the shares in the name of Aluminium Limited appears to have been borrowed in August 1938 on the overdraft account. Repayments on the overdraft account pursuant to that loan are as follows:

1938		
	September	¥200,000
	October	50,000
1939		
	January	50,000
	March	100,000
	April	50,000
	May	50,000

and so on. Exhibit A12 shows that the appellant paid ¥935,000 between September 1938 and August 1939.

I shall attempt to describe the ¥300,000 transaction in the light of the evidence before me.

Aluminium Limited is the parent company of the appellant. A call was made on it to pay ¥300,000 on shares of a certain company which were in its name. The appellant was indebted to its parent company; I assume the indebtedness was consequential to their commercial operations. The appellant sold the products of the parent company. It did business in Japan; it had Japanese currency. The call on the parent company was to be met in Japanese money. It requested its subsidiary to make the payment. It then relieved its subsidiary of its debt to the extent of the amount of the payment. So the parent company creditor was paid in part and subsidiary debtor was relieved of part of its obligation. The ¥300,000 having been paid at the request of the parent company was drawn from an overdraft current account purporting to meet its business obligations. The above sum was paid not only to meet a

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call made on the parent company for the shares it had purchased but also to pay off part of its indebtedness to the parent company. The ¥300,000 was repaid to the bank by the appellant long prior to the closing of its office in Japan. I believe this to be the only logical explanation which can be made of the whole deal.

A certain number of leading cases on the subject of foreign exchange profits were referred to by counsel for both parties in their argument. It goes without saying that the appellant relied on those cases where it was found that the exchange profits arose in respect of funds which were considered as part of the taxpayer's capital assets and therefore not taxable. On the other hand, the respondent laid stress on the decisions dealing with foreign exchange derived from revenue or trading assets which were taxable income. In my opinion, the facts herein contained should be considered in relation to the facts which were the basis of the above decisions.

I shall deal with two English cases in which the exchange profit was held to be of the nature of a capital gain.

The first case is that of *McKinlay v. H. T. Jenkins and Son, Limited*[1] where it was held that the exchange profit was not a profit arising out of the contract for the supply of marble, but was merely an appreciation of a temporary investment, and was not assessable as part of the profits of the Company's trade. This decision was based on the following facts.

Under an agreement for the supply of a quantity of marble by a company of marble and stone merchants to certain building contractors, the contractors agreed to advance part of the price, percentage deductions to be made from the amount due on each consignment until the advance had been repaid. The amount of the advance paid to the company was credited to an account at a London bank. In anticipation of the required marble being purchased in Italy, the company arranged for the conversion of the greater part of the advanced pounds into lira. Later the lira having appreciated in value, the company sold the lira at a profit. The lira were subsequently repurchased for

[1] 10 T.C. 372.

the purpose of the contract for a lesser price than that at which they had been sold. The profit arising from the exchange transaction was, for the purposes of assessment, computed in the company's taxable income. The Court ruled that the amount was not taxable.

The second case is that of *Davies v. The Shell Company of China, Ltd.*[1] in which the Court of Appeal upheld the findings of the Special Commissioner that an exchange profit arising from deposits in the nature of performance guaranty made by the company's selling agents abroad was a capital profit. The company, in this instance, was free to use the money in its hands for investment purposes and it was found that it did, in fact, so use it, and not as circulating capital for the purpose of carrying on its trade of dealing in petroleum products.

The appellant herein, through its branch office, had with the bank an overdraft account which was used for the purpose of carrying on its trade dealings in aluminium and related products. Among the companies with which it dealt in its business activities was the parent company to which it was indebted following their commercial transactions. The appellant was requested by the parent company and agreed to pay off a debt of the parent company. To do so, it drew an amount of ¥300,000 from its overdraft account. In return the parent company credited the appellant for the said sum on account or in part payment of its debt. As time went on, the appellant paid back to the bank the amount disposed of as stated above by making deposits in its overdraft account from the proceeds of its trading operations. All this was done some time before the appellant closed its Japanese office. In my view, there is no comparison possible between these facts and those before the Courts in the above cases.

The *Tip Top Tailors* case[2] was discussed at length before the Court. In that case the company was in the business of manufacturing and selling clothing at retail. . . . It purchased large quantities of cloth and other supplies and for many years followed the practice of paying for such goods immediately after receipt. . . . A very substantial part of

[1] 32 T.C. 133.
[2] [1955] Ex. C.R. 144; [1957] S.C.R. 703.

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its purchases were made in the United Kingdom and for many years the suppliers had been paid in a somewhat different manner. The accounts of these supplies were all payable in sterling funds and it was necessary for the company to purchase and remit sterling funds. Believing that the pound sterling would be devalued, it made an arrangement with its bank in London for an extended line of credit. It made remittance in sterling to this bank, but not in sufficient amounts to take care of the suppliers' accounts. The overdraft progressively increased and in 1949, when the pound was devalued, it paid its overdraft to the bank by purchasing sterling at the lower rate and thereby settled its liability at less than it would have been required to pay had sterling not been devalued.

In that case, Cameron J. of the Exchequer Court held (*inter alia*):

> That the profit received by respondent was one made in the course of its normal business operations while carrying out a scheme for profit-making.
>
> That the loan by the bank was used to pay trade accounts and was circulating capital used in the trade; the fixed capital of the respondent was at no time employed in the transactions and the profit when made did not affect the capital structure of respondent in any way but was an increase in its trading profit and available for distribution to its shareholders.

The Supreme Court of Canada upheld this decision. Rand and Fauteux JJ. found:

> That the profit was not to be regarded as one on a collateral borrowing of capital but rather as one derived from the "business" in which the company was engaged. The loan produced working capital used in the course of the company's business and in substance the creation of debt in the bank was merely a substitution of creditor for the actual transactions. There was no temporary investment in foreign capital.

The evidence adduced by the appellant is to the effect that its trading operation was the obtainment of orders, the placement of these with suppliers, the purchase of the requisite metal by the head office or by other associated offices and the sale to the customer. The financing of such transactions was largely made by arrangement of credit terms with the suppliers compatible with those extended to the customer. Branch offices such as the Japanese office received credit for the profits resulting, with flow of cash to head office from customer remittances. The financing of

these offices was generally limited to an amount sufficient to meet selling and administrative expenses and other local currency outlays. For the financing of its Japanese operations, at the outset the appellant borrowed monies from the bank on a time basis, but in 1938 it borrowed on current account advances by way of overdraft. It was stated that in Japan the appellant's office had no other funds than the above mentioned and that they were used for import duties, salaries, general administration and furnishings for the office. It was from the overdraft account that an amount of ¥300,000 was drawn to make a payment in the name of another company, to wit, its parent company.

As the documents on file show that the amount of ¥300,000 was repaid to the bank in yen currency before the closing of the Japanese office, the only question to be determined is whether the exchange profit on settlement of the Japanese Yen Loans is includible in the appellant's taxable income.

There is no doubt in my mind that the monies borrowed by the appellant from the bank were for the purpose of carrying on its business operations. The debt due to the bank was incurred for the purpose of gaining or producing income from its business. The profit realized from the use of the funds obtained for the purpose of carrying on a business and of producing income from the business seems to me to meet the requirements of s. 4 of the Act.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

At the time of the settlement of the yen borrowings, the appellant was indebted to the bank in the amount of ¥713,014.05. The amount had been borrowed not for capital purpose, but, as stated in evidence, to pay for the current expenses of carrying on the business. The borrowings were not made for investment purposes but to meet the expenditures incurred in the operation of its business activities. In other words it was circulating capital used in its trade.

As a matter of fact, the appellant carried on its trading operations in Japan through a branch office, not through a distinct entity, and all its activities there were in the nature of trade financed by borrowed funds in local currency. Its

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dealings with the bank were in Japanese yen. It seems well established that the funds secured from the bank were intended to be used for and were used for non-capital purposes. Even the ¥300,000 payment for the parent company was used to cover part of the appellant's indebtedness to the parent company, resulting, no doubt, from their business transactions. In its books the appellant carried its indebtedness to the bank as a current liability and not as a capital debt. It treated the profit realized in the settlement of the bank loans as a profit in its profit and loss account and it was only later that, in reconciliation for income tax purposes, it treated it as a capital profit. All the facts established have convinced me that the exchange profit herein resulted from trading or dealing in foreign exchange and from funds received on revenue account.

It could not be otherwise under the system which was followed by the appellant in its trading operations. It sold the products for Japanese yen which, in the final analysis, had to be converted in dollars when the flow of cash arrived at its head office from the remittances of its customers. The reverse had to take place when the appellant had to meet the expenses of its dealing operations in Japan. It had to buy or borrow Japanese yen to meet its obligations. So it is reasonable to conclude that part of its business activities was dealing in foreign currency. The profit or loss from these financing operations, a necessary element of its business, was in the nature of revenue account and to be considered in assessing the taxpayer for income tax purposes.

I have come to the conclusion that the amount of the indebtedness of the appellant to the bank at the time of the settlement of the debt consisted of sums borrowed on demand loans and on advances by way of overdraft on its current account. The sums thus borrowed had been used by the appellant to finance its trading operations and was circulating capital used in the trade. The profit made on the exchange of dollars for yen, when it settled its account with the bank in Japan, was made on funds which had been borrowed and used to pay expenses of its trading operations.

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Though the buying and selling or the exchanging dollars for yen was not the primary business of the appellant, that operation was necessary for the purpose of its transactions on revenue account and the settlement of its debt with the bank in Japan was a part of its trading operations.

That is why I find that the profit realized by the appellant on the settlement of its debt to the bank was includible in its revenue income and assessable for income tax purpose.

Therefore the appeal is dismissed and the respondent's assessment of the appellant's taxable income is affirmed, the whole with costs to be taxed in the usual way.

Judgment accordingly.