BETWEEN:

MONTREAL LIGHT, HEAT & POWER CONSOLIDATED..... APPELLANT;

AND

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

1940
Feb. 7 & 8.
1941
Jan. 11.

Revenue—Income—Deductions—Outlay on account of capital—Expenses incurred in refunding outstanding bond issue and replacing same by a new bond issue carrying lower rate of interest—Income War Tax Act, R.S.C., 1927, c. 97, Sects. 3, 5 and 6 (a) and (b)—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—Appeal from decision of Minister of National Revenue dismissed.

Appellant, in 1936, redeemed a portion of an outstanding bond issue and replaced the same by a new issue of bonds bearing a lower interest charge. Appellant incurred certain expenses in connection with this operation, namely (1) Premium paid upon retirement of the issue of old bonds; (2) Exchange premium paid in connection therewith; (3) Discount on the issue of new bonds; (4) Expenses in connection with the retirement of the issue of old bonds; (5) Interest paid by appellant on funds necessary for the redemption of old bonds from the date of notice of redemption to actual date of redemption. Appellant proposed to amortize these disbursements over the term of the new bonds and claimed a deduction for income tax purposes of the amount required each year for such amortization. This deduction was disallowed by the Commissioner of Income Tax whose decision was affirmed by the Minister of National Revenue and an appeal was taken to this Court.

Held: That the disbursements or expenses incurred by appellant were not "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" of appellant.

2. That s. 5 of the Income War Tax Act is not exhaustive of all permissible exemptions and deductions for income tax purposes.

3. That all the expenses incurred by appellant are of a capital nature and constitute an outlay made on account of capital, they not having been incurred for earning the trading net revenue of appellant.

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4. That expenses incurred in redeeming, refunding or reducing borrowed capital constitute an outlay or payment on account of capital and fall within the prohibition of s. 6 (*b*) of the Act in computing the amount of profits or gains to be assessed.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

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

Aimé Geoffrion, K.C., G. H. Montgomery, K.C. and *G. H. Montgomery Jr.* for appellant.

F. P. Varcoe, K.C. and *A. A. McGrory* for respondent.

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

THE PRESIDENT, now (January 11, 1941) delivered the following judgment:

This is an appeal from the decision of the Minister of National Revenue affirming an assessment levied against the appellant under the Income War Tax Act, for the fiscal year ended December 31, 1936. The question involved in the appeal is whether certain disbursements laid out or expended by the appellant in refunding a portion of an outstanding bond issue and replacing the same by a new issue of bonds at a lower rate of interest, and similar disbursements laid out or expended on the retirement, concurrently, of the balance of the same bond issue, for the purpose of effecting a saving in fixed charges, should be allowed as deductions in the assessment of the appellant for the income tax for the year in question. The appellant sought to amortize the said disbursements over the term of the new bonds, but this was refused by the Minister on the ground that these disbursements constituted outlays on account of capital and not expenses laid out for the purpose of earning the "income" as defined by s. 3 of the Act, and from that decision this appeal was asserted.

In January, 1936, the appellant had outstanding, in the par value of $27,615,000, an issue of 5 per cent bonds payable both as to principal and interest in gold at either Montreal, Toronto, New York or London, at the holder's option. This issue of bonds, by a refunding operation, was replaced in part by an issue of 2½ per cent serial bonds in the par value of $5,000,000, maturing in the years 1937

to 1941 inclusive, in the annual amount of $1,000,000, and in part by an issue of 3½ per cent twenty-year sinking fund bonds, in the par value of $10,000,000, maturing in 1956, making altogether a bond issue of $15,000,000, payable as to principal and interest in Montreal or Toronto, Canada. The balance of the outstanding bond issue, some $12,000,000, was retired from the proceeds of the sale of certain investments in the treasury of the appellant company.

The result of the whole operation was to effect a direct saving of $275,000 per annum in interest alone, being the difference between the old interest sum of $750,000 per annum and the new interest sum of $475,000 per annum. In the issue of the new bonds the gold payment clause was eliminated and this effected an additional average annual saving of $303,119.18 based upon the appellant's experience during the last nine years in which the old bonds had been outstanding, in the payment of exchange rates upon its half yearly interest instalments, and which during that period ran from $275,000 to $354,453.12 per annum, or an average for the nine years of $303,119.18. These savings reflected a corresponding increase in the net income of the appellant.

In the refunding and retirement operation which I have described certain outlays or disbursements became necessary, and the appellant claims they were wholly, exclusively and necessarily laid out for the purpose of earning the assessable income, that is to say, by reducing its fixed charges and thus correspondingly increasing its net income. These disbursements or expenses may be stated in the following form:

(1) Premium paid upon retirement of the issue of old bonds.....		$1,104,600 00
(2) Exchange premium paid upon retirement of the issue of old bonds.....		676,726 00
(3) Expenses in connection with the retirement of the issue of old bonds....		25,753 42
(4) Discount on the issue of new bonds:		
$ 5,000,000 par value at 1½ per cent.....	$ 75,000	
$10,000,000 par value at 4 per cent.....	400,000	475,000 00
Total		$2,282,079 42

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These outlays or disbursements the appellant proposed to amortize over the period of the new bonds and the amount applicable to the year 1936, from the date of issue of the new bonds to the end of that year, was $104,596.04. In addition to the above items of expense, there was also expended an amount for overlapping interest from February 1, 1936, when funds had to be in hand by borrowing for the redemption of the issue of old bonds, up to April 1, 1936, when the old bonds were actually retired, and this amounted to $79,166.64. This amount of expense the appellant claims was also incurred for the purpose of earning the income as in the case of the other items mentioned. The amounts of the several items of expense just mentioned are not in dispute.

I perhaps should here add by way of explanation that there was a provision in the trust deed securing the old bond issue which required the payment of a premium of 4 per cent in the event of redemption before maturity. Concurrently with the giving of notice of the redemption of the old bond issue to holders thereof the appellant was necessarily obliged to make definite financial provision for the redemption which it did by borrowing the requisite sum from its bankers and upon this sum it paid interest from February 1, 1936, to April 1, 1936, when the appellant was in funds from the proceeds of the new bond issue and the sale of certain investments. This interest payment, amounting to $79,166.64, was obviously an unavoidable expenditure because the appellant had actually to be in funds in the amount necessary for the redemption operation before the notice of redemption issued to bond holders, but interest was, of course, running concurrently during the same period on the old bonds until the actual date of redemption. The amortization of the total outlay or disbursements incidental and necessary to the redemption of the old bonds and the issue of the new bonds, and the overlapping interest as just explained, during the term of the new bonds, amounted to $184,652.46 per annum, and this the appellant claims to be an expense incurred to earn the income and therefore deductible in computing the amount of its profits or gains to be assessed for the income tax for the year 1936. The grounds upon which the Minister refused to allow the deductions claimed by the appellant,

and the grounds advanced by the appellant in support of the allowance of the deductions claimed by it, will sufficiently appear from what I have already stated.

The appellant in a statement accompanying its Notice of Dissatisfaction sets forth the reasons which prompted it to engage in the financial operations described and as that is the foundation for the claims which it now puts forward I should perhaps state them briefly. The interest rate upon the old bond issue was considered not only unduly high but the principal and interest were payable in gold at the places already mentioned, at the holder's option, and the taxable earnings of the appellant had been seriously reduced each year since the War in consequence of the heavy exchange rates which the company had been obliged to pay upon its half-yearly interest instalments. As the credit of the appellant was excellent it was decided, early in 1936, to take advantage of a favourable money market and to redeem the outstanding bonds and replace them in part with bonds carrying a lower coupon rate, payable as to principal and interest in certain Canadian centres only, thus relieving itself of its obligation as to the payment of principal and interest in gold. As the old bonds would not mature till 1951 and their redemption was subject to the payment of a premium of 4 per cent, and as new bonds would have to be issued to take their place in part, it was obvious that certain disbursements and expenses would necessarily have to be incurred in consummating the decision reached. The appellant, after consultation with its investment brokers, decided that the most advantageous method of reducing interest and exchange charges would be by the adoption of the refinancing plan which I have described and which was ultimately carried out. The redemption of the old bonds and the issue of new bonds received the approval of the Provincial Electric Board of the Province of Quebec, which, I assume, for some reason was necessary. I have no doubt that the foregoing substantially sets forth the reasons for the action taken by the appellant, and it would seem to be amply justified by sound business and accountancy practice, and the results would seem to have verified the expectations of the appellant.

As already mentioned the objection to the allowance of the deductions here claimed is that the expenditures

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therefor were incurred on account of capital and not wholly, exclusively and necessarily for the purpose of earning the income. The contention of the Minister, is based on sec. 6 (*a*) and 6 (*b*) of the Act, and those provisions read thus:

> (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.
>
> (*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.

Sec. 6 (*a*), as has often been observed, is expressed in negative form, but it has been repeatedly held that this may be read as a positive enactment. Lord Wright in *Hughes* v. *Bank of New Zealand* (1), in discussing a provision corresponding to s. 6 (*a*) of our Act, said: "That is put in negative form, but it is generally, and I think correctly, treated as being capable of being converted into a positive enactment, with the result, that it provides that 'money wholly and exclusively laid out or expended for the purpose of the trade,' may be deducted." Section 5 provides that "income," as defined by s. 3, shall be subject to certain enumerated exemptions and deductions, but that, as has often been pointed out, is not to be construed as exhaustive of all permissible exemptions and deductions. That section is silent as to many matters of the first importance, and the appellant's claim to the specific deductions mentioned is not to be dismissed merely because they are not expressly authorized by the Act. In computing the profits of a trade any expense (as to which there is no express prohibition) is to be deducted, if on the facts of the case it is a proper debit item to be charged against revenue. The generally recognized rule as regards trade expenses is that a deduction is permissible which is justifiable on business and accountancy principles; but this rule is affected by certain specific statutory provisions. To the extent that ordinary business and accountancy principles are not invaded by statute, they prevail.

There seems to be no authority which throws any direct light on the question involved in this appeal as one might expect, at least none was brought to my attention. In

(1) (1937) 1 K.B.D. at p. 448; (1938) A.C. 366.

England, limited companies must deduct the income tax at the appropriate rate from any debenture or other annual interest or annual payments which they may pay or make, and for that reason, it was explained to me, English decisions could have no application here. Whether that is so or not there seem to be no decided cases in England which throw any light on the precise question here to be decided. I might point out here that in Canada, under s. 5 (*b*) of the Act, such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow is permissible as a deduction, and the appellant, in the period in question was allowed a deduction on this account. In the United States, expenses incurred in connection with the refunding or retirement of bond issues are governed by a set of rules issued by the Treasury Department in 1938, and it is probable that there, under such rules, the disbursements here would be allowed as deductions. It is not of course contended here that the appellant should not in its own accounting treat the expenses and disbursements in question here as charges against revenue and not capital. What has to be determined here is the assessable income, the amount of the profits or gains to be assessed, which is not necessarily the same thing, as the profits or income ascertained by the accounting of the appellant for its purpose. A great many cases were cited before me and a great many arguments were adduced. If I do not refer to all those cases or to all those arguments it is not to be inferred that I have failed to do so from any disregard of those cases and arguments, to all of which I have given consideration. I have felt it best to decide the case, as far as I can, on the construction of the relevant sections of the Act and on the broad principles which seem to me to be necessary to be applied in construing these sections.

It was, I think, conceded by counsel for the appellant that expenses incident to the issue of the old bonds would be chargeable to capital and not revenue in computing the assessable income, on the ground, I assume, that it was so much paid for the cost of getting that capital, and it has been said that there could not be one law for a company having sufficient money to carry on all its operations and another which is willing to pay for the accommodation. Now, that much being conceded, I find it difficult to

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distinguish between that state of facts and that where expenses are incurred for redeeming, renewing or refunding, bonds or debentures. Substantially, what took place here was the redemption and renewal in part of an existing capital obligation from the proceeds of a fresh capital obligation, and a redemption of the balance of that first capital obligation from the proceeds of the sale of investments which really was working capital, and which involved a debit entry in the investment accounts because of redemption of a capital obligation. Therefore, I think, that all the expenses in question must be held to have been essentially of a capital nature, an outlay made on account of capital. If that be so does it matter for our purposes here what be the consequences upon the net revenues of the appellant? I think not. The original capital which was the proceeds of the old bonds was now in the form of fixed capital assets or working capital, and whatever was the net result of the financial operations that took place they related to and were on account of capital. It therefore seems to me to be difficult to say otherwise than that all the expenses in question here constituted an outlay on account of capital, within the meaning of the statute, even though on equitable grounds the appellant's view seems attractive and in many ways quite just.

In the case of *Archibald Thompson, Black and Co. Ld.* v. *Batty* (1), it was held that costs incurred in connection with the reduction of capital were inadmissible as a deduction, because it was not a reduction of capital made for the purposes of the trade of the company. The object of the reduction was to enable the company to resume the payment of dividends out of the balance of each year's trading which would otherwise have fallen to be applied in reducing the debit balance in the profit and loss account until it was extinguished, and it was held that the cost of obtaining the order of the Court was inadmissible as a deduction. The Lord Justice Clerk there said: "The expenditure while being quite a proper expenditure and quite properly made in the interests of the company was not, as it seems to me for the purposes of the trade, but was made for the purposes of distributing more advantageously, as it was thought, the results of that trade,

(1) (1919) 7 T.C. 158 at 162.

namely, the profit, which on a trading account balance, would have been available for distribution among the shareholders, had it not been for the debit balance to which I have already referred. I don't think that is in a proper sense of the term, a disbursement made for the purposes of the trade. It is made for the purpose of dealing with the results of that trade, after these results have been realized; that is to say, it was made for the purpose of distributing the balance of profit and loss among the shareholders instead of, as had previously been the case, by placing it to the credit of this debit balance." It seems to me that the reasoning in that case is applicable to the one under consideration. The advantages of a bond issue carrying a lower rate of interest would undoubtedly decrease the outgo of the appellant as compared with a higher rate of interest and leave a larger surplus of receipts over outgo, but that would relate to the results of the trade after the results had been ascertained, and not to the amount of the assessable net profits or gains earned by the trade or business of the appellant, within the meaning of the Act. It did not increase the revenue but it decreased the fixed capital charges of the business, and could not therefore have been incurred exclusively to earn the net profits or gains to be assessed. But the appellant contends that in fact it did increase the assessable income, and that therefore that increase should not be taxed without making deductions for any expense incurred in making that increase possible. The answer to that is, I think, that the expenses were not incurred for earning the trading net revenue but were an outlay made on account of capital which is specifically barred as a deduction by the Act, and next, I think, there is a distinction between what is the net income of the taxpayer and what is the amount of the profits or gains to be assessed.

If the expenses incurred in raising a portion of the initial capital of a company by an issue of bonds are not permissible as a business deduction, and I do not think the contrary has ever been held, then it seems to me to follow that expenses incurred in redeeming, refunding or reducing that borrowed capital, even if the results be beneficial to the net revenues of the company concerned, constitute an outlay or payment on account of capital and fall within the prohibition of s. 6 (*b*), in computing the amount of

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the profits or gains to be assessed. Here, for example, the premium payable on the redemption of the old bonds before maturity, was the direct consequence of a specific obligation made on account of capital, and, I think, in substance that may be said of every item of the expenses incurred. The expenses were not, I think, wholly or exclusively incurred for the purpose of earning the annual net profit or gain of the trade or business of the appellant company. The principle is that it is expenses necessary to earn future profits that are allowable deductions, and this principle has been extended to include expenditure to avoid future trading expenses. The profit of a trade or business is the surplus by which receipts from the trade exceed the expenditure necessary for the purpose of earning the receipts. I think the true view of the facts of this case is that the expenditures here made were outlays on account of capital. That is the conclusion I have reached and I do not think I can usefully add anything further. The appeal must therefore be disallowed and with costs.

Judgment accordingly.

The appeal of *The Montreal Coke & Manufacturing Company* from the decision of the Minister of National Revenue was heard on the same date before the Hon. Mr. Justice Maclean as the appeal of *The Montreal Light, Heat and Power Consolidated,* the same counsel being engaged on the appeal. On January 14, 1941, the learned President delivered the following judgment:

This is an appeal from a decision of the Minister of National Revenue affirming an assessment levied against the appellant under the Income War Tax Act, for the fiscal years 1935 and 1936. The question involved in this appeal is whether certain disbursements laid out or expended by the appellant in refunding an outstanding bond issue and replacing the same by a new issue of bonds, at a lower rate of interest, for the purpose of effecting a saving in fixed charges, should be allowed as deductions in the assessment of the appellant for the income tax for the years in question. The appellant, in its tax returns, sought to amortize the said disbursements over the term of the new issue of bonds but this was refused by the Minister on the ground that these disbursements constituted outlays

on account of capital and not expenses incurred for the purpose of earning the income, within the meaning of the Act, and from that decision this appeal was asserted.

In 1935, the appellant company had outstanding first mortgage 5½ per cent bonds in the principal amount of $3,457,000, maturing on June 1, 1947, redeemable at 102, and payable in United States funds at the option of the holder. In that year the appellant decided to take advantage of a favourable money market and to redeem the outstanding bonds, replacing them with bonds carrying a lower rate of interest, and it requested the Trustee for the old bond issue to give notice of intention to redeem the old bonds on the next interest date, December 1, 1935. The refunding operation was carried out by issuing $1,200,000 of 3½ per cent serial bonds, maturing annually from 1936 to 1940 inclusive, and $2,200,000 of 4 per cent fixed term bonds maturing on September 16, 1947. These bonds were sold to a brokerage firm in Montreal. The prices obtained were 99½ and accrued interest for the 3½ per cent serial bonds, and 99 and accrued interest for the 4 per cent fixed term bonds, resulting in a discount of one-half of one per cent in the case of the serial bonds and one per cent in the case of the fixed term bonds.

The refunding arrangements called for the certification and delivery of the new bonds on September 16, 1935. This required that the mortgage covering the old bond issue be discharged. The appellant, therefore, on September 16, 1935, deposited with the Montreal Trust Company, the Trustee for the old bond issue, the sum of $3,621,207.50, being the par value of that bond issue, the accrued interest to December 1, 1935 (the date on which the old bonds were retired), and the 2 per cent premium payable on redemption of the old bonds before maturity.

The particulars of all disbursements made by the appellant in connection with the refunding operation were as follows:

(1) Interest on new bonds from September 16, 1935, to December 31, 1935, until when interest had to be paid on both the old and new bonds	$23,207 54
(2) Various expenses on retiring the old bonds and issuing the new bonds	12,484 92
(3) Discount on issue of new bonds	28,000 00
(4) Premium paid upon retirement of the issue of old bonds	69,140 00
(5) Exchange premium paid on retirement of the old bonds	36,744 81

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It is the contention of the appellant that these several disbursements were incurred wholly, exclusively and necessarily for the purpose of earning the income which the Minister denies, and he further asserts that they were outlays made on account of capital and therefore not allowable as deductions from income.

The first two items of expense mentioned above were charged directly against the earnings for 1935, and the items numbered (3), (4) and (5) were amortized over the life of the new bond issue, by the appellant, all of which were disallowed by the Minister in the assessment of the appellant for the income tax. As I understand it, if all the expenses incidental to the refunding operation were amortized over the twelve-year life of the term bonds, which the appellant expressed willingness to do, the amount to be deducted annually would be $14,131.44, but even in that event the saving in annual interest would still amount to something over $40,000 per annum, with a corresponding increase in taxable income the appellant claims.

Such are the important facts of the case. This appeal was heard along with one asserted by The Montreal Light, Heat & Power Consolidated from a decision of the Minister confirming an assessment made against it under the Income War Tax Act. After the reception of certain evidence in each appeal they were both argued together, the arguments advanced in support of and against both appeals being identical. The questions involved in both appeals were precisely the same. I have rendered my decision in the case of The Montreal Light, Heat and Power Consolidated, holding that the disbursements and expenses therein made were not permissible deductions in computing the amount of the profits or gains to be assessed, and to my reasons for judgment therein I would refer. The conclusions I there expressed are equally applicable to this appeal, and there is nothing I can usefully add thereto. I therefore dismiss the appeal herein and with costs.

Judgment accordingly.