BRITISH COLUMBIA ELECTRIC RAILWAY COMPANY LIMITED } APPELLANT;

AND

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

1957 *Oct. 10, 11

1958 Jan. 28

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Public utility company carrying passenger and freight traffic—Payments made for discontinuance of passenger services—Whether deductible expense or capital outlay—Income Tax Act, 1948, c. 52, s. 12(1)(a), (b) (R.S.C. 1952, c. 148, s. 12(1)(a), (b)).

The appellant company, under agreements with the municipalities concerned, operated a railway providing both passenger and freight service between New Westminster and Chilliwack. The operation of the passenger service became increasingly unprofitable, and by 1949 it resulted in a substantial loss. The appellant, with the consent of the municipalities, obtained permission from the Public Utilities Commission to discontinue its passenger service, and authorization to a subsidiary company to operate a bus-service in its place. This permission was subject to conditions, one of which was that the appellant should pay $220,000 to the municipalities for the improvement of roads. The moneys were paid in 1950 and the appellant wrote them off as operating expenses over a 10-year period and deducted proportionate amounts from income in making its returns for 1950 and 1951.

*PRESENT: Kerwin C.J. and Locke, Cartwright, Fauteux and Abbott JJ.

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The deductions were disallowed on the ground that the moneys were outlays of capital, or paid on account of capital, within s. 12(1)(*b*) of the *Income Tax Act*, 1948, and were not expended for the purpose of gaining or producing income from the appellant's business within s. 12(1)(*a*). The Minister's assessment was affirmed by the Exchequer Court.

Held: The assessment was correct, and the moneys were not deductible from income.

Per Kerwin C.J. and Fauteux and Abbott JJ.: Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, it must next be ascertained whether the expenditure is an income or a capital outlay. Since income is determined on an annual basis, an income expense is one incurred to earn the income of a particular year and should be allowed as a deduction from gross income in that year. On the other hand, most capital outlays may be amortized or written off over a period of years, depending upon whether or not the asset in respect of which the outlay is made is one coming within the capital cost allowance regulations.

In the present case, the payments were connected with the appellant's profit-making operations, and were, therefore, made "for the purpose of gaining or producing income" within the meaning of s. 12(1)(*a*); but they were made on account of capital within the meaning of s. 12(1)(*b*), since they were made "with a view of bringing into existence an advantage for the enduring benefit" of the appellant's business. *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue*, [1942] S.C.R. 89, affirmed [1944] A.C. 126; *British Insulated and Helsby Cables, Limited v. Atherton*, [1926] A.C. 205, applied.

Per Locke and Cartwright JJ.: Since the appellant was not completely or permanently relieved from its obligations under the franchises, the benefit accruing from the payments was not "enduring" in the sense in which that expression was used in the *British Insulated* case, *supra*.

To say, however, that an expenditure made with a view to bringing into existence an asset or advantage for the enduring benefit of a trade is a capital expenditure is not to say that all other expenditures must, in order to be properly classified as outlays of a capital nature or on account of capital, be made in order to produce such a benefit. Here, the relief obtained through the payments substantially increased the value of the franchises to the appellant. Such payments were outlays of capital and payments on account of capital, within the meaning of s. 12(1)(*b*), to the same extent that payments made to secure the franchises in the first instance, had any been made, would have been. In view of this conclusion, it was not necessary to decide whether the payments were made "for the purpose of gaining or producing income from a property" within the meaning of s. 12(1)(*a*).

APPEAL from a judgment of Dumoulin J. in the Exchequer Court of Canada[1], affirming an income tax assessment. Appeal dismissed.

A. Bruce Robertson, Q.C., and *W. H. Q. Cameron*, for the appellant.

[1] [1957] Ex. C.R. 1, [1957] C.T.C. 120, [1957] D.T.C. 1034.

W. R. Jackett, Q.C., and *G. W. Ainslie*, for the respondent.

The judgment of Kerwin C.J. and Fauteux and Abbott JJ. was delivered by

ABBOTT J.:—The material facts in this appeal, most of which are set out in an agreed statement of facts, may be summarized as follows. For many years prior to 1950 the appellant operated a railway providing freight and passenger service in the Lower Fraser Valley in British Columbia between New Westminster and Chilliwack. The right to operate such service in the municipalities of Surrey, Langley, Matsqui, Sumas and Chilliwack was granted to a predecessor company, Vancouver Power Company Limited, under various agreements, one condition of which was that at least one passenger train would be operated each day each way, including Sunday. For a number of years prior to 1950 passenger revenue had been declining steadily and in 1949 the operating results of the railway showed a substantial loss on its passenger traffic although a substantial profit was made with respect to freight traffic. Moreover, if passenger traffic was to be continued, appellant would be required to make substantial capital expenditures with no prospect of any corresponding increase in revenue.

Under the *Public Utilities Act* of British Columbia, R.S.B.C. 1948, c. 277, appellant could not abandon its rail passenger service without the consent of the Public Utilities Commission and apparently such consent could not be obtained unless an alternative passenger service were made available and approval given by the interested municipalities. In order to obtain the approval of these municipalities to the operation of a bus-service in place of the rail passenger service, appellant entered into agreements with the five municipalities concerned under which these municipalities were paid sums aggregating $220,000 to be expended by them in putting certain roads in shape for the operation of buses thereon. In consideration of these payments the said municipalities consented to the appellant's application to the Public Utilities Commission for permission to cease the operation of passenger service over its railway. This permission was given in due course and the rail passenger service was discontinued.

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In making up its accounts, appellant elected to write off to operations the said sum of $220,000 over a period of approximately 10 years and claimed a deduction of $5,499.99 for 1950 and $22,000 for 1951.

On assessment of appellant for income tax for its 1950 and 1951 taxation years, these deductions were disallowed and subsequently the assessments were confirmed by the respondent. Appellant appealed the 1950 assessment to the Exchequer Court and on January 15, 1957, Mr. Justice Dumoulin rendered judgment[1] dismissing the appeal. The present appeal is from that judgment.

Two questions arise on this appeal: (1) was the expenditure of $220,000 by appellant made for the purpose of gaining or producing income? and (2) if it was so made, was such payment an allowable income expense or was it a capital outlay?

The answer to both questions turns upon the effect to be given to s. 12(1)(*a*) and (*b*) of *The Income Tax Act 1948*, c. 52, as amended, which reads as follows:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
>
> (*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

Section 12(1)(*a*) and (*b*) was first enacted in 1948 and it replaced s. 6(*a*) and (*b*) of the *Income War Tax Act*, which read as follows:

> 6. Deductions not allowed.—1. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*a*) Expenses not laid out to earn income,—disbursements or expenses *not wholly exclusively and necessarily* laid out or expended for the purpose of earning the income;
>
> (*b*) Capital outlays or losses, etc.—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 italics are mine.)

The less stringent provisions of the new section should, I think, be borne in mind in considering judicial opinions based upon the former sections.

[1] [1957] Ex. C.R. 1, [1957] C.T.C. 120, [1957] D.T.C. 1034.

Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of s. 12(1)(*a*) whether it be classified as an income expense or as a capital outlay.

Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay. The principle underlying such a distinction is, of course, that since for tax purposes income is determined on an annual basis, an income expense is one incurred to earn the income of the particular year in which it is made and should be allowed as a deduction from gross income in that year. Most capital outlays on the other hand may be amortized or written off over a period of years depending upon whether or not the asset in respect of which the outlay is made is one coming within the capital cost allowance regulations made under s. 11(1)(*a*) of *The Income Tax Act*.

Turning now to the facts of this particular case, it is clear that the payments aggregating $220,000 made by appellant to various municipalities were connected with appellant's profit-making operations. The evidence established that as a result of being relieved of its obligation to operate the highly unprofitable rail passenger service, while retaining the right to operate the freight service, the appellant's profits were increased substantially and by the terms of s. 4 of the Act "income for a taxation year from a business or property is the profit therefrom for the year". In my view, therefore, the payment in issue here was clearly one made for the purpose of gaining or producing income within the meaning of s. 12(1)(*a*).

The general principles to be applied to determine whether an expenditure which would be allowable under s. 12(1)(*a*) is of a capital nature, are now fairly well established. As Kerwin J., as he then was, pointed out in *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue*[1], applying the principle enunciated by Viscount Cave in *British Insulated and Helsby Cables, Limited v.*

[1] [1942] S.C.R. 89 at 105, [1942] 1 D.L.R. 596, [1942] C.T.C. 1, affirmed [1944] A.C. 126, [1944] 1 All E.R. 743, [1944] 3 D.L.R. 545.

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Atherton[1], the usual test of whether an expenditure is one made on account of capital is, was it made "with a view of bringing into existence an advantage for the enduring benefit of the appellant's business".

Applying this test to the facts of the present case, in my opinion the payment of $220,000 made by appellant was a payment on account of capital within the terms of s. 12(1)(*b*), and that is sufficient for the disposal of the appeal which should be dismissed with costs.

The judgment of Locke and Cartwright JJ. was delivered by

LOCKE J.:—The agreement entered into between the corporation of the District of Surrey and the Vancouver Power Company Limited, dated March 1, 1907, is in similar terms to those made by the power company at the same time with the municipalities of Langley, Matsqui, Sumas and Chilliwack.

The moneys sought to be charged as an operating expense of the appellant were paid for the purpose of obtaining an alteration in the rights of the municipalities and the obligations of the appellant under these contracts. By their terms, the power company was granted the right to construct and operate a single or double line of railway for the transportation of passengers and freight on its own right-of-way to connect the city of New Westminster and the town of Chilliwack. The company agreed, *inter alia,* to complete the line within 48 months from the passage of the necessary by-law authorizing the making of the contract by the municipality and, thereafter, to run one passenger train per day each way, Sunday included, over the line. On its part, the municipality agreed that the property rights, franchises and privileges belonging to the company subject to taxation by it should be exempt from such taxation for a period of 10 years, and agreed that it would not allow any other electric railway or tramway to be built or operated along any public highway or road thereafter used by the company under the provisions of the agreement. The agreement further provided that it should be binding upon and enure to the benefit of the successors and assigns of the parties.

[1] [1926] A.C. 205 at 214, 10 T.C. 155.

While these rights, which may be properly referred to as a franchise, were granted to the power company, the line when built and equipped was operated by the appellant company under the terms of agreements made between the companies dated March 1, 1909, and March 31, 1915, and, by agreement made between the two companies dated June 30, 1924, the appellant company purchased the assets of the power company and its rights under the contracts made with the various municipalities, agreeing to fulfil the obligations of the power company under these contracts. It does not appear whether the appellant company entered into direct contractual relations with the municipalities, but it is common ground that the line was operated by it under the terms of the 1907 agreement.

While under no obligation to do so under the terms of the various franchises, the material shows that the appellant company operated three trains daily in each direction over the line, and during the years in question in this appeal these operations resulted in serious losses.

In view of an argument advanced on behalf of the appellant, it is necessary to consider the manner in which the appellant was relieved of the obligation to maintain this passenger service. By the *Public Utilities Act* of British Columbia, first enacted as c. 47 of the statutes of 1938 and which now appears as R.S.B.C. 1948, c. 277, certain public utilities, which included that of the appellant company, were made subject to certain duties and restrictions. By s. 7 a public utility which has been granted a franchise and has commenced operations under it may not cease or desist from such operations or any part of them without the permission of the Public Utilities Commission constituted under the Act. By s. 120 the powers vested in the Commission apply, notwithstanding that the subject-matter in respect of which the powers are exercisable is the subject-matter of any agreement or statute.

The appellant company applied to the Public Utilities Commission for leave to discontinue the passenger service. The municipalities were interested parties entitled to be heard on this application and, after the application had been made, agreement was reached between the interested parties for a substituted passenger service, in consideration

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of which the municipalities consented to the Commission making an order permitting the appellant to discontinue the passenger service upon certain defined terms.

Contemporaneously with the application by the appellant company, British Columbia Motor Transportation Limited, its wholly-owned subsidiary, had applied to the Commission for approval of the operation of motor buses over certain routes to the municipalities through which the railway-line ran. By an agreement dated September 25, 1950, made with the District of Surrey, the appellant agreed to pay to the municipality a sum of $50,000 to be expended for putting the roads in the municipality over which British Columbia Motor Transportation Limited proposed to operate in suitable condition for their operations and, thereafter, to spend such sums as it would ordinarily spend on the roads. The municipality agreed to advise the Public Utilities Commission that it consented to the company's application for permission to cease the operation of passenger service and, on its part, the appellant agreed that until the roads had been improved in accordance with the agreement it would keep available passenger cars and give service on the line whenever bus service was cancelled for more than a "short while". Similar agreements were reached with the other municipalities and a total sum of $220,000 was paid.

Thereupon, on September 20, 1950, the Public Utilities Commission made an order granting permission to the appellant to cease the operation of the passenger service on terms that British Columbia Motor Transportation Limited should provide a bus-service in the area served by the railway line in accordance with the application made by it to the Commission, directing the appellant to make the payments specified to the five municipalities and that, after the cessation of passenger service on the railway line, the appellant was to keep passenger cars available and, as an emergency measure, operate them whenever the bus-service was cancelled for more than a short while, and directing the appellant to continue the freight service in operation.

This order was approved by an order in council made on September 22, 1950.

It was contended for the appellant that what took place did not work any change in its various franchises from the municipalities, since there was no agreement releasing the obligation to operate one passenger train daily over the line and none which affected its right to resume the passenger service if it saw fit. While it is true that the covenant of the power company to operate a passenger service was not released, it would be manifestly impossible for any of the municipalities after there has been compliance with the terms of the Commission's order of September 20, 1950, and so long as such compliance continued, to insist upon the restoration of the service. The moneys stipulated to be paid have been paid and the right to insist upon the maintenance of the passenger service on the line waived, except under the circumstances defined. In my opinion, the terms upon which the franchises are held were modified by what took place in the same manner as if they had been accomplished by agreements between the parties.

The appellant company contends that these payments were made for the purpose of gaining or producing income from its business, within the meaning of s. 12(1)(*a*) of *The Income Tax Act 1948,* c. 52, and that such payments were not outlays of capital or payments on account of capital, within the meaning of subs. 1(*b*) of that section.

It is not decisive of the question as to whether the payments were made for the purpose of gaining income, within the meaning of the subsection, that making them resulted in an increase of the income of the appellant. Since, however, that question does not arise if they fall within the prohibition of s. 12(1)(*b*), this question should be first considered.

The language of *The Income Tax Act* differs from that employed in the Income Tax Acts in England which applies in the numerous cases there decided on the question as to what constitutes a capital disbursement. The words "outlay, loss or replacement of capital or any payment on account of capital" first appeared in the *Income War Tax Act 1917* by an amendment made in 1923 (c. 52, s. 3). It was continued in this form and appeared as s. 12(1)(*b*) when *The Income Tax Act* which applies to the present matter was enacted as c. 52 of the statutes of 1948.

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The Imperial Act of 1842 (5 & 6 Vict., c. 35) provided in the rules for the application of Schedule D that in estimating profits there should be no deduction

> on account of any capital withdrawn therefrom; nor of any sum employed or intended to be employed as capital in such trade, manufacture, adventure or concern.

This language, with an immaterial change, was repeated in the *Income Tax Act 1918,* s. 3(*f*) of Schedule D.

Neither the Canadian nor the Imperial Act attempts to define the term "capital" nor, in the case of our Act, what is meant by a payment on account of capital.

The question has, however, been discussed in a number of cases. In *Vallombrosa Rubber Co., Ltd. v. Farmer*[1], Lord Dunedin said in part:

> Now, I don't say that this consideration is absolutely final or determinative, but in a rough way I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year.

In *Atherton v. British Insulated and Helsby Cables Limited*[2], Lord Cave said that:

> . . . when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

As the quotation shows, this was not intended as an exhaustive definition, as pointed out by Scott L.J. in *Bean v. Doncaster Amalgamated Collieries, Ltd.*[3], but as a useful guide.

In *Mallett v. The Staveley Coal and Iron Company, Limited*[4], a colliery company held the right to work certain beds of coal under mining leases in one of which they covenanted to restore the surface of the land after completing the mining operations. No provision was made in the leases for the surrender of any part of the seams demised. By agreement with the lessor, the company was permitted to surrender some of the seams demised and to be absolved from the obligation to restore the surface

[1] (1910), 5 T.C. 529 at 536.
[2] (1925), 10 T.C. 155 at 192, [1926] A.C. 205.
[3] (1944), 27 T.C. 296 at 305, 175 L.T. 10.
[4] (1928), 13 T.C. 772, [1928] 2 K.B. 405.

of the land, paying substantial sums as consideration. The company claimed to deduct these payments as an expense of operation. Rowlatt J., after saying that it was abundantly clear that when a colliery company acquires a lease the expense of acquiring it is a capital expenditure, said[1]:

> If they sell the lease that they have acquired, or part of it, at an advantage, I cannot but think that that is a receipt on account of capital, and here what they have done is to get rid of some areas which they thought would be unremunerative; . . . they have now got a list of leases or a field of mineral which has the advantage of being minus an undesirable part of it, instead of having one that is encumbered with an undesirable part of it.

On appeal the judgment was approved. Lawrence L.J., after referring to the facts, said[2]:

> The Company, for sufficient reasons, decided to get rid of certain seams of coal constituting part of its fixed capital assets. The only practical way of disposing of those seams was to procure the lessors to accept a surrender of the leases under which they were held, and in order to effect such surrender the Company had to pay the £6,500 in question . . . In substance and in fact it was a sum paid for the purpose of getting rid of a capital asset of the Company which had become burdensome to the Company. In principle, such a payment seems to me to stand on precisely the same footing as a loss or profit sustained or made by a trading company on the disposal of part of its fixed capital.

In *Anglo-Persian Oil Company, Limited v. Dale*[3], Rowlatt J., referring to the word "enduring" in the passage from Lord Cave's judgment, said that quite clearly he was speaking of a benefit which endures in the way that fixed capital endures, not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. A further passage from his judgment reads:

> It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets or something of that sort as we have had in the cases, endures.

On appeal, Romer L.J. agreed with this interpretation and said[4]:

> The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in the case of *Mallett v. Staveley Coal and Iron Company.*

[1] 13 T.C. at 778.
[2] 13 T.C. at 787.
[3] (1931), 16 T.C. 253 at 262, [1932] 1 K.B. 124.
[4] 16 T.C. at 274.

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Lord Hanworth M.R. said[1]:

> Lord Cave's test that where money is spent for an enduring benefit it is capital, seems to leave open doubts as to what is meant by "enduring". In the case of *Noble v. Mitchell* (1927) 11 T.C. 372, the dismissal of the director once and for all might have connoted an enduring benefit, but the expenditure was held not to be a capital expense.

In *West Africa Druy Co., Ltd. v. Lilley*[2], the appellant company held business premises in West Africa under a lease for 21 years under which the lessee covenanted to keep the premises in repair. The premises were completely destroyed by earthquake and a dispute arose as to whether the lessor or the lessee was liable to rebuild and the lessee to pay the rent for the balance of the terms. The lessors accepted a net sum of £2,753 for the surrender of the lease and the release of the company from all liability thereunder. On appeal to the special commissioners, the appellant company contended that the payment was made to relieve the company of an onerous contract and did not bring into existence any asset or advantage for the enduring benefit of its trade and should be allowed as a deduction in computing its profit. The commissioners held that the expenditure being a sum paid for the purpose of getting rid of a permanent disadvantage or onerous liability arising under the terms of the lease was of a capital nature and not an admissible deduction.

This decision was upheld on appeal by Atkinson J., who considered that the matter was determined by the decision in *Mallett's Case* above referred to.

If by the use of the word "enduring" the Lord Chancellor meant permanent, as Rowlatt J. and Romer L.J. in the *Anglo-Persian Oil Company* case seemed to think, the benefits accruing to the appellant in the present matter were not of that nature. It may be noted in passing that that is not the interpretation placed upon the expression by Sir Lyman Duff C.J. in *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue*[3]. The covenant of the Vancouver Power Company Limited to operate one passenger train a day on the line to Chilliwack is still outstanding though, as I have said, it is my view that, so long as there is compliance with the order of the

[1] 16 T.C. at 268.

[2] (1947), 28 T.C. 140.

[3] [1942] S.C.R. 89 at 92, [1942] 1 D.L.R. 596, [1942] C.T.C. 1, affirmed [1944] A.C. 126, [1944] 1 All E.R. 743, [1944] 3 D.L.R. 545.

Public Utilities Commission, the municipalities may not enforce that term. It would also appear to be the case that the appellant is still entitled to operate a passenger service over the line, subject to the approval of the Public Utilities Commission. If British Columbia Motor Transportation Limited were to cease to operate a bus-service in accordance with the order of the Commission, there appears to be no reason why, assuming that the company remained a subsidiary of the appellant, the municipalities might not apply to that body for an order directing the appellant to provide a suitable passenger service. In that sense, the benefit is not permanent.

To say, however, that an expenditure made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade is a capital expenditure is not to say that all other expenditures must, in order to be properly classified as outlays of a capital nature or on account of capital, be made in order to produce such a benefit.

The franchises held by the appellant which were acquired by the assignment from the power company were capital assets. The payments in question were made to obtain relief from the obligation to maintain passenger service, an obligation which was resulting in heavy annual losses to the company, and the relief obtained, to the extent above indicated, substantially increased the value of the franchises to the appellant. In my opinion, such payments were outlays of capital and payments on account of capital, within the meaning of the subsection, to the same extent that payments made to secure the franchises in the first instance, had any such payments been made, would have been.

In view of this, I find it unnecessary to consider whether the payments were made "for the purpose of gaining or producing income from a property", within the meaning of s. 12(1)(*a*) and I express no opinion on that point.

I would dismiss this appeal with costs.

Appeal dismissed with costs.

Solicitor for the appellant: A. Bruce Robertson, Vancouver.

Solicitor for the respondent: A. A. McGrory, Ottawa.