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BENNETT AND WHITE CONSTRUCTION COMPANY LIMITED } APPELLANTS;

*May 3, 4
*Oct. 5

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Revenue—Income Tax—Deductions from Income—Payments by construction company to obtain working capital to guarantors of bank loans—Whether "disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning income", s. 6(1) (a). Whether "payments on account of capital", s. 6(1) (b),—Income War Tax Act, R.S.C., 1927, c. 97.

Held: That payments by a construction company to obtain necessary working capital for its operations, to guarantors of bank loans, are "disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" within the meaning of s. 6(1) (*a*), and therefore not allowable deductions under the Income War Tax Act, R.S.C., 1927, c. 97. They are "payments on accounts of capital" within the meaning of s. 6(1) (*b*).

Montreal Coke and Manufacturing Co. v. *Minister of National Revenue* [1944] A.C., 127 followed.

Judgment of the Exchequer Court of Canada [1947] Ex. C.R. 474, affirmed.

APPEAL from the judgment of the Exchequer Court of Canada, O'Connor J., (1), dismissing the appeal of the appellant with costs and affirming an assessment made under the provisions of the *Income War Tax Act* and *Excess Profits Tax Act* for the years 1941 and 1942.

James L. Lawrence and *Ross Tolmie* for the appellant.

L. St. M. Du Moulin and *J. D. C. Boland* for the respondent.

The judgment of the Chief Justice and Locke, J. was delivered by:

LOCKE J.:—The appellant is incorporated by letters patent under the *Dominion Companies Act*. Its declared objects are many in number including the carrying on of a contracting and construction business and that of financial agents and brokers but, of these, its activities have

*PRESENT: Rinfret C.J., and Rand, Kellock, Estey and Locke JJ.

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been confined to the former. Its authorized capital stock when incorporated in 1925 was $100,000: this was later increased to $250,000, of which as of October 31, 1942, shares to the par value of $136,320 had been issued.

Joseph G. Bennett was one of the original incorporators and a large shareholder. In the year 1934 Bennett informed his sons, John G. and A. G. Bennett that he wished to substantially retire from the business and the sons then acquired larger interests in the company and carried on the business. A. G. Bennett found when he applied to the bank for a loan that the company's credit was very low and asked his father to give a guarantee to the bank to enable the company to borrow money for its business purposes and it was arranged that he would do so for a consideration and this was agreed upon as being an annual amount equal to the amount of interest paid to the bank. One of the amounts required at this time was for a deposit of $15,000 for a tender on the Calgary Administration Building. During the years 1934 to 1939 inclusive Joseph G. Bennett continued his guarantees to the bank. In 1937 and thereafter John G. Bennett gave his guarantees. A. G. Bennett guaranteed the loans for the year 1938 and thereafter. In June of 1940 Joseph G. Bennett died and thereafter his widow gave her guarantees to the bank. In respect of these guarantees varying amounts were paid to all of the persons named during the years 1935 to 1940 inclusive and apparently the sums so paid were allowed by the Department of National Revenue as expenses of the business.

Apparently no written agreement was made at any time concerning these payments but on June 19, 1935, a resolution of the Executive Committee of the company fixed "the rate of interest" to be paid to Joseph G. Bennett for his guarantee at five per cent on the amounts borrowed. Similarly in 1940 the payments to be made to the guarantors for the fiscal year ending October 31, 1940, were authorized by the directors and designated as interest and like resolutions were passed by the Board in the years terminating on October 31, 1941, and 1942. For the fiscal year ending on October 31, 1941, $20,969.34 were paid to the guarantors and for the year following $23,984.15 and these were disallowed by the Department, giving rise to the present litigation.

In the interval between the giving of the first guarantee by Joseph G. Bennett and those given in later years the business of the company was largely increased. In the year 1938 contracts undertaken by it amounted to $1,116,652.15. In 1940, 1941 and 1942, due to the company obtaining large war contracts, these amounts were respectively $3,267,148.13, $3,581,019.49 and $4,458,108.59. The bank loans and overdrafts secured by the guarantees which when given by Joseph G. Bennett in 1935 had approximated some $46,000 totalled as of the date of the preparation of the balance sheet in 1940 some $588,000, in 1941 some $534,000 and in 1942 $505,000. Upon these advances interest was paid to the Bank of Montreal in amounts slightly in excess of the amount paid to the guarantors: such interest was claimed as a deductible expense and allowed by the Department. A. G. Bennett, vice-president of the company, giving evidence at the trial said that it was not possible for the company to carry on its business without substantial loans from the bank and these could not be obtained without having satisfactory guarantors: he estimated that without the loans from the bank the company could not have done more than twenty-five per cent of the business which was carried on during these years. In view of the comparatively small subscribed capital of the company, it is apparent that this would be so. The evidence is not very clear as to all of the purposes for which these large amounts were required: a statement filed, however, shows that as of October 31, 1940, approximately $196,000 was deposited on contracts that were either completed or in progress and as of October 31, 1942, the total amount of funds so deposited approximated $122,000. These, it was shown, were amounts paid as deposits to ensure the company's performance of contracts undertaken and were presumably retained until the completion of the work in accordance with the terms of the various contracts. In addition to these large sums which were thus rendered inactive for extended periods, the moneys were required for payrolls, the purchase of materials and, part of it at least, for the purchase of bulldozers and other equipment, though to what extent they were used for this latter purpose is not disclosed.

While the amounts paid to the guarantors were described as interest in the various resolutions which authorized their

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payment, this was clearly inaccurate. Interest is paid by a borrower to a lender: a sum paid to a third person as the consideration for guaranteeing a loan cannot be so described. Sec. 6(*a*) prohibits the deduction of disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income and the first matter to be determined is whether amounts such as these, paid to enable the company to obtain the necessary working capital for its operations by way of loans from the bank, are properly so described. In *Addie* v. *Commissioners of Inland Revenue* (1), the Lord President, considering the meaning to be assigned to the expression "money wholly and exclusively laid out for the purposes of the trade" in the *Income Tax Act* of 1918 (8 & 9, Geo. V, cap. 40) said in part:

> It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question, Is it a part of the Company's working expenses; is it expenditure laid out as part of the process of profit earning? Or, on the other hand, is it a capital outlay; is it expenditure necessary for the acquisition of property or of rights of a permanent character, the possession of which is a condition of carrying on its trade at all? It was pointed out by Lord Davey in the case of *Strong* v. *Woodifield* (2), and it has long been recognized, that in order to make deduction of a disbursement admissible "it is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits".

In *Tata Hydro-Electric Agencies Ld., Bombay* v. *Income Tax Commissioner* (3), the appellant company sought to have deducted from its profits as an expense twenty-five per cent of the annual commissions earned by it which it had agreed to pay as part of the purchase price of the agency under which the amounts became payable. Under the Indian Income Tax Act of 1922 the deduction was allowable if it had been incurred "solely for the purpose of earning income, profits or gains" in the business. In delivering the judgment of the Judicial Committee upholding the disallowance of the claim Lord Macmillan said in part, p. 695:—

> Their Lordships recognize, and the decided cases show, how difficult it is to discriminate between expenditure which is, and expenditure which is not, incurred solely for the purpose of earning profits or gains. In the present case their Lordships have reached the conclusion that the payments in question were not expenditure so incurred by the

(1) (1924) S.C. 231 at 235.
(2) [1906] A.C. 448 at 453.
(3) [1937] A.C. 685.

appellants. They were certainly not made in the process of earning their profits; they were not payments to creditors for goods supplied or services rendered to the appellants in their business; they did not arise out of any transactions in the conduct of their business. That they had to make those payments no doubt affected the ultimate yield in money to them from their business, but that is not the statutory criterion. They must have taken this liability into account when they agreed to take over the business. In short, the obligation to make these payments was undertaken by the appellants in consideration of their acquisition of the right and opportunity to earn profits, that is, of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business.

and approved the above quoted statement of the Lord President in *Addie's case* (1). In *Montreal Coke and Mfg. Co.* v. *Minister of National Revenue* (2), the right of the appellant company to charge as a disbursement expenses incurred in redeeming certain of its bonds before maturity and borrowing again at lower rates of interest and less onerous conditions as to payment, these including the payment of premiums on redemption, disbursements on account of exchange, discount to underwriters and legal and other expenses, was considered. The passage from the judgment of Lord Macmillan quoted in the judgment of the learned trial judge clearly points out the distinction to be drawn between expenditures made in providing capital for an enterprise and those for the carrying on of the trade from which its earnings are derived. I think the character of the payments in the present case does not differ in essence from those which were disallowed in the *Montreal Coke* case. They were, in my opinion, simply expenditures incurred in obtaining the capital to make the large deposits required, to purchase equipment and generally to finance the operations. A sum expended as interest for the use of capital is clearly to be distinguished from expenditures such as these, being the cost of obtaining guarantees without which the loans would not have been made by the bank, expenditures of the same character as the cost of floating issues of bonds or debentures or of selling shares for the purpose of obtaining capital.

Sec. 6(*b*) prohibits the deduction of "any payment on account of capital". The subsection did not appear in the *Income Tax Act* of 1917: it was enacted by cap. 52, Statutes of 1923, sec. 3, and was not taken from the English Act. While the expression "any payment on account of

(1) (1924) S.C. 231. (2) [1944] A.C. 126.

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capital" is capable of meaning any return of capital, I think it obvious that this cannot have been intended since no statutory prohibition of deducting amounts so paid could be required. In *Montreal Coke and Mfg. Co.* v. *Minister of National Revenue supra,* 94, Duff C. J. and Kerwin J. were of the opinion that the deductions there claimed were payments on account of capital within the meaning of this subsection. I am of the opinion that expenditures such as these made by reason of the necessity of obtaining working capital are payments of the same nature.

The appeal should be dismissed with costs.

RAND J.:—The company carries on general construction work. In doing so, its current outlays are in part financed by temporary bank loans. For the years in question the bank required as collateral the guarantee of three shareholders who held a controlling interest in the company. These persons in turn agreed to give the guarantees on terms that they should be paid a sum equal to the amount of interest in each year paid to the bank. In calculating the net profit of the business for income tax purposes, the company, in addition to the interest paid to the bank, deducted the amounts so paid to the guarantors. The latter deductions were disallowed and the question is whether the company is entitled to have them restored.

The case for the company is that the payments were "wholly, exclusively and necessarily" paid out to earn the income. In a remote sense that is so; but the same can be said for almost every outlay in the organization of the company. The conception of the statute however is an earning of income through the use of capital funds which in one form or another constitute the means and instruments by which the business is prosecuted; but that providing or organizing them must be clearly differentiated from the activities of the business itself has been lately reaffirmed by the Judicial Committee in *Montreal Coke and Manufacturing Co.* v. *Minister of National Revenue* (1).

The acquisition of capital may be by various methods including stock subscriptions, permanent borrowings through issues of securities, or term loans; and ordinarily

(1) [1944] A.C. 126.

it should make no difference in taxation whether a company carried on financially by one means or another. In the absence of statute, it seems to be settled that to bring interest paid on temporary financing within deductible expenses requires that the financing be an integral part of the business carried on. That is exemplified where the transctions are those of daily buying and selling of securities: *Farmer* v. *Scottish North American Trust* (1); or conversely lending money as part of a brewery business: *Reid's Brewery* v. *Mail* (2).

Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (*b*). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue. The lender might insist on being furnished with premises near the scene of the works; it might exact any other accommodation as the price of its willingness to provide funds; but all that would be outside the circumference of the transactions from which the income arises. Within the meaning of the Act, the premiums create part of the capital structure and are a capital payment: *Watney* v. *Musgrave* (3). They furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business. That was the view of O'Connor J. below (4) and I agree with it.

I would, therefore, dismiss the appeal with costs.

KELLOCK J.:—For the reasons given by my brother Locke I am of opinion that the amounts sought to be deducted by the appellant fall within section 6(*a*) of the *Income War Tax Act* and are therefore not deductible in ascertaining the taxable income of the appellant.

I would dismiss the appeal with costs.

(1) [1912] A.C. 118.
(2) [1891] 2 Q.B. 1.
(3) (1880) 5 Ex. D. 241.
(4) [1947] Ex. C.R. 474.

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ESTEY J.:—The appellant borrowed funds from the Bank of Montreal under a line of credit secured by the personal continuing guarantee of three of its shareholders. These shareholders received in consideration of their giving that guarantee an amount in each year equal to the interest paid to the bank in the same period. In the year 1941 the guarantors were paid $20,813.06, and in the year 1942, $23,455.07. These amounts were not allowed as deductions in computing the profits by the taxing authorities. In the Exchequer Court this disallowance was confirmed.

The appellant contends that its borrowings from the bank under the security of the guarantee were not capital nor were the payments made to the guarantors part of its "financial arrangements", but rather that these payments to the guarantors were disbursements "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" and therefore should be deducted under the provisions of para. 6(1) (*a*) of the *Income War Tax Act,* (1927 R.S.C., c. 97).

The appellant, incorporated by Dominion letters patent dated February 25, 1925, carries on a general construction business in the provinces of British Columbia, Alberta and Saskatchewan. As early as 1934 its paid up capital and surplus was such that in relation to the volume of business available it required additional funds. These funds were advanced in 1934 by the Bank of Montreal under a line of credit of $10,000 secured by a personal continuing guarantee by the founder of the company, J. G. Bennett. In 1935 the guarantee was raised to $90,000, and in 1938 to $150,000. In the latter year J. G. Bennett and his two sons, A. G. Bennett and John G. Bennett, were the guarantors. In 1940 it was raised to $300,000. In that year J. G. Bennett died and when later in the same year the amount was raised to $370,000 the guarantors were Mrs. Mabel Bennett, widow of J. G. Bennett, and her sons, A. G. Bennett and John G. Bennett. This last guarantee continued throughout the fiscal years 1941 and 1942 and all payments here in question were made to the guarantors in consideration of this guarantee.

The first guarantee given in 1934 was obtained in order that the appellant company might have sufficient funds to undertake "some prospective business that was offering."

No other reason was suggested for the $90,000 or $150,000 guarantees. Then came the war and the government required "plants, air fields and that sort of thing." These had to be constructed, the appellant desired a share of that business, and as the vice-president stated, "it was necessary to get this money in order to carry those projects on." He made it clear that the bank would not have granted the line of credit without the guarantee, and without the funds so available the company would "not have been able to do 25 per cent of the business" that it did in 1941. The guarantee was therefore the asset which the company purchased to enable it to borrow the necessary funds.

The importance and position of this line of credit in the finances of the company is evidenced by the following figures: At the end of the fiscal year October 31, 1941, the paid-up capital of the company was $104,060, while at the same date the bank loan under the guarantee was $424,882.50. At the end of the appellant's fiscal year October 31, 1942, the paid-up capital was $136,320, and the bank loan at the end of that year was $273,050. Moreover, at the end of each fiscal year October 31, 1935, to October 31, 1942, the appellant company showed an overdraft at the bank. In 1941 at the end of its fiscal year this overdraft was $109,978.09, and in 1942 it was $232,721.80. These figures support what was stated at the trial that the appellant's "paid-up capital and surplus has never been large, compared with the magnitude of its operations." In these circumstances it appears to have been the settled policy of the company to provide for its expansion by funds made available under these guarantees.

The money borrowed under this line of credit was treated as capital and the interest paid to the bank allowed under sec. 5(1) (*b*), which provides:

> 5. (1) "Income" * * * shall * * * 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 * * *

No exception is taken to this allowance of interest upon capital by the appellant and it is therefore not an issue in this appeal.

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This was not a borrowing of money on a temporary or short-term basis such as is necessary and incidental to the ordinary and usual transactions in the course of the appellant's business. In effect this line of credit made available to the appellant for an indefinite period the ability to borrow funds for the purpose of accepting contracts beyond the volume its paid-up capital and surplus would permit. The provision for the cancellation of the guarantee, having regard to the relation of the guarantors to the company, and the practice since 1934, does not detract from the conclusion that this line of credit provided a long-term basis upon which the company might obtain the funds it required.

In *Scottish North American Trust* v. *Farmer,* (1) Lord Johnston stated at p. 698:

> It may be well said that if money is borrowed on a permanent footing as from year to year, the capital of the concern is in a commercial sense enlarged thereby, and the business extended, whereas no commercial man would consider that his banking facilities were part of his capital, or the consideration he paid for them anything but an expense of his business.

That the bank computed the interest from day to day, that payments were made on account thereof as funds were available, and if construction contracts were at any time not available this loan in the normal course would be paid in full, do not of themselves require, under the authorities, the description of the borrowing under this line of credit as temporary. These factors are here but the details of the way in which the loan was dealt with and do not affect its character, as evidenced by the reason therefor and the use thereof to expand and increase its business. A company engaged in the construction business may from time to time find it necessary to borrow on a temporary basis as necessary and incidental to its business, but the evidence does not establish that such obtained in this case. The learned trial Judge held that the sums as borrowed were capital and the evidence fully supports his finding.

The appellant's position is similar to that of the taxpayer in *The European Investment Trust Co., Ltd.* v. *Jackson* (2), where it was engaged in the business of financing the purchase of automobiles. Its paid-up capital was relatively small and when that and the proceeds of a

(1) (1911) 5 T.C. 693. (2) (1932) 18 T.C. 1.

loan, admittedly capital, from the Finance Corporation of America, were exhausted, in order to finance further purchases it was arranged that the Finance Corporation of America would make further advances. It was contended that the interest on these further advances should be deducted in computing the profits. These advances were made as required by the taxpayer and were repaid by amounts as received from the purchasers. They were described by the taxpayer as short loans and the interest was computed upon monthly statements. The commissioners found as a fact that the proceeds of these additional advances were "employed or intended to be employed as capital in the trade" and that therefore the interest paid could not be deducted in computing profits. On appeal this decision was affirmed. The taxpayer in that case, as the appellant here, when its capital was exhausted found it necessary to borrow in order that further contracts or a larger volume of business might be accepted.

The *Jackson* case was decided since that of *Scottish North American Trust* v. *Farmer, supra,* so much relied upon by the appellant. The taxpayer in that case was engaged in the buying and selling of securities. In the course of its business it purchased securities in New York in amounts beyond its available cash. Arrangements were made with a New York banker for an overdraft (for a period a line of credit was arranged). The interest paid on this overdraft was held to be a deductible expense. In the Court of Sessions their lordships stressed that these were short-term loans, or as stated by the Lord President:

> I cannot see how a temporary accommodation in the course of business ever is or ever can be capital.

Then in the House of Lords Lord Atkinson pointed out that the money was borrowed in a "fluctuating temporary manner" and the daily borrowing and lending of money being part of their business is not to be treated as capital. Moreover, in discussing this case in the *Jackson* case, Romer L.J., pointed out that in the *Farmer* case the money was found by the commissioners not to be capital and after reviewing that decision and others in relation thereto, concluded that in each case:

> * * * it is a question of fact whether the capital money borrowed is or is not capital employed in the trade within the meaning of this sub-paragraph, and if the Commissioners have decided, as a question of fact, that it is, then this Court cannot interfere.

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In *Ascot Gas Water Heaters, Ltd.* v. *Duff* (1), it was held that the commission paid for a guarantee of an existing debt was deductible in computing the profits as an expense wholly and exclusively laid out for the purpose of the trade, while the commission on a guarantee of a loan for further capital facilities was not deductible. It appeared in the facts stated that "further expansion is only possible if an adequate long-term credit is obtainable and sufficiently large liquid assets in the form of reserves are formed." A commission of 3 per cent *per annum* was paid to the guarantor and the loan supported by this guarantee made in 1935 was due in 1953. See also *Bridgwater* v. *King* (2).

In *Southwell* v. *Savill Brothers, Ltd.* (3), expenditures incurred to obtain new licences and therefore to extend the business were held to be capital expenditures.

The funds borrowed were therefore capital and the payments made to the guarantors constituted a part of the "financial arrangements" of the appellant. They are in principle identical with those dealt with by the Privy Council in *Montreal Coke and Mfg. Co. Ltd.* v. *Minister of National Revenue* (4), where the expenses of refinancing a bond issue in order to effect a low rate of interest and other savings were disallowed under sec. 6(1) (*a*). Lord Macmillan stated at p. 133:

> It is important to attend precisely to the language of s. 6. If the expenditure sought to be deducted is not for the purpose of earning the income, and wholly, exclusively and necessarily for that purpose, then it is disallowed as a deduction. If the expenditure is a payment on account of capital it is also disallowed * * *

And again:

> Expenditure to be deductible must be directly related to the earning of income.

And further:

> Of course, like other business people, they must have capital to enable them to conduct their enterprises, but their financial arrangements are quite distinct from the activities by which they earn their income. No doubt, the way in which they finance their businesses will, or may, reflect itself favourably or unfavourably in their annual accounts, but expenditure incurred in relation to the financing of their businesses is not, in their Lordships' opinion, expenditure incurred in the earning of their income within the statutory meaning.

The disbursements of the guarantors here in question were made not as interest on the money borrowed but as

(1) (1942) 24 T.C. 171.
(2) (1943) 25 T.C. 385.
(3) [1901] 2 K.B. 349.
(4) [1944] A.C. 126.

the purchase price for the guarantee that made borrowing under the line of credit possible. The appellant upon obtaining this line of credit was enabled to complete its financial arrangements at the bank, which enabled it to undertake the larger volume of business. Sums borrowed under such circumstances are capital and the sums paid are not deductible under the provisions of 6(1) (*a*).

The judgment of the Exchequer Court should be affirmed and this appeal dismissed with costs.

Appeal dismissed with costs.

Solicitor for the appellant: *J. L. Lawrence.*

Solicitor for the respondent: *E. S. MacLatchy.*