PREMIUM IRON ORES LIMITED .....APPELLANT;

AND

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

1965
*Nov. 25, 26
1966
June 28

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Sales agent of mining company—Payment of 20 per cent of income receipts paid to third party under contract for sharing financing obligation—Whether deductible expenses or capital outlay—Legal expenses incurred in resisting U.S. income tax claim—Whether deductible—Income Tax Act, R.S.C. 1952, c. 148, s. 12(1)(a), (b).

The appellant company was incorporated in Ontario to participate in the financing of the Steep Rock Iron Ore Mines Ltd. and in the marketing of the ore produced by it. Initially the financing had been undertaken by Transcontinental Resources Ltd. When it became necessary to obtain substantial additional capital, the appellant company was incorporated so as to have all the financing and marketing operations done through one agency. Thereupon, by contract dated January 15, 1943, the appellant became the exclusive sales agent for Steep Rock and became entitled to a commission of 2 per cent of the value of all ores sold. The agreement also provided for the appellant to purchase shares of Steep Rock and to lend it money. Eighteen days later, the appellant entered into an agreement with a Mr. Carr, president of Transcontinental Resources Ltd., whereby the appellant agreed to pay over to him 20 per cent of the moneys received from Steep Rock. In that agreement, Mr. Carr had waived his right to be appointed sales agent for Steep Rock. Additional funds were soon needed, and another agreement, dated December 29, 1944, was entered into whereby the appellant agreed to take 267,000 shares of Steep Rock for $600,000, of which 100,000 shares were to be taken by Transcontinental Resources Ltd. in its role as a continuing participant in the financing. The appellant covenanted at that time to pay to Transcontinental Resources Ltd., from the 2 per cent commission on Steep Rock Iron Ore sales, the 20 per cent which it had previously undertaken to pay to Carr.

The first issue under appeal was the question as to whether the appellant could deduct from its taxable income the 20 per cent paid in the years 1951 and 1952 to Transcontinental Resources Ltd. The Minister refused to allow the deduction. The Tax Appeal Board allowed the deduction but its decision was reversed by the Exchequer Court.

The second issue under appeal involved the question as to whether legal expenses incurred by the appellant in 1951 and 1952, in successfully contesting a claim asserted by the United States tax authorities, were deductible as business expenses. The Minister disallowed these expenses and his decision was supported by the Tax Appeal Board and by the Exchequer Court. The taxpayer appealed to this Court on both issues.

Held (on the first issue): The appeal should be allowed.

Held (on the second issue) (Ritchie and Abbott JJ. dissenting): The appeal should be allowed.

*PRESENT: Abbott, Martland, Ritchie, Hall and Spence JJ.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

[AS TO THE FIRST ISSUE]

Per Curiam: There is no doubt that agreements are to be construed in accordance with the plain and ordinary meaning of the words which they contain, and that the words used in a written agreement are to be construed in the light of the circumstances under which it was concluded. In the present case, it was apparent that from the time of its incorporation the appellant company was engaged with Transcontinental Resources Ltd. in the joint venture of financing Steep Rock and that the 20 per cent represented Transcontinental's share in the venture. Therefore, the appellant was never beneficially entitled to retain more than 80 per cent of the commissions which it received from Steep Rock, and the remaining 20 per cent could not be said to form a portion of its taxable income.

[AS TO THE SECOND ISSUE]

Per Martland and Spence JJ.: While the legal expenses were not made solely for the purpose of earning income, they were made with a view to protecting the income earning capacity of the appellant. Had the claim of the U.S. government been established, it would have created a liability in relation to the appellant's income. The expense incurred here was for the purpose of resisting the demands of a foreign taxing authority which, had it succeeded, would have substantially depleted the income of a Canadian company. A claim of that kind is a claim by a third party. It mattered not, so far as the Canadian authority was concerned, that the nature of the claim was one for income tax. In so far as the Canadian taxing authority was concerned, there was no difference in principle between an expenditure in the form of legal fees paid by a railway company to defend a damage claim by a passenger, and thus protect the company's income, and the expenditure for legal fees paid by the appellant to resist a foreign tax claim and thus to protect its income. A payment made for legal services in an attempt to protect income against encroachment by a third party is in principle properly deductible on the authority of *The Minister of National Revenue v. The Kellogg Co. of Canada,* [1943] S.C.R. 58 and *Evans v. The Minister of National Revenue,* [*1960*] *S.C.R. 391.*

Per Hall J.: The working capital of the appellant and its profit earning potential were preserved by the successful resistance of the unjustified U.S. claim for income tax. The majority judgment in *Smith's Potato Estates Ltd. v. Bolland,* [1948] 2 All E.R. 367, is not the correct statement of the law as applied to the provisions of the Canadian *Income Tax Act.* The "income" means the net receipts over disbursements in the taxation year in the totality of the taxpayer's business as an on-going concern, other than capital expenditures, gifts and the like. There is no reason to regard legal expenses as differing from other expenses. No distinction is to be drawn between proper legal expenses and other business expenses. The expenditures in this case were ones which under sound accounting and commercial practices would be deducted as expenditures for the year in determining the profit, if any, of the company for that year.

Per Abbott and Ritchie JJ., *dissenting in part:* The reasoning in the majority judgment in *Smith's Potato Estates* case, *supra,* applies to the present case. The cost of ascertaining the true amount of tax to be paid is not an expense made in order to earn profits but rather for the purpose of preserving profits already earned. There is no material

distinction between a payment made to resist income tax demand abroad and one to resist a similar demand at home.

Revenu—Impôt sur le revenu—Représentant d'une compagnie minière—Paiement de 20 pour-cent des sommes reçues à une tierce personne en vertu d'un contrat pour partager une obligation de financement—Ce paiement est-il une dépense déductible ou un déboursé en capital—Dépenses légales encourues lors de la contestation d'une réclamation pour impôt provenant des États-Unis—Ces dépenses sont-elles déductibles—Loi de l'Impôt sur le revenu, S.R.C. 1952, c. 148, art. 12(1)(a), (b).

La compagnie appelante a été incorporée dans l'Ontario dans le but de participer au financement de la compagnie Steep Rock Iron Ore Mines Ltd. et de mettre sur le marché le minerai produit par cette dernière. Au début, la compagnie Transcontinental Resources Ltd. avait entrepris ce financement. Lorsqu'il devint nécessaire d'obtenir un capital substantiel additionnel, la compagnie appelante fut incorporée pour que le financement et les opérations de marché puissent passer par les mains d'une seule agence. Conséquemment, en vertu d'un contrat en date du 15 janvier 1943, l'appelante est devenue le représentant exclusif de Steep Rock avec droit à une commission de 2 pour-cent de la valeur du minerai vendu. En vertu du contrat, l'appelante devait se porter acquéreur d'actions de Steep Rock et devait lui avancer des fonds. Quelque dix-huit jours plus tard, l'appelante et un monsieur Carr, président de Transcontinental Resources Ltd., signèrent un contrat en vertu duquel l'appelante s'engagea à payer à monsieur Carr 20 pour-cent des argents reçus de la Steep Rock. Dans ce contrat, monsieur Carr a renoncé à son droit d'être nommé représentant de Steep Rock. Des fonds additionnels ayant été requis, un autre contrat, en date du 29 décembre 1944, fut signé par les parties. Par ce contrat, l'appelante devait se porter acquéreur de 267,000 actions de Steep Rock pour une somme de $600,000. De ces actions, 100,000 devaient être acquises par Transcontinental Resources Ltd. en vertu de son rôle de participant continuel au financement. L'appelante s'engagea alors à payer à Transcontinental Resources Ltd. à même le 2 pour-cent de commission sur les ventes de Steep Rock, le 20 pour-cent qu'elle s'était engagée préalablement à payer à monsieur Carr.

Le premier point sous appel était celui de savoir si l'appelante pouvait déduire de son impôt taxable le 20 pour-cent qui avait été payé durant les années 1951 et 1952 à Transcontinental Resources Ltd. Le Ministre a refusé de permettre la déduction. La Commission d'Appel de l'Impôt a permis la déduction mais sa décision fut renversée par la Cour de l'Échiquier.

Le second point sous appel était celui de savoir si les dépenses légales encourues par l'appelante en 1951 et 1952, lorsqu'elle contesta avec succès une réclamation d'impôt présentée par le gouvernement des États-Unis, étaient déductibles comme dépenses d'affaires. Le Ministre n'a pas permis ces dépenses et sa décision a été supportée par la Commission d'Appel de l'Impôt et par la Cour de l'Échiquier. Le contribuable en appela devant cette Cour sur les deux points.

Arrêt (sur le premier point): L'appel doit être maintenu.

Arrêt (sur le second point): L'appel doit être maintenu, les Juges Ritchie et Abbott étant dissidents.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

[SUR LE PREMIER POINT]

La Cour: Il n'y a aucun doute que les contrats doivent être interprétés conformément au sens clair et ordinaire des mots qu'ils contiennent, et que les mots dont on se sert dans un écrit doivent être interprétés à la lumière des circonstances en vertu desquelles l'accord a été conclu. Dans le cas présent, il était évident qu'à partir du moment de son incorporation la compagnie appelante était engagée avec Transcontinental Resources Ltd. dans une opération en commun pour le financement de Steep Rock et que le 20 pour-cent représentait la part de Transcontinental Resources Ltd. dans l'opération. En conséquence, l'appelante n'avait jamais eu droit de garder plus que 80 pour-cent de la commission qu'elle recevait de Steep Rock, et on ne peut pas dire que le 20 pour-cent qui restait formait une partie de son impôt taxable.

[SUR LE SECOND POINT]

Les Juges Martland et Spence: Quoique les dépenses légales n'avaient pas été faites seulement en vue de produire un revenu, cependant elles avaient été faites en vue de protéger la capacité de l'appelante de gagner un revenu. Si la réclamation du gouvernement des États-Unis avait été établie, ceci aurait créé une charge sur les revenus de l'appelante. La dépense avait été encourue en vue de résister à la demande venant d'une autorité étrangère qui, si elle avait réussi, aurait substantiellement réduit le revenu d'une compagnie canadienne. Une telle réclamation est une réclamation par une tierce partie. En autant que l'autorité canadienne était concernée, cela n'avait pas d'importance que la réclamation en soit une pour impôt sur le revenu. En autant que l'autorité canadienne était concernée, il n'y avait aucune différence en principe entre une dépense pour frais légaux payés par une compagnie de chemin de fer pour se défendre contre une réclamation d'un passager, et ainsi protéger le revenu de la compagnie, et la dépense pour frais légaux payés par l'appelante pour résister à une réclamation pour taxe étrangère, et ainsi protéger son revenu. Un paiement fait pour services légaux dans le but de protéger le revenu contre les empiétements d'une tierce partie est en principe déductible en vertu de l'autorité des causes *The Minister of National Revenue v. Kellogg Co. of Canada,* [1943] R.C.S. 58 et *Evans v. The Minister of National Revenue,* [1960] R.C.S. 391.

Le Juge Hall: La contestation de la réclamation non justifiée des États-Unis a eu pour effet de conserver le capital d'exploitation de l'appelante ainsi que son potentiel de gagner un revenu. Le jugement de la majorité dans la cause *Smith's Potato Estates Ltd. v. Bolland,* [1948] 2 All E.R. 367, ne reflète pas la loi qui doit s'appliquer aux dispositions de la *Loi de l'Impôt sur le revenu* du Canada. Le mot «revenu» signifie les reçus nets après déboursements durant l'année de taxation dans la totalité des affaires du contribuable, autres que des dépenses de capital, donations et autres semblables. Il n'y a aucune raison de considérer que les déboursés légaux comme étant différents des autres déboursés. On ne peut établir aucune distinction entre des dépenses légales et des dépenses d'affaires. Les dépenses dans le cas présent étaient de celles qui, en vertu des principes de comptabilité et de commerce, seraient déductibles comme dépenses pour l'année dans la détermination du profit d'une compagnie pour ladite année.

Les Juges Abbott et Ritchie, *dissidents en partie:* Le raisonnement de la majorité de la Cour dans la cause *Smith's Potato Estates, supra,* s'applique au cas présent. Le coût de la détermination du montant véritable de taxe à être payé n'est pas une dépense faite en vue de gagner un profit mais plutôt en vue de conserver des profits déjà gagnés. Il n'y a aucune distinction matérielle entre un paiement fait pour résister à la demande pour impôt sur le revenu venant d'un pouvoir étranger et un paiement fait pour résister à une demande similaire domestique.

APPEL d'un jugement du Juge Cattanach de la Cour de l'Échiquier du Canada[1], dans une matière d'impôt sur le revenu. Appel maintenu, les Juges Abbott et Ritchie étant dissidents en partie.

APPEAL from a judgment of Cattanach J. of the Exchequer Court of Canada[1], in a matter of income tax. Appeal allowed, Abbott and Ritchie JJ. dissenting in part.

Hazen Hansard, Q.C., and *D. O. Mungovan, Q.C.,* for the appellant.

D. S. Maxwell, Q.C., and *B. Verchère,* for the respondent.

The judgment of Abbott and Ritchie JJ. was delivered by

RITCHIE J. (*dissenting in part*):—This is an appeal from two judgments of the Exchequer Court of Canada[1] based on a single decision rendered by Cattanach J. whereby he allowed the appeal of the Minister of National Revenue from a decision of the Tax Appeal Board and thereby approved a reassessment of the present appellant's taxable income for the years 1951 and 1952 adding thereto amounts of $46,532.56 and $45,192.03 which were described by the Minister of National Revenue as "Commissions paid pursuant to agreement of December 29, 1944 with Transcontinental Resources Limited" and whereby he also dismissed the present appellant's cross appeal from a decision of the Tax Appeal Board disallowing a deduction from its taxable income for the years 1951 and 1952 of $20,832.51 being the total amount paid in those two years as legal expenses incurred in respect of a disputed claim for income tax by the United States Internal Revenue Service.

The appellant company was incorporated in Ontario in November 1942 for the purpose of undertaking, in co-operation with other Canadian and United States interests, the

[1] [1965] 1 Ex. C.R. 25, [1964] C.T.C. 202, 64 D.T.C. 5131.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

financing of the development of an iron ore deposit at Steep Rock Lake in northwestern Ontario and for the further purpose of marketing the ore produced from that deposit and the question raised by this appeal with respect to the payment of commissions must, in my view, be considered in light of the circumstances surrounding the early stages of this important mining development.

The ore deposit in question was discovered in 1938 on property owned by Steep Rock Iron Ore Mines Limited (hereinafter called "Steep Rock") and the financing of the very considerable operation necessary to extract the ore from under the Lake was initially undertaken by a Canadian group consisting of Mr. Arthur Carr, the President of Transcontinental Resources Limited and his associates in that Company. Large sums of money were expended in sinking a shaft and running drifts under the Lake in an effort to mine the ore but this proved unsuccessful and it was decided that the only alternative was to embark on the extensive and very costly task of pumping over 100 billion gallons of water out of Steep Rock Lake.

In order to obtain the substantial additional capital necessary to finance this difficult operation, contact was made with Mr. Cyrus Eaton and the Otis Company of Cleveland, Ohio, of which he was the President. It was originally contemplated that the financing would be arranged by Steep Rock issuing $7,500,000 worth of first mortgage bonds of which $1,500,000 were to be marketed in Canada through Mr. Carr and Transcontinental Resources Limited (hereinafter referred to as "Transcontinental") and the balance in the United States through Otis and Company; Steep Rock, however, found it more convenient to deal through one agency and it was for this reason that after discussing the matter with Otis and Company and Transcontinental it was decided that the appellant company should be incorporated. The way in which this decision was made is perhaps best described in the evidence of Mr. William R. Daley, who is now President of Otis and Company and Chairman of the Board of Directors of the appellant company and who was the only witness called in these proceedings. In this regard he said:

> Q. In your previous testimony when you have referred to Mr. Carr and his associates, we must imply that you referred to Transcontinental as being the principal associate?

A. Yes, I am. We ran into some complications in that Steep Rock wanted to deal with one agency. So in the ultimate—I guess it is a long time before we got to the ultimate setup, *but we then agreed we would form one agency, which would be a Canadian company—Premium Iron Ores Limited, which would have a branch company in the United States.* Arthur Carr and his associates would have a contract to distribute the iron ore that was being sold in Canada. Steep Rock wanted to deal with one agency, so it was finally agreed that Premium Iron Ores Limited itself would have exclusive agency and that it would have the co-operation of Arthur Carr and his associates both in the financing and in the sale of the iron ore.

The italics are my own.

In the result, by reason of wartime conditions the Canadian Minister of Finance refused to permit the marketing of these bonds in Canada and therefore the major portion of the financing had to be arranged by way of a loan from the United States Reconstruction Corporation. This loan was granted on the understanding that the appellant would undertake to procure firm purchasing contracts for the delivery of 10,000,000 tons of ore during a period of the next ten years, not less than 500,000 tons of which was to be delivered in each year, and upon a further undertaking by the appellant to furnish additional funds up to $1,000,000 if the actual cost of bringing the mine into production proved greater than the then estimate of $7,500,000.

In furtherance of these arrangements an agreement was entered into between Steep Rock and the appellant on January 15, 1943, wherein it was recited that Steep Rock had appointed the appellant the exclusive selling agent in respect of the iron ore to be mined and produced and the appellant agreed to procure firm purchasing orders for 10,000,000 tons of ore in the manner aforesaid and to render financial assistance up to $1,000,000 if the same were required. The terms of this agreement which most directly concern the issues in this appeal are contained in paragraphs 5, 9, 10 and 11.

Paragraph 5 contains an express covenant by Steep Rock

> ...subject as herein provided, to pay Premium for services referred to herein an amount equal to two percentum (2%) of the value of all Steep Rock ores sold by Premium and Steep Rock during the life of this agreement, whether such ores are delivered within the life of this agreement or not.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

and by paragraphs 9, 10 and 11 the appellant undertook to provide on demand additional financing for Steep Rock of $1,000,000 by way of a loan against promissory notes to be issued and further undertook to deposit voting trust certificates representing 800,000 shares of Steep Rock in trust with an approved trust company by way of assurance to Steep Rock of its ability to make such a loan. It was also agreed by paragraph 18 that 1,437,500 shares of Steep Rock would be allotted to Premium forthwith at a price of 1 cent per share.

Eighteen days after the execution of the last-mentioned agreement, *i.e.*, on February 2, 1943, an agreement was entered into between the appellant and Arthur W. Carr wherein it was recited that Carr had agreed to waive his right to be appointed sales agent by Steep Rock and whereby the appellant covenanted and agreed

> ...that in each year hereafter during the lifetime of the Agency Contract it will pay to Carr a sum equal to Twenty Per Centum (20%) of all monies paid to it by Steep Rock or its successor during such year by way of commission or other compensation under the terms of the said Agency Contract.

As an indication of the continuing participation of Transcontinental in the financing of the Steep Rock Project, it is to be noted that on May 29, 1943, it entered into an agreement with the appellant whereby it agreed to contribute voting trust certificates representing 200,000 of the 800,000 shares of Steep Rock which the appellant had agreed to deposit under the terms of the agreement of January 15th.

In the latter part of 1944 it became apparent that the $7,500,000 which had been estimated as the cost of bringing the mine into production was not enough and Steep Rock accordingly called on Premium Iron Ores to put up part of the $1,000,000 which it had agreed to furnish but in accordance with the contracts existing between Steep Rock and the Reconstruction Finance Corporation, the form of the advance had to be approved by the latter body with the results which are described in the following evidence of Mr. Daley:

> When Steep Rock and Carr and myself reached Washington and took the matter up with Mr. McCartney, who represented the R.F.C. at that time, after a discussion with his associates he said the R.F.C. was not willing to let Steep Rock undertake any further obligations to pay out

money. We pointed out, of course, to Mr. McCartney that R.F.C. had agreed to the provision in the Steep Rock/Premium Contract whereby it was to be represented, the advances were to be represented by an obligation of Steep Rock up to a maximum of six percent, as I recall it, for up to a five-year period.

Mr. McCartney said in spite of that they were not willing to let Steep Rock assume any more debt but that they would agree if Steep Rock desired to do it, to let them issue stock at the market price for the amount that was needed.

The Steep Rock officials and Mr. Carr and I then conferred on that proposal, which resulted in an agreement whereby Premium agreed to take 267,000 shares of Steep Rock stock for approximately $600,000.00, of which Transcontinental Resources was to take 100,000 shares with the balance to be taken by Premium Iron Ores.

A formal agreement was accordingly entered into on December 29, 1944, whereby Transcontinental in its role as a continuing participant in the financing, agreed to purchase 100,000 of the Steep Rock shares which the appellant had agreed to take up and the appellant covenanted to pay to Transcontinental from the 2 per cent commission on Steep Rock Iron Ore sales for which provision was made under the agreement of January 15, 1943, the 20 per cent which it had previously undertaken to pay to Carr under the agreement of February 2, 1943.

The sums of $46,532.56 and $45,192.03 which are now sought to be deducted from the appellant's taxable income represent the 20 per cent payable in accordance with the December 1944 agreement which were paid by the appellant in the years 1951 and 1952 respectively to one A. C. McFadyen who was the ultimate assignee of the rights of Transcontinental thereunder.

In disallowing the deduction of these amounts from the appellant's taxable income for the years in question, Cattanach J. basing his judgment upon his construction of the "plain ordinary meaning" of the words used in the agreements of January 15, 1943, and December 29, 1944, concluded that the payments were made in consideration of Transcontinental purchasing the 100,000 shares of Steep Rock and his analysis of the effect of the 1944 agreement is summarized in the following excerpt from his judgment:

On the one hand, as I view it, the respondent provides services as a sales agent to Steep Rock. On the other hand, the respondent has made an investment in Steep Rock shares. The purchase of such shares is an investment of capital and monies paid to a third party for purchasing some of those shares is equally a capital outlay and cannot be regarded as a current expense of the respondent's business.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

In my opinion the Minister was, therefore, right in assessing the respondent as he did and accordingly the appeal herein must be allowed with costs.

With the greatest respect it appears to me that in confining himself to the two agreements to which he refers, Mr. Justice Cattanach has failed to take into account the gradually developing chain of circumstances which led up to the mine being finally brought into production and in which Carr and his associates in Transcontinental had played a dominant role from the outset.

There is, of course, no doubt that the agreements are to be construed in accordance with the plain and ordinary meaning of the words which they contain. It is equally clear, however, that the words used in a written agreement are to be construed in light of the circumstances under which it was concluded. In this regard I accept the opinion expressed by Lord Blackburn in *River Wear Commissioners v. Adamson*[1], where he said:

> ...I shall therefore state, as precisely as I can, what I understand from the decided cases to be the principles on which the Courts of Law act in construing instruments in writing;...In all cases the object is to see what is the intention expressed by the words used. But, from the imperfection of language, it is impossible to know what that intention is without inquiring farther, and seeing what the circumstances were with reference to which the words were used, and what was the object, appearing from those circumstances, which the person using them had in view; for the meaning of words varies according to the circumstances with respect to which they were used.

The same proposition was more succinctly stated by Jessel M.R. in *Cannon v. Villers*[2]:

> When construing all instruments you must know what the facts were when the agreements were entered into.

When the series of agreements which are exhibits in the present case are considered against the background of Mr. Daley's evidence it is, as I have indicated, apparent that the appellant was incorporated at the instance of Otis and Company and Transcontinental for the purpose of participating in the financing of Steep Rock in co-operation with the two financial groups represented by these companies and that the agreement of January 1943 was entered into as the first step in fulfilment of this purpose, while the agreements of February and May 1943 and December 1944

[1] (1877), 2 A.C. 743 at 763. [2] (1878), 8 Ch. D. 415 at 419.

were entered into in recognition of the continuing participation of the Transcontinental interests in the development of a final plan for the successful outcome of a venture with which they had been closely associated from the beginning.

It is to be remembered that the 2 per cent commission payable to the appellant under the January 1943 agreement was

> ...two percentum (2%) of the value of all Steep Rock ores sold by Premium and Steep Rock...

and that within eighteen days of entering into that agreement, *i.e.*, on February 2, 1943, 20 per cent of this 2 per cent commission was assigned to Carr and later made payable to Transcontinental under the agreement of December 1944 by which, to use the language of Mr. Daley, "the Carr agreement was absorbed".

It is thus apparent that from the time of its incorporation the appellant was engaged with the Transcontinental group in the joint venture of financing Steep Rock, and that before the ore deposits had been brought into commercial production, it had agreed to forego 20 per cent of its commission on their sale which represented the share of its associates in this venture. By reason of the agreement which it entered into in recognition of the part played by its associates, the appellant was never beneficially entitled to retain more than 80 per cent of the commissions which it received from Steep Rock, and the remaining 20 per cent cannot in my opinion be said to form a portion of its taxable income. In this regard I agree with the following statement made by Mr. R. S. W. Fordham in the course of his reasons for judgment rendered by him on behalf of the Tax Appeal Board:

> I think too, it may be said that the appellant and Transcontinental were in a kind of joint adventure; each played an important part in making it possible for Steep Rock to acquire needed funds. The appellant—and not Steep Rock—became obligated to Transcontinental as a consequence. The monies paid to the latter were for a valued service rendered to the appellant in its fulfilment of an important part of the agency agreement with Steep Rock. Appellant was entitled to retain 80 per cent of the monies received from Steep Rock and no more. The remaining 20 per cent had become, by formal and enforceable agreement, the property of Transcontinental or its assignees. Hence, it was on the beneficial assignee that liability for tax on the 20 per cent fell and not on the appellant, which had no proprietary interest therein.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

I would accordingly allow the appeal with respect to the commissions paid by the appellant to Mr. McFadyen in the years 1951 and 1952 and direct that the reassessment by the Minister of National Revenue in this regard be set aside.

The legal expenses which the appellant seeks to deduct for the years 1951-52 were incurred in respect of a claim asserted by the United States tax authorities in the year 1950 relating to earnings of the appellant during the years 1943-1950 inclusive. The exact nature of the claim in respect of which the legal expenses were incurred can best be explained by somewhat lengthy reference to the evidence of Mr. Daley.

After having been questioned as to the arrangement whereby Premium Iron Ores was permitted to purchase 1,437,500 shares of Steep Rock for $14,375, Mr. Daley's examination continued:

> Q. Turning to the question of the legal expenses involved in the United States and here, Mr. Daley, I did not quite understand when you said that the matter first came up in 1950 and you indicated, I think, some two or three million dollars in tax that they wanted. For what period was this two to three million dollars—how long? Was it from the beginning of operations or for the year 1950 or what?
>
> A. I recall that Premium received this large block of shares of Steep Rock at one cent per share and while the Canadian Income Tax Department had said no tax will result from this transaction the United States government tried to assert a claim on profit for the difference between the market value on the Toronto Stock Market and the one cent.
>
> Q. That was with respect to your capital gain between the one cent and the 1.66?
>
> A. No, it was not. They said that was income for services.
>
> * * *
>
> Q. I am not getting into whether it is a capital gain or profit, but it represented what we might normally call the capital gain, whether it was considered profit or what it was considered. It represented the difference between the one cent and the 1.66?
>
> A. Yes, that is correct.
>
> Q. Was that the chief substance of what they were claiming against you?
>
> A. From 1945 on the claim also included all of the commissions that had been received from Steep Rock.
>
> Q. Generally it was with respect to the income from the beginning of Premium's existence; is that the idea?
>
> A. You say 'generally'. Of course that amount was not as large as the other amount, but they did assert a claim against all of those commissions claiming that was United States' income.

Mr. Daley was later asked:

> Q. Can you tell me any better than you have, Mr. Daley, with respect to what precise years the United States government were claiming tax? I do not want to put words into your mouth. Was it 1943 and every year up to 1950?
>
> A. 1943 was the most important one and it was every year up through.
>
> Q. To the end?
>
> A. To, I think, 1950—the time they started their investigation.
>
> Q. Did you have accounts after the cases proceeded to court? Did you have accounts—presumably you did—from solicitors?
>
> A. Yes.

The appellant contends that these legal expenses in the years 1951-52 were deductible as having been incurred "for the purpose of gaining or producing income" under the provisions of s. 12(1)(*a*) of the *Income Tax Act* 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.*

The italics are my own.

In disallowing the deduction sought by the appellant for these expenses, Mr. Justice Cattanach adopted the reasoning of the majority of the House of Lords in *Smith's Potato Estates Limited v. Bolland (Inspector of Taxes)*[1], in which it was held that under Rule 3(*a*) Schedule D of the English *Finance Act* 1940, the expense incurred for legal and accounting costs in the preparation and prosecution of an appeal to the Board of Referees was not deductible in computing the taxable income of a taxpayer on the ground that the cost of ascertaining the true amount of tax to be paid is not an expense made in order to earn profits but rather an application of profits after they had been earned. The view of the majority of the Law Lords in this case which was later followed in the unanimous judgment of the House of Lords in *Rushden Heel Co., Ltd. v. Inland Revenue Comrs.*[2] is epitomized in the following paragraph from the reasons of Lord Simonds to which Cattanach J. has referred:

> ...Neither the cost of ascertaining taxable profit nor the cost of disputing it with the revenue authorities is money spent to enable the trader to earn

[1] [1948] A.C. 508, 2 All E.R. 367.

[2] [1948] 2 All E.R. 378.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

profit in his trade. What profit he has earned, he has earned before ever the voice of the taxgatherer is heard. He would have earned no more and no less if there was no such thing as income tax.

The appellant sought to distinguish these cases from the present one on the ground that the wording of the English Rule 3(*a*) differs from s. 12(1)(*a*) of the *Income Tax Act*. The English Rule reads as follows:

> In computing the amount of the profits or gains to be charged, no sum shall be deducted in respect of
>
> (*a*) disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade...

It is to be noted, however, that the reasons of the majority in the *Smith's Potato Estates Ltd.* case were predicated on an acceptance of the interpretation placed on Rule 3(*a*) by Lord Davey in *Strong & Co. v. Woodifield*[1]. In that case Lord Davey, in commenting on the words "wholly and exclusively laid out or expended for the purposes of the trade" as they occur in Rule 3(*a*), had this to say:

> These words...appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade.

Viewed in this light I am of opinion that the reasoning employed in the *Smith's Potato Estates Ltd.* case applies to the interpretation to be placed on s. 12(1)(*a*).

It was not until 1964, twelve years after the last payment of legal expenses had been made by the appellant in the present case that Canadian taxpayers were afforded relief from the effect of the *Smith's Potato Estates Ltd.* case, *supra*. In that year Parliament enacted section 11(1)(*w*) of the *Income Tax Act*, the relevant portions of which read as follows:

> 11(1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:
>
> (*w*) *Expenses of objection or appeal.*—amounts paid by the taxpayer in the year in respect of fees or expenses incurred in preparing, instituting or prosecuting an objection to, or an appeal in relation to, an assessment of tax, interest or penalties under this Act.

It has been suggested that the decision of this Court in the case of *Evans v. Minister of National Revenue*[2] affords some support for the contention of the appellant on

[1] [1906] A.C. 448.

[2] [1960] S.C.R. 391, C.T.C. 69, 60 D.T.C. 1047, 22 D.L.R. (2d) 609.

this branch of the appeal, but that was not a case in which the taxpayer was seeking to deduct legal fees paid in respect of a dispute as to tax liability. There the taxpayer had incurred legal expenses in respect of an originating notice to the Supreme Court of Ontario for the opinion, advice and direction of the Court as to whether she was entitled to be paid income for life under the will of the father of her first husband. It was ultimately decided in the Ontario Court that she was so entitled and the very considerable legal fees were deducted by the trustee of the will out of the income to which she would otherwise have been entitled for the taxation year in question. The question at issue was whether in computing her income for that year the taxpayer was entitled to deduct those fees. The main question to be determined was whether the life interest to which the taxpayer was found to be entitled was a capital asset or whether it was income, and Cartwright J. who delivered the reasons for judgment on behalf of the majority of the Court held that it was income to which the taxpayer was entitled but the payment of which could not have been obtained without the expense of litigation, and he therefore allowed the deduction. It will be seen that these circumstances are very different from those in the present case, and I find it to be clearly distinguishable.

It is, however, argued on behalf of the appellant that even if it be accepted that such legal expenses are not deductible when they have been incurred to dispute a claim of the tax authorities of the taxpayer's own country, entirely different considerations apply when the outlay is made in order to determine the taxpayer's position in relation to a claim by a foreign government. In this regard, like the learned judge in the Exchequer Court, I am persuaded that the reasoning of the House of Lords in *Inland Revenue Commissioners v. Dowdell O'Mahoney & Co., Ltd.* [1] applies to such a claim. That was a case in which a company resident in Eire carried on business at two branches in England. The whole of its profits, including those arising from business in England, were subject in Eire to income tax and the company sought to deduct a proportion of the Eire taxes in computing the profits of the business in England for assessment of excess profits tax. In the course

[1] [1952] A.C. 401, 1 All E.R. 531.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Ritchie J.

of his reasons for judgment disallowing the deduction, Lord Radcliffe appears to me to have come to the heart of the matter when he said at p. 543:

> *But, once it is accepted that the criterion is the purpose for which the expenditure is made* in relation to the trade of which the profits are being computed, I have been unable to find any material distinction between a payment made to meet such taxes abroad and a payment made to meet a similar tax at home.

The italics are my own.

In the present case, as I have indicated, the purpose for which the expenditure was made concerned a claim for income tax in the United States in relation to profits made by the appellant in 1943 which the Canadian authorities had characterized as capital profits as well as a claim in respect of income which had been earned in the years 1945-1950 inclusive. These expenditures made in the years 1951 to 1952 do not appear to me to have been made "for the purpose of gaining or producing income" but rather for the purpose of preserving profits already earned by the appellant from a claim made by the United States tax authorities. The exceptional cases in which a taxpayer is permitted to deduct expenses when computing taxable income are confined by the terms of s. 12(1)(*a*) to expenses

> ...made or incurred by the taxpayer for the purpose of gaining or producing income...

and except as otherwise expressly provided by s. 11, do not extend to expenses made for the purpose of preserving that income once it has been earned.

The effect of the provisions of s. 12(1)(*a*) is discussed and explained by Mr. Justice Abbott in the course of the reasons for judgment which he delivered on behalf of the majority of this Court in *B. C. Electric Ry. Co. Ltd. v. Minister of National Revenue*[1], where he said:

> 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*

[1] [1958] S.C.R. 133 at 137, C.T.C. 21, 71 C.R.T.C. 29, 58 D.T.C. 1022, 12 D.L.R. (2d) 369.

distinction is, of course, that since for tax purposes income is determined on an annual basis, an income expense is one incurred to earn income of the particular year in which it is made and should be allowed as a deduction from gross income in that year.

The italics are my own.

It cannot in my opinion be said that the legal expense in question in the present case was incurred to earn the income of the particular year in which it was made and it should therefore not "be allowed as a deduction from gross income in that year".

For these reasons, as well as for those expressed in the opinion of Mr. Justice Cattanach, I would dismiss the appeal from the reassessment of the Minister of National Revenue with respect to legal expenses incurred in the years 1951 and 1952 in the resisting of the claim of the United States taxing authority.

In the result, the appeal in respect of the commissions paid in the years 1951 and 1952 is allowed and the appeal with respect to legal expenses in the same years is dismissed.

As the appellant has been substantially successful in this Court it will have the costs of this appeal together with the costs of the appeal to the Exchequer Court. The order as to costs of the cross appeal in the Exchequer Court will, of course, remain undisturbed.

MARTLAND J.:—I agree with my brother Ritchie that the commissions paid by the appellant to Mr. McFadyen in the years 1951 and 1952 were not taxable in the hands of the appellant. I agree with the conclusion reached by my brother Hall that the appellant was entitled to deduct as items of expense the amounts of $12,317.36 and $8,514.16, paid for legal expenses, in the years 1951 and 1952 respectively, when determining its taxable income in those two years. I have, however, reached this conclusion on somewhat narrower grounds than those which he has stated.

The reason for these payments is given in the judgment of the Tax Appeal Board, as follows:

Turning to the second phase of the matter, the appellant learned some years after it had begun to sell ore in substantial quantities that the American revenue authorities had designs on its income on the alleged grounds that it had been earned in the United States of America and that the appellant had a permanent establishment there within the meaning of the Tax Convention and Protocol between Canada and the United States

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Martland J.

of America, signed on or about 4th March, 1942. The suggestion that tax liability obtained in the latter country was both surprising and startling to the appellant and steps were taken promptly to ascertain its legal position. It was a matter of great importance to the appellant as, if liability were to be established, the income relating to past, present and future years would be in jeopardy and, according to the evidence heard, in the event of the American claim proving successful, immense harm would be done to the appellant, financially. On this account, opinions were sought in Canada and the United States of America and great trouble was gone to and expense incurred in the latter country for the purpose of ascertaining all relevant facts and reaching a position in which the claim could be effectively opposed if it were proceeded with in the appropriate American court.

The relevant provisions of the *Income Tax Act*, R.S.C. 1952, c. 148, are s. 12(1)(*a*) and (*b*) which provide:

> 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,

The predecessor of s. 12(1)(*a*) was s. 6(1)(*a*) of the *Income War Tax Act*, R.S.C. 1927, c. 97, which provided that:

> 6. (1) 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.

It seems clear that the present wording of para. (*a*), which first appeared in the 1948 *Income Tax Act*, 1948 (Can.), c. 52, was intended to broaden the definition of deductible expenses. The *Income War Tax Act* defined "income" as meaning "the annual net profit or gain or gratuity." Under s. 6(1)(*a*), in computing such profit or gain it was only permissible to deduct expenses wholly, exclusively and necessarily expended for the purpose of earning that income. The present Act does not contain this definition of "income." It frequently uses the phrase "income for a taxation year", which appears in s. 11(1) dealing with allowable deductions. The phrase does not appear in s. 12(1)(*a*) which, as now worded, permits the deduction of any expense made for the purpose of producing income from a property or business.

Even under the narrower provisions of s. 6(1)(*a*) of the *Income War Tax Act,* legal expenses were deductible in the ordinary course as a current expenditure. This was stated by Duff C.J. in *The Minister of National Revenue v. The Dominion Natural Gas Company Limited,*[1] a case which involved the application of s. 6(1)(*a*) and (*b*) of the *Income War Tax Act.* The statement was affirmed by unanimous decision of this Court when he delivered the judgment in *The Minister of National Revenue v. The Kellogg Company of Canada, Limited*[2]. In that case the question in issue was as to the right of the Kellogg Company to claim as an expense, in determining its taxable income under the *Income War Tax Act,* legal fees incurred by it in successfully defending a suit for an injunction against alleged infringement of registered trade marks by using certain words in connection with the sale of its products. These expenses were held to be deductible under s. 6(1)(*a*) of that Act, and not to constitute an outlay or payment on account of capital within s. 6(1)(*b*). They fell within the general rule that in the ordinary course legal expenses are simply current expenditures and deductible as such.

Clearly these expenses were not made solely for the purpose of earning income in the year in which they were incurred. They did not directly result in the earning of income at all. But they were made with a view to protecting the income earning capacity of the company, since it must be assumed that the loss of the right to the use of the words in connection with its sales would have indirectly resulted in a reduction of its income, not only in the year in which they were incurred, but also in future years as well.

In *Evans v. The Minister of National Revenue*[3], the question in issue was as to the right to deduct, under s. 12(1)(*a*) of the *Income Tax Act,* legal expenses incurred by the appellant in connection with an application by the trustee of an estate for advice and directions. What the Court had to determine upon the application was the appellant's right to receive the income from a portion of the estate. Judgment on that application was given in 1954. There were appeals to the Court of Appeal for Ontario and to this Court. The final judgment was given in 1955 and

[1] [1941] S.C.R. 19 at 25, 4 D.L.R. 657.
[2] [1943] S.C.R. 58 at 61, 3 Fox Pat. C. 13, 2 C.P.R. 211, 2 D.L.R. 62.
[3] [1960] S.C.R. 391, C.T.C. 69, 60 D.T.C. 1047, 22 D.L.R. (2d) 609.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Martland J.

the appellant sought to deduct from her income for that year her legal fees which she paid in that year.

Here again, the expense was not one which was made solely for the purpose of earning income in that year. In the light of the decision of this Court, she had been entitled to that income all along. Such expense was made in order to protect her right to receive income, not only in 1955, but in each of the years in which income became available for distribution from the estate. This right was held not to be a capital asset, and the expense in question did not fall within s. 12(1)(*b*). Such expense was held to be properly incurred within s. 12(1)(*a*) for the purpose of gaining an income to which the appellant was entitled.

In the present case the legal fees paid by the appellant were expended with a view to resisting the claim of the American government that the appellant had a permanent establishment in the United States and so was liable for the payment of income tax there. As stated in the reasons of the Tax Appeal Board, previously cited:

> It was a matter of great importance to the appellant as, if liability were to be established, the income relating to past, present and future years would be in jeopardy, and, according to the evidence heard, in the event of the American claim proving successful, immense harm would be done to the appellant, financially.

I have great difficulty in seeing how, in principle, this expense for legal services, made as it was for the purpose of protecting the appellant's income, can be regarded as being different from that which was held to be properly deductible in the Kellogg case and also in the Evans case. The disbursement made was not an outlay or replacement of capital, nor a payment on account of capital, within s. 12(1)(*b*). The claim of the American government was not in respect of the appellant's capital, but a claim which, if established, would have created a liability in relation to its income. It is true that the American government considered as taxable income items of profit which had not been so regarded in Canada, but the basis of the claim was in respect of income. It is also true that the disbursement was made to protect profits earned in years prior to the year in which the disbursement was made as well as the income of that and subsequent years. But in the light of the present wording of s. 12(1)(*a*) and its application in the Evans case, this does not prevent this expense from being deducti-

ble. In both that case and the Kellogg case the expense involved was to establish a right to receive income, or for the protection of income in other years as well as that of the year in which the expenditure was made.

The learned trial judge refused to allow the deduction of these expenses because he felt that the matter was determined by the judgment of the House of Lords in *Smith's Potato Estates Limited v. Bolland (Inspector of Taxes)*[1]. In that case, by a majority of three to two, the appellant was held not to be entitled, in determining its taxable income, to deduct legal and accountancy expenses made to contest an assessment to excess profits tax.

Assuming, without agreeing, that the reasoning of the majority should be preferred to that of the minority, I do not agree that that case is a parallel to the present one. The relevant statutory provision in that case was materially different from s. 12(1)(*a*) of our Act. The English statute only permitted deduction of:

> money *wholly and exclusively* laid out and expended for the *purposes of the trade*.

Reference to the words which I have italicized, as compared with the wording of our s. 12(1)(*a*), indicates that the English provision was much narrower in its scope.

The *Smith* case was concerned with legal expenses made by an English company in England with a view to reducing its liability for tax in England. The effect of the decision is that an expenditure by a trader for legal fees incurred for the purpose of contesting an assessment of income tax cannot, *as against the assessor of that tax,* be claimed as money wholly and exclusively expended for the purpose of the trade. But that is not this case. The expense incurred here was for the purpose of resisting the demands of a foreign taxing authority, which, had it succeeded, would have substantially depleted the income of a Canadian company. In my opinion, a claim of that kind is a claim by a third party. The resistance of the claim is an attempt to protect Canadian income, and it matters not, so far as the Canadian taxing authority is concerned, that the nature of the claim is one for income tax. In so far as the Canadian taxing authority is concerned, I can see no difference, in

[1] [1948] A.C. 508, 2 All E.R. 367.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Martland J.

principle, between an expenditure in the form of legal fees paid by a railway company to defend a damage claim by a passenger, and thus to protect the company's income, and the expenditure for legal fees paid by the appellant to resist a foreign tax claim and thus to protect its income. The former type of expense is admittedly properly deductible.

The other authority relied upon by the learned trial judge, also a decision of the House of Lords, was *Inland Revenue Commissioners v. Dowdell O'Mahoney & Co. Ltd.*[1]. That case is also distinguishable. It dealt with a claim by an Irish company, doing business in England, to deduct, in computing its excess profits tax in England, tax paid by it in Ireland. This claim was refused. The case does not involve legal fees at all. The payment of the Irish tax was not made with a view to resisting a claim which would reduce its income.

In my opinion a payment made for legal services in an attempt to protect income against encroachment by a third party is, in principle, on the authority of the Kellogg and Evans cases in this Court, properly deductible.

I would allow the appeal in toto, with costs throughout.

HALL J.:—I have had the opportunity of reading the reasons for judgment of my brother Ritchie and I agree with him that the commissions paid by the appellant to Mr. McFadyen in the years 1951 and 1952 were not taxable in the hands of the appellant. However, with respect, I disagree as to the $20,832.51 paid in the two years in question as legal expenses incurred as a result of an unwarranted claim for income tax and capital gains tax amounting to between two and three million dollars by the United States Internal Revenue Service which claim was successfully resisted resulting in this very substantial saving to the appellant, or, put differently, the working capital of the appellant and its profit earning potential were preserved by the rejection of this unjustified demand. Had the claim succeeded, according to the witness Daly whose evidence was not challenged, it would have taken up nearly all the income of the appellant, leaving the appellant unable to carry out its obligations under the sales contract of January 15, 1943, and to earn the income needed to sustain its operations.

[1] [1952] A.C. 401, 1 All E.R. 531.

Mr. Justice Cattanach[1] dealt with this item as follows:

It is well settled that the legal costs incurred in disputing a claim for income tax may not be allowed as a deduction in computing business profits. In *Smith's Potato Estates, Ltd., v. Bolland,* (1948) 2 All E.R. 367 Lord Simonds said at page 374:

> "...neither the cost of ascertaining taxable profit nor the cost of disputing it with the revenue authorities is money spent to enable the trader to earn profit in his trade. What profit he has earned, he has earned before ever the voice of the taxgatherer is heard. He would have earned no more and no less if there was no such thing as income tax..."

I cannot accept the proposition that "it is well settled that the legal costs incurred in disputing a claim for income tax may not be allowed as a deduction in computing business profits".

Cattanach J. quotes Lord Simonds in *Smith's Potato Estates* case[2], but he also said on the same page:

My Lords, I suppose that few expressions have been discussed more often in the courts than that which you have once again to consider, "money wholly and exclusively laid out or expended for the purposes of the trade," but it is their application rather than their meaning that is in doubt. I agree with the submission of learned counsel that it does not help to substitute other words for those which are found in the statute and then to put a gloss on those other words, but it is, I think, important to emphasize that the words "for the purposes of the trade" in their context, i.e., where a computation of "profits" for the ascertainment of taxable income is being made, must mean "for the purpose of enabling a person to carry on and earn profits in the trade." These familiar words I cite from LORD DAVEY'S speech in *Strong & Co. Ltd. v. Woodifield* ((1906) A.C. 448, 453). They have been cited and applied over and over again, and, if they are kept firmly in mind, they dispose *in limine* of the argument which prevailed with ATKINSON J., and has been urged before your Lordships.

It will be seen that Lord Simonds adopts a phrase from Lord Davey's speech in *Strong & Co., Ltd. v. Woodifield*[3].

Strong v. Woodifield was a case where the taxpayers, innkeepers, were seeking to deduct costs and damages paid to a person staying in their inn who was injured by the fall of a chimney. I do not think it has ever been successfully contended in Canada that damages and costs payable by a common carrier or by an occupier to an invitee or licensee or in any similar circumstances were not proper deductions in arriving at the taxable income of such a taxpayer. I understood counsel for the Minister to concede that such

[1] [1965] 1 Ex. C.R. 25, [1964] C.T.C. 202, 64 D.T.C. 5131.
[2] [1948] A.C. 508, 2 All E.R. 367 at 374.
[3] [1906] A.C. 448.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

deductions are not challenged. Even in *Strong v. Woodifield* Lord Loreburn said at p. 452:

> In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade, or it may be connected with something else quite as much as or even more than with the trade. I think only such losses can be deducted as are connected with in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered. To give an illustration, losses sustained by a railway company in compensating passengers for accidents in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted. Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise.

and Lord James of Hereford said at p. 454:

> The only question is as to the application of that principle in one small matter to the facts of this case. If the fact were that the accident had occurred to a stranger walking in the street, then I should have no doubt at all. The doubt that did arise in my mind was as to the rule applicable when the accident occurred to a person who was a customer in the house who would not have been injured unless the business of an innkeeper was being carried on, and when it was in the course of the carrying on of a portion of that business that the customer injured was there; then I think a different principle might arise, and my doubts consequently existed.

Now reverting to *Smith's Potato Estate* case, Viscount Simon said regarding Lord Davey's statement in *Strong v. Woodifield* at p. 369:

> It seems to me that it is essential for the proper carrying on of a trade that the trader should know what portion of his profits in a given year is left to him after the Revenue has taken its share by taxation. If, therefore, he considers that the Revenue seeks to take too large a share and to leave him with too little, the expenditure which the trader incurs in endeavouring to correct this mistake is a disbursement laid out for the purposes of his trade. If he succeeds, he will have more money with which to earn profits next year. It is true that the *result* of his success is to reduce the tax he had to pay—alternatively, one may say that the result is to show that the profit of the years trading left to him after paying tax is greater than the Revenue was willing to admit—but, to my mind, the *purpose* was a trading purpose and nothing else. The trade is not to be regarded as extending over twelve months and no more. Indeed, as I have already pointed out, excess profits tax is liable to be adjusted in the light of subsequent trading results, and assessment for income tax is arrived at on figures of the previous year. With all respect to those who think otherwise, I regard it as fallacious to argue that the trader's expenditure in fighting the Revenue's assessment is not "wholly and exclusively" incurred for the purposes of the trade because the expenditure would not be

incurred if there was no tax to pay. If there was no tax to pay, the benefit realised by the trader from carrying on the trade would not be reduced by taxation, and it is the purpose of trade (at any rate, under private enterprise) to make its legitimate profit.

Viewed in this light, I do not see why the expenditure here in question is not wholly and exclusively laid out for the purposes of the trade—if it had not been incurred, the trade would be less profitable. LORD DAVEY'S gloss on the words of the statute in *Strong & Co., Ltd. v. Woodifield* (1) ((1906) A.C. 448, 453) is well known, but I think it is better to concentrate on the statutory words themselves. Rightly understood, however, I do not find that LORD DAVEY'S words contradict the view I am disposed to take. *Strong & Co., Ltd. v. Woodifield* (1) was a case in which the taxpayer sought to deduct a loss not connected with or arising out of his trade. LORD LOREBURN said (ibid., 452): "I think only such losses can be deducted as are connected with, in the sense that they are really incidental to, the trade itself." LORD DAVEY'S test was that the purpose of the expenditure must be "the purpose of enabling a person to carry on and earn profits in the trade..." (ibid., 453). Here, the expenditure was, in my view, incurred for the purpose of carrying on and earning profits in the trade, for a reduction in the amount of tax does increase the fund in the trader's hands after tax is paid and so promotes the carrying on of the trade and the earning of trading profits. The incidental consequence that the trader is not taxed so heavily in respect of his profits from trade does not, as it seems to me, alter the fact that the litigation was wholly and exclusively undertaken for the purposes of the trade.

Lord Oaksey in the same case said at p. 377:

My Lords, the question in this appeal is whether the costs of litigation undertaken for the purpose of arriving at the true profits of a trade for the purposes of taxation are proper deductions in order to arrive at the balance of profits and gains or as expenses wholly and exclusively laid out or expended for the purposes of the trade within the meaning of 3. (*a*) of the Rules Applicable to Cases I and II of sched. D to the Income Tax Act, 1918. The contention on behalf of the Crown is that no expenses connected with taxation are deductible because it is said they are not expended for the purposes of the trade and it is sought to limit the words "the purposes of the trade" to the purpose of earning the profits of the trade by the operations of the trade. Reliance is placed on the *dictum* of LORD DAVEY in *Strong & Co., Ltd. v. Woodifield* (1) ((1906) A.C. 448, 453), which has frequently been cited with approval in other cases, but it is to be observed that LORD DAVEY did not say earning the profits by the operations of the trade and, in my opinion, the words "the purposes of the trade" ought not to be construed in this way. A trader does not expend money in an action brought for or against him for negligence or breach of contract in the course of his trade for the purpose of earning the profits of the trade in this sense, for it is not an operation of his trade to engage in litigation. It is, of course, an incident which he may think reasonably necessary for the purposes of his trade to bring or defend actions, but so it is an incident which he may think reasonably necessary for the purposes of his trade to engage in litigation as to the amount of his taxes. If he succeeds in either case he increases the profits arising from his trade, and it appears to me to be no straining

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

of language to say that a trader who increases his profits by incurring a certain expense incurs that expense for the purpose of earning the profits.

In my opinion, the real question which has to be decided in every case is whether the expense is one which is incurred in order to earn gain or profit from the trade, or is the application of the gain or profit when earned: see *per* LORD SELBORNE, L.C. in *Mersey Docks & Harbour Board v. Lucas* (6) ((1883) 8 App. Cas. 891, 906), and, in my opinion, it cannot be truly said that the expense of paying accountants or of litigating the question of what is the balance of profits and gains for the purposes of taxation is the application of these profits. Profits cannot properly be applied or divided until they are ascertained, and every expense which is properly incurred for the ascertainment of profits is, in my opinion, an expense of earning the profits and not an application of them. That is not to say that all expenses which are incurred in point of time before the profits are ascertained can be deducted. The point of time is unimportant. Some expenses which are clearly the application or distribution of profits may be incurred before the ascertainment of profits, e.g., capital investments or payments of interim dividends, but it is the character of the expense which must be considered. The expense in this case was not a capital investment. It was incurred, not to distribute, but to increase, and, in that sense, to earn, the profits. On the other hand, if it is to be held that such expenses are not deductible, what is to be said of the costs of audit which the Companies Acts make necessary or of that part of the cost of bookkeeping which is used in the preparation of such an audit or of accounts for taxation? They are not incurred for the purposes of earning the profits of the trade in the limited sense contended for by the Crown. It is said that the expense of litigating questions of taxation has never been sought to be deducted, and it may be so, but it is also true that the expense of paying accountants and auditors has been deducted, and, in any event, the fact, if it be the fact, throws no legal light on the construction of the words in question.

The judgment in *Smith's Potato Estate* case is persuasive and entitled to respect, but as Lord Oaksey says, Lord Davey's statement in *Strong v. Woodifield,* relied on so strongly by the majority was *dictum* (p. 377).

I cannot accept the majority judgment in *Smith's Potato Estates* case as being the correct statement of the law as applied to the provisions of the *Income Tax Act.* It will be observed that the English rule differs somewhat in wording from the Canadian Act. The former reads:

> In computing the amount of the profits or gains to be charged, no sum shall be deducted in respect of
>
> (*a*) disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade...

The latter reads:

> 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.

It cannot be overlooked that Parliament, in enacting s. 12(1)(*a*), did not include the words 'not wholly, exclusively and necessarily laid out or expended' which were in s. 6 of the *Income War Tax Act* prior to 1948 and which are found almost verbatim in the English counterpart quoted above except for the word "necessarily". Consequently, the English decisions like *Strong v. Woodifield* and all those founded on *Strong v. Woodifield* based on the wording of the English rule cannot now be invoked as wholly applicable and indistinguishable in the interpretation of s. 12(1)(*a*). Some significance must be given to the difference in wording noted above and to the change in wording when the *Income Tax Act* was enacted in 1948. The statement by Abbott J. in *B.C. Electric Railway Co. Ltd. v. Minister of National Revenue*[1],

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

points up the error that may arise from an unquestioned acceptance of such cases as *Smith's Potato Estates* as being completely applicable in Canada after 1948. In that year the words 'wholly, exclusively and necessarily' were replaced with the much broader 'made or incurred for the purpose of gaining or producing income from property or a business'. The limitation, spelled out in s. 12(1)(*a*), does not, in referring to 'producing income from the property or business of a taxpayer', limit the words quoted solely to the taxation year in which the deduction is being claimed. It is a clear indication to me that the income thus referred to may be the income of the taxation year under review or of a succeeding year.

A company such as the appellant exists to make a profit. All its operations are directed to that end. The operations must be viewed as one whole and not segregated into revenue producing as distinct from revenue retaining functions, otherwise a condition of chaos would obtain. For example, is the function of the Paymaster's Department to be considered as directly relating to the production of income, which it undoubtedly is, as distinct from the Audit Department which scrutinizes the disbursements made by the

[1] [1958] S.C.R. 133 at 136, C.T.C. 21, 71 C.R.T.C. 29, 58 D.T.C. 1022, 12 D.L.R. (2d) 369.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

Paymaster? What of the sophisticated systems of internal and external audits adopted by commercial companies to assure that the income received by the company is properly retained? What of security arrangements to protect income already earned? What of claims against, say, a shopping centre for damages sustained by a customer or claimed to have been sustained and the legal costs of investigating and defending such claims? Counsel for the Minister freely admitted that these are routinely allowed as expenses incurred in earning "the income".

"The income" surely means the net receipts over disbursements in the taxation year in the totality of the taxpayer's business as an on-going concern other than capital expenditures, gifts and the like. I can see no reason to regard legal expenses as differing from other expenses in that they differ solely by the fact that they are disbursements paid to lawyers as distinct from payments made to auditors or to accountants and others for work done in preparing the yearly income tax returns, or premiums paid for insurance to indemnify the taxpayer from loss by fire or from negligence or liability imposed by law. In my view, no distinction is to be drawn between proper legal expenses and other business expenses. All must be tested by the same standards.

Canadian courts have not always accepted the result in *Strong v. Woodifield.* Angers J. in *Hudson's Bay Company v. Minister of National Revenue*[1] made an exhaustive review of many cases, including *Strong v. Woodifield.* The facts in the *Hudson Bay* case were that a company calling itself Hudson Bay Fur Company was organized to deal in furs in the States of Oregon and Washington and for a time operated two stores in Seattle, Washington. The Hudson Bay Company took action in the State of Washington to restrain Hudson Bay Fur Company from interfering with its trade and it was successful. It paid out for legal costs in connection with that action the sum of $10,377 in 1938 and $22,952.80 in 1939 and included these disbursements as deductible expenses in its income tax returns for the said years. The Minister disallowed these deductions and Hudson Bay Company appealed the disallowances.

[1] [1947] Ex. C.R. 130, 6 Fox Pat. C. 49, C.T.C. 86.

Section 6 of the *Income War Tax Act* then read:

(1) 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 absolescence, except as otherwise provided in this Act.

Angers J. at pp. 148-9 said:

Can the expenses or costs paid out by the appellant in the circumstances hereinabove related be considered as disbursements or expenses "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"? This is the question which I have to solve.

Counsel for the appellant in his argument pointed out that the Minister, assisted by a very able staff, did not think at first that there was any objection to the legal costs and expenses in issue being deducted from the income and the return was accepted. He submitted that it was only when the decision of the Supreme Court in the case of *The Minister of National Revenue v. Dominion Natural Gas Company Limited,* (1941) S.C.R. 19, was rendered that the Minister changed his mind, reopened the assessment and disallowed the deduction of the said costs and expenses.

Counsel intimated that the reassessment was made on an erroneous view of what was decided in the *Minister of National Revenue v. Dominion Natural Gas Company Limited* case and that, if the case of *Income Tax Commissioner v. Singh,* (1942) 1 A.E.R. 262, had been decided before the *Minister of National Revenue v. Dominion Natural Gas Company Limited* case, the decision of the Supreme Court in the latter case might have been different. Counsel suggested that the Supreme Court thought that they were compelled to give judgment against their own opinions possibly, because they considered themselves bound by some remarks of the Privy Council. He drew the conclusion that it is clear, according to the judgment in the case of *Income Tax Commissioner v. Singh,* that the Privy Council did not intend to lay down any such rule as that suggested in the Supreme Court judgment.

Counsel for respondent on the other hand relied on the case of *Minister of National Revenue v. Dominion Natural Gas Company Limited,* among several others, and it seems convenient to analyze it first.

It is important to note that at p. 25 of *Minister of National Revenue v. Dominion Natural Gas Company Limited,* Duff C.J.C. said:

In the ordinary course, it is true, legal expenses are simply current expenditure and deductible as such; but that is not necessarily so. The legal expenses incurred, for example, in procuring authority for reduction of capital were held by the Court of Sessions not to be deductible in *Thomson v. Batty* ((1919) S.C. 289).

and Mr. Justice Crocket said at p. 26:

If we were free to decide this appeal on considerations of practical business sense and equity, or to deduce from decided cases the governing

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

rule, which should be applied in determining whether the respondent was or was not entitled, under the formula prescribed by s. 6 of the Canadian *Income War Tax Act*, to the deduction claimed in computing its assessable profits or gains for the year 1934, I should have no hesitation in adopting the conclusion at which the learned President of the Exchequer Court arrived and the reasons he has given therefor. We are confronted, however, with a recent judgment of the Judicial Committee of the Privy Council in the case of the appeal of *Tata Hydro-Electric Agencies, Ltd., Bombay, v. Commissioner of Income Tax, Bombay Presidency and Aden* ((1937) A.C. 685) in which a test, formulated in 1924 by Lord President Clyde of the Scottish Court of Session in the case of *Robert Addie & Sons Collieries, Ltd. v. Commissioners of Inland Revenue* ((1924) S.C. 231), for determining whether a deduction is allowable under practically identical provisions of the English *Income Tax Act*, 1918, is expressly adopted and applied. The English Act of 1918, ch. 40, 8 & 9 Geo. V. by rule 3 of Schedule "D", prohibits deductions in respect of "any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession, employment or vocation," or in respect of "any capital withdrawn from, or any sum employed or intended to be employed as capital in such trade," etc., as well as other specified capital expenditures for improvements and the like, the effect of which, as regards this case, it seems to be impossible to distinguish from the prohibitions (*a*) and (*b*) of s. 6 of the Canadian Act. I apprehend, therefore, that the test so distinctly adopted by the Judicial Committee in the *Tata* case ((1937) A.C. 685) is binding upon us.

Maclean P. in the *Dominion Natural Gas* case at pp. 19 and 20 said:

> It seems to me that if legal expenses are incurred in successfully defending an action in which one's title to existing assets, rights or facilities are put in serious question, such expenses should normally be admissible as deductions, and particularly would this be so in the case where the earning of profits are directly dependent upon and require the utilization of such assets, rights or facilities, as was the case here. If the action is unsuccessfully defended the revenue authorities might contend that there was no asset, right or facility to defend, and that therefore such expenses should not be allowed as a deduction in computing net taxable income, but that is not this case. If such expenses arose out of the promotion or acquisition of additional assets, rights or facilities, it is probable no deduction would be permissible. It was imperative here that the Dominion Company defend the action and the failure of its directors to do so would probably have rendered themselves liable in damages to the shareholders of that company. The action threatened the earnings of the Dominion Company, wholly or partially, and had the action succeeded it would have been unable to sell gas, at least in some sections of the City of Hamilton; the company's capacity to earn revenue was put in jeopardy and, I think, it is immaterial that its capital assets, or some of them, were incidentally threatened with extinction or depreciation. It was because the Dominion Company was producing and selling gas that it had to defend the action and thus protect and preserve its credit and its revenue. The United Company sought an injunction restraining the Dominion Company from continuing to supply gas to the inhabitants of the City of Hamilton, which, had the United Company been successful, would have prevented the Dominion Company from earning its usual revenue.

The Supreme Court reversed Maclean P. because they felt bound by *Tata Hydro-Electric Agencies, Ltd.*[1] (see remarks of Crocket J. above).

Angers J. in the *Hudson Bay Company* case dealt at length with the *Tata* decision at pp. 156, 157 and 158 and concluded by saying that the *Tata* decision had very little, if any, weight in the circumstances of the *Hudson Bay Company* case. The facts in *Tata were:*

...the appellant was a private limited company carrying on the business of managing agents of Tata Power Co. Ltd. and other hydro-electric companies. The company acquired this agency business from Tata Sons Ltd. under an assignment whereby the latter transferred to the appellant their rights and interest as agents of the hydro-electric companies under their subsisting agreement with them, but subject, as to their rights and interest under their agreement with Tata Power Co. Ltd., to their obligations under two agreements with F. E. Dinshaw Ltd. and Richard T. Smith. The assignment declared that the appellant should thenceforth be and act as the agents of the hydro-electric companies and be entitled to all benefits conferred by the agreement between Tata Sons Ltd. and these companies and should perform all the obligations thereby imposed and that the appellant should receive all the commissions to which Tata Sons Ltd. were entitled thereunder. The appellant agreed to carry out the conditions of the agreements with F. E. Dinshaw Ltd. and Richard T. Smith and to indemnify Tata Sons Ltd. against any consequences of the non-observance thereof. Under the agency agreement between Tata Sons Ltd. and Tata Power Co. Ltd., the benefit whereof the appellant acquired, the remuneration of Tata Sons Ltd. for their services consisted of a commission of 10 per cent on the annual net profits of Tata Power Co. Ltd., with a minimum of Rs. 50,000 whether the company should make any profits or not, and they were entitled to have their expenses reimbursed. In return, Tata Sons Ltd. undertook to endeavour to promote the interests of Tata Power Co. Ltd. The agreement was declared assignable and Tata Power Co. Ltd. undertook to recognize any assignees as its agents and, if required, to enter into an identical agreement with such assignees. In 1926, Tata Power Co. Ltd., being in need of financial assistance, Tata Sons Ltd., its then managing agents, approached F. E. Dinshaw Ltd. and Richard T. Smith, who agreed to provide the necessary funds. One of the conditions on which they agreed to do so was that in addition to the interest payable by Tata Power Co. Ltd. for the loan, they should each receive from Tata Sons Ltd. two annas in the rupee or 12½ per cent of the commission earned by Tata Sons Ltd. under their agreement with Tata Power Co. Ltd. Agreements were entered into between Tata Sons Ltd. and F. E. Dinshaw Ltd. and between Tata Sons Ltd. and Richerd T. Smith dated October 15 and 19, 1926, respectively. After the acquisition of the agency business by the appellant the Tata Power Co. Ltd., in fulfilment of its obligation under the agreement with Tata Sons Ltd., entered into a new agency agreement with the appellant in terms identical with those of its previous agreement with Tata Sons Ltd. and the appellant also entered into agreements with F. E. Dinshaw Ltd. and the administrator of the estate of Richard T. Smith, who had died in the meantime, in terms identical with those of the previous agreements

[1] [1937] A.C. 685.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

between Tata Sons Ltd. and these parties. By these transactions the appellant came in the place and stead of Tata Sons Ltd., both as regards the right to receive from Tata Power Co. Ltd. the agency remuneration and as regards the obligation to pay out of its remuneration 12½ per cent to F. E. Dinshaw Ltd. and 12½ per cent to the administrator of Richard T. Smith's estate. The assessment of appellant's income for the fiscal year to March 31, 1934, is based on its income, profits and gains for the year 1932 and the question is whether in the computation for tax purposes of its income, profits and gains for that year it is entitled to deduct a sum representing the 25 per cent of the commission earned and received from Tata Power Co. Ltd. which it paid to F. E. Dinshaw Ltd. and Richard T. Smith's administrator.

It was held that in computing its income, profits and gains, the appellant was not entitled to deduct the 25 per cent in question; that this percentage of the commission paid to F. E. Dinshaw Ltd. and the administrator of Richard T. Smith's estate was not expenditure incurred by appellant "solely for the purpose of earning...profits or gains" of its business; that the obligation to make the payments was undertaken by appellant in consideration of its acquisition of the right and opportunity to earn profits, i.e. of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business.

I am bound to paraphrase Angers J. in saying that in my opinion the Tata case has little, if any, relevance to the present case except that it may resemble it on the first question upon which we all agree the Minister fails.

The following quotation from Angers J. starting at p. 166 is very helpful:

There are two cases in which the judgments were delivered subsequently to the hearing by the Supreme Court of the case of the Minister of National Revenue and Dominion Natural Gas Company. These cases, in my opinion, offer as much relevancy to the problem at issue herein as those previously referred to and they certainly deserve being noted.

The first of these cases is that of *Southern v. Borax Consolidated, Ltd.*, (1940) 4 A.E.R. 412.

The respondent purchased certain property for the purposes of its business. Subsequently an action was taken against the company claiming that its title was invalid. The company defended the action and incurred legal expenses amounting to 6,249£, which it claimed to be entitled to deduct as business expenses in computing its profits for the purposes of assessment to income tax.

The Crown contended that the action concerned the capital assets of the company and was contested in order to preserve the existence of those assets and that the sum of 6,249£ was a capital expense.

The King's Bench Division (Lawrence, J.) held that the expense had been incurred, not in creating any new asset, but in maintaining the title to the company's property and was, therefore, an expense wholly and exclusively incurred for the purposes of the company's trade and, as such, properly deductible.

Lawrence J., after reviewing the precedents cited by counsel, concluded as follows (p. 419):

> "It appears to me that the legal expenses which were incurred by the respondent company did not create any new asset at all, but were expenses which were incurred in the ordinary course of maintaining the assets of the company, and the fact that it was maintaining the title, and not the value, of the company's business does not make it any different."

The second case is *Income Tax Commissioner v. Singh* (exactly Maharajadhiraj Sir Rameshwar Singh of Darbhanga) (1942) 1 A.E.R. 362.

In this case the Judicial Committee of the Privy Council affirmed the judgment of the High Court of Judicature at Patna, India, which had decided a reference made to it, at the request of the respondent, in favour of the latter.

The summary of the judgment, fairly comprehensive and exact, may advantageously be quoted:

> "The respondent's father made a loan of 10 lakhs of rupees to a company in which he was a shareholder, and recovered this loan in an action, the costs of which were allowed as an expense incurred in his moneylending business in the assessment of his income tax. Certain shareholders in the company brought an action against the respondent's father and others for conspiracy, collusion, misrepresentation, and breach of contract. The basis of this action was an alleged transaction, of which the loan was part, whereby the respondent's father agreed to finance and manage the company. The action was dismissed, the version of what took place relied upon by the plaintiffs being found to be completely false. The respondent's father died before the conclusion of the suit, and the respondent who continued his business claimed to deduct the costs in arriving at the assessment of profits. The appellant contended that there was no connection between the loan and the alleged transaction which was the basis of the action against the respondent's father, the action being of a personal character and unrelated to his business as a moneylender:
>
> *Held*: the respondent was entitled to make the deduction claimed. The allegations against the respondent's father were built up upon the transaction in which the loan was made, and the defence of the action was necessary for the protection of his rights as the creditor in the loan."

Lord Thankerton, who delivered the judgment of the Court, stated (p. 365, *in fine*):

> "Their Lordships are, therefore, of opinion that the facts stated by the commissioner cannot justify the opinion expressed by him, but that the expenditure in question was incurred solely for the purpose of earning the profits or gains of the moneylending business, and that the High Court are right in holding the respondent entitled to the deduction claimed and in answering the question of law asked by the commissioner in favour of the respondent."

Angers J. concluded by allowing the deductions. No appeal was taken from his judgment.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

The decision in *Kellogg Company of Canada Limited and the Minister of National Revenue*[1] is very helpful. Angers J. deals with it at pp. 177-8 as follows:

> . . . the appellant, a manufacturer of cereal products, and one of its customers were made defendants in an action brought by Canadian Shredded Wheat Company which claimed infringement by both defendants of certain trade mark rights and asked for an injunction restraining them from using the words "Shredded Wheat" or "Shredded Whole Wheat" or "Shredded Whole Wheat Biscuit" or any words only colourably differing therefrom and damages. The appellant successfully defended the action on behalf of both defendants. In computing its income for 1936 and 1937 the appellant deducted the sums of money paid out for legal expenses on account of said action. These deductions were disallowed by the Commissioner of Income Tax. The latter's disallowance was naturally affirmed by the Minister of National Revenue, from whose decision an appeal was taken to the Court. It was held that the payments were made involuntarily in the course of business to enable the appellant to continue the sales of its products as before action was taken against it and not to secure or preserve an actual asset or enduring advantage to appellant.
>
> A brief extract from the judgment of Maclean J. may be convenient (p. 43):
>
> > "The broad principle laid down by Lord Cave in *British Insulated v. Atherton,* (1926) A.C. 205 at 213, is not, in my opinion, of any assistance in the present case. Applying that test to the present case, the payment here made was not, I think, an expenditure incurred or made "once and for all", with a view of bringing a new asset into existence, nor can it, in my opinion, properly be said that it brought into existence an advantage for the enduring benefit of Kellogg's trade within the meaning of the well known language used by Lord Dave in a certain passage of his speech in that case. What the House of Lords was considering in that case was a sum irrevocably set aside as a nucleus of a pension fund established by a trust deed for the benefit of the company's clerical staff, and, as was said by Lawrence L. J. in the *Anglo Persian Oil Company Limited v. Dale* case, (1932) 1 K.B. 124, I have no doubt that Lord Cave had that fact in mind when he spoke of an advantage for the enduring benefit of the company's trade. Such an expenditure differs fundamentally from the expenditure with which we are concerned in the present case. Here, the expenditure brought no such permanent advantage into existence for the taxpayer's trade. I do not think it can be said that the expenditure in question here brought into existence any asset that could possibly appear as such in any balance sheet, or that it procured an enduring advantage for the taxpayer's trade which must pre-suppose that something was acquired which had no prior existence."

After stating that the case of *Kellogg and the Minister of National Revenue* closely resembles that of *Mitchell v. B. W. Noble Limited,* (1927) 1 K.B. 719, in which a large sum of money was expended by a company to get rid of a managing director, and quoting passages from the reasons of the Master of the Rolls and of Lord Justice Sargent, which I do not deem necessary to transcribe here and which may be easily referred

[1] [1942] Ex. C.R. 33, 3 Fox Pat. C. 1, 2 D.L.R. 337.

to, Maclean J. declared that these remarks would appear to be applicable and added (p. 45):

> "Here, Kellogg had encountered a business difficulty, one associated directly with the sales branch of its business, which it had to get rid of, if possible, in order to continue the sales of its products as it had in the past."

An appeal was taken by the Minister of National Revenue and the same was dismissed (1943) S.C.R. 58. Sir Lyman Duff, who delivered the judgment of the Court, after referring to the case of the *Minister of National Revenue v. The Dominion Natural Gas Company, Limited,* made, among others, the following statements (p. 60):

> "The present appeal concerns expenditures made by the respondent company in payment of the costs of litigation between that company and the Canadian Shredded Wheat Company.
>
> * * *
>
> As regards this payment, the question in issue was whether or not the registered trade marks of the plaintiffs in the action were valid trade marks, or, in other words, whether or not the present respondents, the Kellogg Company, and all other members of the public were excluded from the use of the words in respect of which the complaint was made. The right upon which the respondents relied was not a right of property, or an exclusive right of any description, but the right (in common with all other members of the public) to describe their goods in the manner in which they were describing them."

Halsbury, 3rd ed., at p. 168, states as part of para. 287:

Legal expenses have been allowed where they did not create a new asset but maintained a company's title to land abroad (h) *Southern v. Borax Consolidated, Ltd.,* (1941) 1. K.B. 111; (1940) 4 All E.R. 214; 23 T. C. 597, and where they were incurred by a moneylender in protection of his rights as a creditor for a loan (i) (*Income Tax Commissioners (Bihar and Orissa) v. Singh,* (1942) 1 All E.R. 362, P.C., Sums paid by a company to settle an action for fraud in connection with its trade have also been allowed, together with incidental legal expenses (k) (Golder *(Inspector of Taxes) v. Great Boulder Proprietary Gold Mines, Ltd.,* (1952) 1 A11 E.R. 360; 33 T. C. 75.)

and again on p. 169:

Though it is clear that the expenses allowable are such only as are necessary to earn the receipts of the trade (u), (*Russell v. Town and County Bank* (1888) 13 App. Cas. 418, at p. 424; 2 T.C. 321, at p. 327, per LORD HERSCHELL: *Gresham Life Assurance Society v. Styles,* (1892) A. C. 309, H. L., at p. 316; 3. T.C. 185, at p. 189; and see p. 166, ante.), this proposition must be applied in a reasonable way, and must not be construed so as to preclude the deduction of those expenses as a result of which receipts or profits may accrue in the future. For example, the cost of a reasonable amount of advertising is usually admitted as a business expense, although the result of a particular advertisement might not be reflected in an increase in trade receipts in the year in which the cost was

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

incurred. The principle is that expenses to earn future profits are allowable deductions (a),

> (a) *Vallambrosa Rubber Co., Ltd. v. Farmer (Surveyor of Taxes)*, (1910) S.C. 519; 5. T.C. 529 (a rubber company part only of whose estate was producing rubber was allowed the cost of weeding, watching, manuring and clearing immature areas); *Whelan (Inspector of Taxes) v. Dover Harbour Board* (1934), 151 L.T. 288, C.A.; 18 T.C. 555, cited in note (1), p. 227, *post; Cooke (Inspector of Taxes) v. Quick Shoe Repair Service* (1949), 30 T.C. 460 (purchaser of business paid, by sale agreement, vendor's business debts to preserve goodwill and continuity of supplies; allowed as deductions)

and this principle has been extended to include expenditure to avoid future expense which does not bring into being a tangible asset (b)

> (b) *Mitchell v. B. W. Noble, Ltd.*, (1927) 1. K.B. 719, C.A.; 11 T.C. 372 (payment to get rid of a director); *Hancock v. General Reversionary and Investment Co., Ltd.*, (1919) 1 K.B. 25; 7 T.C. 358 (an annuity purchased to get rid of an annual payment to a retired servant); *Anglo-Persian Oil Co., Ltd. v. Dale*, (1932) 1 K.B. 124, C.A.: 16 T. C. 253 (payment to cancel an agency agreement); *Scammell and Nephew, Ltd. v. Rowles*, (1939) 1 All E.R. 337, C.A.; 22 T.C. 479 (payments to compromise action procuring termination of disadvantageous trading relations); *Inland Revenue Commissioners v. Patrick Thomson, Ltd.* (1956), L. (T.C.) 1813 (change in control of company; compensation to managing director for cancellation of service agreement; right of company to treat compensation as trade expense not affected by subsequent liquidation of company and carrying on of company's trade by the other company which had secured control of the company which went into liquidation); but see *Alexander Howard & Co., Ltd. v. Bentley* (1948), 30 T.C. 334 (lump sum paid by a company for the surrender of a right to an annuity to widow of previous owner of company's business; not deducted).

It is of interest that all of the decisions referred to in footnotes (a) and (b) above were decided after *Strong v. Woodifield.*

The Privy Council decision in *Income Tax Commissioner v. Singh*[1], referred to on p. 168 of Halsbury, in which the appellant relied on *Strong v. Woodifield, supra,* shows how far the English courts have moved since *Strong v. Woodifield* was decided in 1906. The editorial note on p. 363 of the report points this out as follows:

> It is clear that in the conduct of any business the bringing of proceedings to enforce the payment of sums due to the owner of the business must from time to time form part of the transactions necessary to the proper carrying on of the business. The expenses of bringing these actions are recognised as a proper deduction against profits. The present case takes the matter a considerable step further. Here an action, which the court in the exercise of considerable judicial restraint has characterised

[1] [1942] 1 All E.R. 362.

as unfounded, was brought against the taxpayer. The action in fact was based on matters which the plaintiffs found it quite impossible to prove, and it seems that the plaint itself covered some 80 pages of print, and was said to be quite unintelligible. The defence of such an action, which must be a serious charge upon the profits of the business, is held to be undertaken as part of the transactions of the business and the costs incurred in such defence are held to be a proper deduction against profits. The material provisions of the Indian Act in this connection are the same as those of the English Act, and the decision can be cited in relation to the latter Act to the same extent as any other decision of the Privy Council may—that is, though not absolutely binding, it is to be treated with the greatest respect.

The references to advertising in some of the cases are most apt. The millions now spent by commercial companies on advertising in any given taxation year which admittedly is aimed at securing business in succeeding years could not, on an acceptance of the so-called rule in *Strong v. Woodifield,* be allowed. But such expenses are allowed without question and it is only common sense that they should be allowed. While it may be possible to isolate the receipts and expenditures of a salaried individual for a one taxation year period, it is impossible to do so with commercial or corporate enterprises whose business activities are continuous and where expenditures made in one taxation year may have no effect nor be intended to have any effect in producing the income of that year but are expected to produce income from the business operation of the taxpayer in subsequent taxation years within the meaning of s. 12(1)(*a*) of the *Income Tax Act.*

A passage from the reasons for judgment of Abbott J. in *B.C. Electric Railway Co. Ltd. v. Minister of National Revenue* at p. 137 has been quoted by my brother Ritchie. I think the important fact to note is that in *B.C. Electric Railway Co. Ltd. v. Minister of National Revenue,* Abbott J. went on to find that the expenditure then in question was a *capital outlay* within the terms of s. 12(1)(*b*), (p.138), of the *Income Tax Act.* As such it was not deductible as an income expense in any event. The *B.C. Electric Railway Co. Ltd.* decision does not in consequence deal with the type of expenditure in issue here. To limit the expenditure, if it is to qualify as a deductible, to the income of the particular year in which it was made requires writing into s. 12(1)(*a*) of the *Income Tax Act* words which Parliament did not put there. The only qualification which Parliament imposed was that the outlay or expense be

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

"made or incurred by the tax-payer for the purpose of gaining or producing income from the property or business of the taxpayer". No limitation as to time can be found in the section in question.

Two other Canadian decisions are very much in point. They are *Minister of National Revenue v. Goldsmith Bros.* and *Minister of National Revenue v. L.D. Caulk Co.* (tried together)[1] and *Rolland Paper Co. v. Minister of National Revenue*[2]. In the *Goldsmith* and *Caulk* cases, Rand J. said:

> The question here is whether expenses incurred by the respondent company in defending itself against charges of violating the criminal law by combining with others to prevent or lessen unduly competition in the commercial distribution of dental supplies, are deductible in ascertaining taxable income. The agreement or arrangement alleged to have been unlawful purported to regulate day to day practices in the conduct of the respondent's business. It formed no part of the permanent establishment of the business; it was a scheme to govern operations rather than to create a capital asset; and the payment to defend the usages under it was a beneficial outlay to preserve what helped to produce the income. These expenses included legal fees both for appearing before the Commissioner under the *Combines Investigation Act* and at the trial which resulted in acquittal.
>
> The provisions of the *Income Tax Act* are imposed on the settled practices of commercial accounting, but they create in effect a statutory mode of determining taxable income. Deductions from revenue must have been "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income". Each word of this requirement is significant, and decisions based on different statutory language are strictly of limited assistance.
>
> The payment arose from what were considered the necessity of the practices to the earning of the income. The case is then governed by *The Minister v. Kellogg,* (1943) S.C.R. 58. Proceedings there had been brought against the company to restrain it from using certain ordinary descriptive words in connection with the sale of its products and the expenses had been incurred in successfully resisting them. That use was likewise part of the day to day usage in marketing the company's products and the expenses were held to be deductible.
>
> The word "necessarily" was urged by Mr. Varcoe as being unsatisfied by the facts. This term is not found in the English Act and it cannot be taken in a literal or absolute sense. Fire insurance, for instance, is admittedly a deductible expense, and yet how can it be said to be necessary when thousands of business houses have gone through generations of trade without loss from fire? The word must be taken as it was in *Kellogg* in the commercial sense of necessity.
>
> The judgment of this Court in *The Minister v. Dominion Natural Gas,* (1941) S.C.R. 19, is clearly distinguishable as having been a case of expenses to preserve a capital asset in a capital aspect.

[1] [1954] S.C.R. 55, C.T.C. 28, 54 D.T.C. 1011, 20 C.P.R. 68, 2 D.L.R. 1.
[2] [1960] Ex. C.R. 334, C.T.C. 158, 60 D.T.C. 1095.

In the *Rolland Paper* case the deduction challenged was for legal fees of $5,948.27 paid in the taxation year 1955 as its share of the legal costs of an appeal against the judgment of the Supreme Court of Ontario finding Rolland Paper Company and others guilty of illegal trade practices contrary to s. 498(1)(*d*) of the *Criminal Code*. The case resembled *Goldsmith and Caulk* but differed in that where the Goldsmith Company and the Caulk Company had been acquitted Rolland Paper Company was convicted. Fournier J. followed the *Goldsmith* and *Caulk* decision, holding that the fact of conviction was not material. He allowed the deduction. Notice of Appeal to this Court was given by the Minister. The appeal was not proceeded with, Notice of Discontinuance having been filed.

Finally, this Court dealt with s. 12(1)(*a*) of the *Income Tax Act* in *Evans v. The Minister of National Revenue*[1]. The facts of that case are stated in the headnote as follows:

> Exercising a power of appointment conferred upon him by the will of his father, the appellant's first husband bequeathed her the income for life of a one-third share of the father's estate. The trustee of the father's estate applied to the Court for advice and direction as to whether she was entitled to the income. In 1955, the matter was finally decided by this Court in favour of the appellant who had been represented by counsel in all the proceedings. In computing her income tax return for 1955, she deducted the legal fees she had paid her solicitors. The deduction was disallowed by the Minister. The Income Tax Appeal Board allowed the deduction, but the Minister's assessment was affirmed by the Exchequer Court of Canada.

Cartwright J., speaking for the majority, said at p. 395 *et seq.*:

> As I read the whole of his reasons, the learned judge was of opinion that if the decisions of the courts in England were applicable he would have decided the question in favour of the tax-payer but felt himself bound by the decision of this Court in *Dominion Natural Gas Ltd. v. M.N.R.* (1941) S.C.R. 19, (1940) 4 D.L.R. 657 to reach a contrary conclusion. That case was decided under s. 6(1) of the *Income War Tax Act*, quoted above. In giving the judgment of the majority of this Court in *B.C. Electric Ry. Co. v. M.N.R.* (1958) S.C.R. 133 at 136, 12 D.L.R. (2d) 369, 77 C.R.T.C. c. 29, my brother Abbott said:
>
> > "The less stringent provisions of the new section should, I think, be borne in mind in considering judicial opinions based upon the former sections."
>
> Whether, in view of the later decisions of this Court in *M.N.R. v. The Kellogg Company of Canada Ltd.* (1943) S.C.R. 58, 2 D.L.R. 62 and *M.N.R. v. Goldsmith Bros. Smelting and Refining Co. Ltd.* (1954) S.C.R. 55, 2. D.L.R. 1, the *Dominion Natural Gas* case would be decided in the

[1] [1960] S.C.R. 391, C.T.C. 69, 60 D.T.C. 1047, 22 D.L.R. (2d) 609.

1966

PREMIUM IRON ORES LTD. v. MINISTER OF NATIONAL REVENUE

Hall J.

same manner if it arose to-day under the present section is a question which I do not have to consider. It is distinguishable from the case at bar.

* * *

The "asset" or "advantage" under consideration in *Dominion Natural Gas* was a valuable, exclusive perpetual franchise; this franchise did not of itself yield any income to the Company which held it; it was a permanent right used and useful in the earning of the company's income by the sale of its product to the persons residing in the territory covered by the franchise; it was rightly regarded as an item of fixed capital.

* * *

If the circumstances of the case at bar are viewed in the light most favourable to the respondent it can be said that the legal expenses were incurred not only to collect the income to which the appellant was entitled and which was being wrongly withheld from her but also to prevent the right to receive that income being destroyed; the right in question remains throughout a right to income. In the *Dominion Natural Gas* case, on the other hand, the expenses were incurred in litigation the subject matter of which was an item of fixed capital.

In my opinion, in the circumstances of this case there are two relevant questions both of which must, on the admitted facts, be answered in the affirmative; (i) was the appellant's claim in regard to which the expenses were incurred a claim to income to which she was entitled? (ii) were the legal expenses properly incurred in order to obtain payment of that income? It does not appear to me to be either necessary or relevant to inquire further as to what were the grounds (held by the Court to be without substance) upon which the payment of the income was withheld. It would be a strange result if the question, whether legal expenses incurred in enforcing or preserving a right should be regarded as an outlay on account of capital or on account of income, fell to be determined on a consideration not of the true nature of that right but of the nature of the ill-founded grounds on which it was disputed.

For the above reasons it is my opinion that the outlay of the legal expenses in question was not a payment on account of capital falling within s. 12 (1)(*b*) but was an expense, falling within s. 12(1)(*a*), incurred by the appellant for the purpose of gaining income from property, to which income she was at all relevant times entitled but of which she was unable to obtain payment without incurring these expenses.

These observations are equally applicable to the expenditures made by the appellant in the instant case.

In conclusion, as I see it, the expenditures here were ones which under sound accounting and commercial practice would be deducted in the Statement of Profit and Loss as expenditures for the year in determining the profit, if any, of the company for that year. Cattanach J. appears to have placed too much reliance on Lord Simond's words in *Smith's Potato Estates* case: "What profit he has earned, he has earned before ever the voice of the tax-gatherer is heard." I think it proper to observe that in each of the years in question *before ever the voice of the taxgatherer was heard* the expenditures in question had to be made to preserve the income and the working capital

from the unwarranted claim of a foreign taxing authority otherwise the Canadian taxgatherer would have called in vain. He would have found an empty treasury and a commercial operation condemned to pay the United States Internal Revenue Service tribute by way of income tax in future years.

I would accordingly allow the appeal *in toto* with costs throughout payable by the respondent.

SPENCE J.:—I am in agreement with my brother Ritchie as to the appeal on the first judgment and would allow the appeal to permit the deduction of $46,532.56 and $45,192.03 described as "commissions paid pursuant to agreement of December 29, 1944, with Transcontinental Resources Limited".

However, I must differ with Ritchie J. as to his disposition of the appeal from the second judgment as to the deduction of $20,831.51 being the total amount paid in the years 1951 and 1952 as legal expenses incurred in respect of a disputed claim for income tax asserted by the United States Inland Revenue Services. With regard to this latter appeal, I am in agreement with the reasons of my brother Martland and would allow the appeal and permit the deduction.

In the result, I would allow the appeal *in toto* with costs throughout.

Appeal allowed with costs, ABBOTT and RITCHIE JJ. *dissenting in part.*

Solicitors for the appellant: Mungovan & Mungovan, Toronto.

Solicitor for the respondent : E. S. MacLatchy, Ottawa.