1954
Feb. 1
June 17

BETWEEN:

BECKFORD LITHOGRAPHERS LIMITED ..... APPELLANT;

AND

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

Revenue—Income Tax—The Income Tax Act R.S.C. 1952, c. 148, s. 11(1)(a)(c), 12(1)(b)—Money paid for use of collateral—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income".

Appellant deducted from its gross income for the taxation years 1949 and 1950 certain sums of money as being "a service charge for use of collateral". The Minister of National Revenue disallowed such deductions and an appeal from his assessments for the years named was dismissed by the Income Tax Appeal Board. The appellant appealed to this Court.

Held: That the deductions claimed were not disbursements or expenses wholly, exclusively and necessarily laid out or expended for the purpose of earning the income of appellant within the meaning of s. 12(1)(*a*) of the Income Tax Act, nor were they interest on borrowed money within the meaning of s. 11(1)(*c*) of the Act but were payments on account of capital within the meaning of s. 12(1)(*b*) of the Act.

APPEAL from the decision of the Income Tax Appeal Board.

(1) [1954] Ex. C.R. 1.

The appeal was heard before the Honourable Mr. Justice Potter at Toronto.

Stuart Thom for appellant.

Peter Wright, Q.C. and *T. Z. Boles* for respondent.

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

POTTER J. now (June 17, 1954) delivered the following judgment:

This is an appeal by Beckford Lithographers Limited, hereinafter called the appellant, from a decision of the Income Tax Appeal Board dated the 19th day of February, 1953, and mailed on the 23rd day of February, 1953, dismissing an appeal from assessments by the Minister of National Revenue, hereinafter called the respondent, whereby he disallowed a deduction of $5,160.07 from the appellant's declared income for the taxation year of 1949 and a deduction of $7,147.42 for the taxation year of 1950, both of which amounts had been shown in the appellant's returns as having been paid to a Mrs. F. Schmukler of Brooklyn, New York, as a "service charge for use of collateral" and deducted from its gross incomes for those years as interest paid or payable.

At the instance of Mr. Moe Becker of Mount Vernon, New York, the appellant was incorporated by letters patent issued under the Companies Act of the Province of Ontario on the 29th day of November, 1946, with head office in the City of Toronto in that Province, and with a capital divided into

100 Class "A" 5 per cent Cumulative, Redeemable Preference Shares at a par value of	$ 5,000.00
15,000 Class "B" Preference Shares of No Par Value	15,000.00
30,000 Common Shares of No Par Value	30,000.00
	$50,000.00

The 100 shares of Class "A" preferred stock were issued for cash considerations in the following proportions: Lorne Sandiford, 20%; Memory Lane Limited (a Canadian corporation controlled by Moe Becker and his associates), 20%; Moe Becker, 60%.

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Mr. Moe Becker, president of the company, was called as a witness and, while his evidence with reference to the distribution of the shares of the company and his personal undertakings with the Industrial Development Bank and the Dominion Bank was vague and in some respects contradictory, the following appear to be the facts:—

The only amount of cash put into the capital of the appellant was $5,000.00, the amount paid for the Class "A" preferred stock, and the 15,000 Class "B" preferred shares and the 30,000 common shares were issued for considerations other than cash, viz. the assignment of reproduction rights, franchises and good will.

Arrangements were made with the Industrial Development Bank to finance the purchase of equipment and with the Dominion Bank to finance the activities of the appellant.

While he first said that he gave his personal notes to one of the banks to obtain credit for the appellant, he later withdrew that statement and said that he gave a guarantee of the company's overdraft.

United States bonds to the total value of $50,000.00 were obtained by Becker from his father-in-law, Harry Schmukler, since deceased, and his mother-in-law, Mrs. Fay Schmukler, to be used as collateral security for his guarantee or guarantees to the two banks, but it finally became evident that $15,000.00 of these bonds, which were obtained from Mrs. Fay Schmukler and were payable to bearer, were used as collateral security for his guarantee of the credit of the appellant.

There was no agreement in writing made with Mrs. Fay Schmukler when, in March, 1947, she furnished him with $15,000.00 in United States bearer bonds.

> Q. . . . What was your understanding with Mrs. Schmukler as to the return of her property to her?
>
> A. The original understanding was strictly an oral one that we would use the bonds and return them to her at our earliest convenience, or possibility of returning them to her. *There was really no formal understanding at the time.*

Mr. Becker's evidence with reference to the clipping of the coupons from these bonds was also contradictory.

According to Mr. Becker, Mr. Harry Schmukler having died in 1946, Mrs. Fay Schmukler, the widow, felt that the bonds were not bringing in sufficient income, and she required them for her own use, but he, Becker, was unable to arrange for their release by the bank.

As a result of discussions with Mrs. Fay Schmukler or her advisors, an agreement was entered into on December 5, 1947, and filed as Exhibit 14, which was in part as follows:—

THIS AGREEMENT made in duplicate this 5th day of December, 1947.

BETWEEN:

FAY SCHMUKLER, of the City of Brooklyn in the State of New York, Widow, hereinafter called the Party

OF THE FIRST PART

AND

BECKFORD LITHOGRAPHERS LIMITED, a corporation organized and existing under the laws of the Province of Ontario, hereinafter called the "Company"

OF THE SECOND PART

WHEREAS the Party of the First Part has heretofore loaned certain securities of the par value of Fifteen Thousand Dollars ($15,000.00), as listed in Schedule "A" attached hereto, to one Moe Becker, President of the Company, to lodge with the Dominion Bank as collateral security to his personal guarantee of the Company's indebtedness to the said Bank;

AND WHEREAS it was contemplated and intended that the said securities would be released and returned to the Party of the First Part on or before the date of this Agreement;

AND WHEREAS the said securities have been hypothecated for the purposes of the Company to The Dominion Bank and The Industrial Development Bank and the Company is presently unable to have the same released and returned to the Party of the First Part;

WITNESSETH that in consideration of the premises and the agreements herein contained, the parties hereto covenant and agree as follows:

1. The Company shall use its best endeavours to have the said securities released and returned to the Party of the First Part as quickly as possible.

2. As from the 1st day of January, 1948 and continuing until all of the said recited securities shall have been released and returned to the Party of the First Part, the Company shall pay to the Party of the First Part annual sums equivalent to one per centum (1%) of its net sales, exclusive of any sales to Memory Lane Limited, computed on a calendar year basis. Such annual sums shall be due and payable on the 15th day of February next following the close of each calendar year respectively

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during the currency of this Agreement. In the event of the said securities being released and returned before the end of any calendar year, the net sales in respect of such calendar year shall be apportioned to the date of the release and return of the said securities to the Party of the First Part and the amount payable in respect thereto shall be due and payable within forty-five (45) days thereafter.

3. Nothing herein contained shall prejudice or alter the rights of the Party of the First Part in and to the said securities or operate to prevent her from demanding the return thereof at any time.

The agreement was executed by Fay Schmukler and by Beckford Lithographers Limited, Moe Becker president, and L. J. Sandiford secretary-treasurer, and was under seal.

Schedule "A" showed 3 x $5,000.00 United States of America Treasury Bonds, 2½ per cent, due December 15, 1972-67, serial No. 1888 1A, No. 78881 1A, and No. 89987 H.

It will be noted that the recitals and terms of this agreement do not agree with the evidence of Moe Becker previously quoted to the effect that the original understanding was strictly oral, that the bonds would be returned at their earliest convenience, and that "there was really no formal understanding at that time".

It is to be noted that Becker said in cross-examination as follows:—

Q. Now I believe you made this clear, but I want it to be perfectly clear, the advances—I understand that but I wish you to confirm it—that the advances on these bonds was a personal advance to you?

A. Yes.

Q. And that you gave them to the Bank to support your guarantee?

A. Yes.

Q. And the Bank held them as your bonds?

A. Yes.

In the allegations of fact set out in the appellant's notice of appeal from the decision of the Income Tax Appeal Board and dated June 3, 1953, it was alleged in paragraph B as follows:—

1. The aforesaid amounts were paid by the Appellant for the use of property necessarily required and used in the conduct of its business and where an outlay or an expense made and incurred for the purpose of gaining or producing income from the Appellant's business.

2. The said payments were not an outlay of or payment on account of capital.

In the respondent's reply to the notice of appeal dated August 21, 1953, the following was alleged:—

B. 5. The Respondent relies upon sections 11 and 12 of The Income Tax Act.

6. The Respondent says that, if the amounts of $5,160.07 and $7,147.42 were paid by the Appellant as alleged by the Notice of Appeal, which is not admitted, such amounts were not outlays or expenses incurred by the taxpayer for the purpose of gaining or producing income within the meaning of paragraph (*a*) of subsection (1) of section 12 of The Income Tax Act.

7. The Respondent further says that if the said amounts were expended by the Appellant, as alleged in the Notice of Appeal, which is not admitted, such amounts were outlays on account of capital within the meaning of paragraph (*b*) of subsection 1 of section 12 of the said Act.

8. The Respondent further says that if the said amounts were expended, as alleged in the Notice of Appeal, which is not admitted, they were not interest on borrowed money used for the purpose of earning income within the meaning of paragraph (*c*) of subsection 1 of section 11 of the said Act.

In its trading profit and loss statement for the year ended December 31, 1949, attached to its income tax return for that year covering the fiscal period ending the 31st of December, 1949, the appellant showed as an item of interest and exchange $11,321.02, which was broken down in item 25 (*a*)—Interest Paid or Payable as follows:—

Dominion Bank, Toronto	$ 2,252.31
Industrial Development Bank, Toronto	2,649.74
Industrial Acceptance Corp., Toronto	187.72
Harris-Seybold (Canada) Limited, Toronto	321.16
Mrs. F. Schmukler, 1800 Bay Parkway, Brooklyn, N.Y., U.S.A. Service Charge for Use of Collateral	5,910.09
	$11,321.02

As a result of representations made by the appellant, the respondent amended his assessment for the 1949 taxation year by reducing the amount of $5,910.09, disallowed, to $5,160.07, as set out in the notification by the Minister dated March 24, 1952.

In its trading profit and loss statement for the fiscal period ending the 31st of December, 1950, the appellant showed as an item of interest and exchange $14,090.64,

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which was broken down under item 2 (*h*)—Interest Paid To:—

On loans from shareholders—			
L. J. Sandiford	$475.00		
M. Becker	275.00	$750.00	
Less Accrued 1st January, 1950	565.08		
Accrued 31st December, 1950	493.75	71.33	$ 678.67
Industrial Development Bank			2,968.35
The Dominion Bank, Toronto			3,296.20
Mrs. F. Schmukler, 1800 Bay Parkway, Brooklyn, N.Y., U.S.A.			
Service Charge for Use of Collateral			7,147.42
			$14,090.64

In other words, the appellant has shown and deducted from income interest paid to the Industrial Development Bank and the Dominion Bank as interest on loans from those corporations and then has also claimed the amounts paid to Mrs. Schmukler of $5,160.07 and $7,147.42 for the use of $15,000.00 in bonds used by Moe Becker as collateral security to obtain from those institutions the loans on which the interest shown was paid to them.

If the appellant had paid to Mrs. Fay Schmukler six per cent per annum for the use of the bonds which she had furnished to Moe Becker, the company would have been paying double interest on some parts of its borrowings from the Industrial Development Bank and the Dominion Bank.

The relevant sections of the Income Tax Act, Chapter 148, R.S.C. 1952, are 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:

(*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),

or a reasonable amount in respect thereof, whichever is the lesser;

12. (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it is made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

Section 12 (1) (*a*) is derived from section 6 (*a*) and (*e*) of the Income War Tax Act, Chapter 97, R.S.C. 1927, as amended, which was as follows:—

6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;

(*e*) carrying charges or expenses of unproductive property or assets not acquired for the purposes of a trade, business or calling or of a liability not incurred in connection with a trade, business or calling;

In *Bennett and White Construction Company Limited* v. *The Minister of National Revenue* (1), the appellant company had paid large amounts to the guarantors of its bank loans and in the fiscal year ending October 31, 1941, $20,969.34 were paid to the guarantors, and for the year following, $23,984.15, and these were disallowed by the Department. The matter eventually came before this Court, and the late Mr. Justice O'Connor dismissed the appeal of the company with costs and affirmed the assessment.

On appeal to the Supreme Court of Canada, Mr. Justice Locke said at pages 289 and 290:—

While the amounts paid to the guarantors were described as interest in the various resolutions which authorized their payment, this was clearly inaccurate. Interest is paid by a borrower to a lender: a sum paid to a third person as the consideration for guaranteeing a loan cannot be so described. Section 6(*a*) prohibits the deduction of disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income and the first matter to be determined is whether amounts such as these, paid to enable the company to obtain the necessary working capital for its operations by way of loans from the bank, are properly so described.

(1) [1949] S.C.R. 287.

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The learned judge then reviewed all the authorities and at page 291 said:—

They were, in my opinion, simply expenditures incurred in obtaining the capital to make the large deposits required, to purchase equipment and generally to finance the operations. A sum expended as interest for the use of capital is clearly to be distinguished from expenditures such as these, being the cost of obtaining guarantees without which the loans would not have been made by the bank, expenditures of the same character as the cost of floating issues of bonds or debentures or of selling shares for the purpose of obtaining capital.

Mr. Justice Rand, after stating the facts, said at page 293.

Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (*b*). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue. . . .

Within the meaning of the Act, the premiums create part of the capital structure and are a capital payment; *Watney* v. *Musgrave* (1880) 5 Ex. D. 241. They furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business. That was the view of O'Connor, J., below, and I agree with it.

Kellock, J. concurred with Locke, J.

Estey, J. said at page 298:—

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

In my opinion, the judgments in *Bennett and White Construction Company Limited* v. *The Minister of National Revenue* (*supra*) apply to this case, and therefore hold that the sums of $5,160.07 and $7,147.42, paid by the appellant to Mrs. Fay Schmukler and disallowed as deductions by the respondent from the taxable income of the appellant for the 1949 and 1950 taxation years, were not outlays or expenses incurred by the taxpayer for the purpose of gaining or producing income within the meaning of section 12 (1) (*a*) and were not interest on borrowed

money used for the purpose of earning income within the meaning of section 11 (1) (*c*), but were payments on account of capital within section 12 (1) (*b*) of the Income Tax Act.

The appeal will therefore be dismissed with costs.

Judgment accordingly.