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BETWEEN:

STOCK EXCHANGE BUILDING CORPORATION LIMITED ..... } APPELLANT;

AND

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

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97 ss. 5(b), 6(n), 62—Ruling No. 15—Minister's discretion under s. 5(b) relates only to allowance of rate of interest—Borrower-lender relationship essential to deductibility of interest under s. 5(b)—Interest on unpaid interest not deductible under s. 5(b)—No right in appellant to have depreciation allowances recast—Amount of depreciation allowance in discretion of Minister—Interest on borrowed capital deductible only to the extent that it was used in the business to earn the income.

By a deed of mortgage and trust the appellant conveyed its property to a trustee to secure the issue of $550,000 first mortgage bonds. The bonds carried interest at 6 per cent after as well as before maturity and after as well as before default and interest on overdue interest at the same rate. The bonds were sold to the public at $99 per $100 bond and the underwriters charged the appellant $9 per $100 bond for its services. Except for the first three years the appellant did not pay any interest on the bonds but in every year it deducted the interest payable including the interest on the interest, although unpaid, as a charge

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against its operating revenue. In assessing the appellant for 1946, 1947 and 1948 the Minister disallowed the deductions of the compound interest and also the deductions of the interest on 10 per cent of the face value of the bonds. The appellant appealed to the Income Tax Appeal Board which dismissed the appeals against the disallowance of the compound interest and the claim relating to depreciation but allowed it in respect of the disallowance of the deduction of the simple interest. From this decision the appellant appealed to this Court and the respondent cross-appealed.

Held: That the discretion vested by section 5(b) in the Minister relates only to the allowance of the rate of interest. When in the exercise of his discretion the Minister has determined the rate which he considers reasonable he has no further discretionary powers under the section.

2. That it is essential to the deductibility of interest under section 5(*b*) that it should be payable pursuant to a contract between a borrower and a lender, that is to say, a contract that establishes a *bona fide* borrower-lender relationship between the parties to it.
3. That the compound interest sought to be deducted by the appellant, being interest payable on the unpaid interest on the bonds, was not interest on borrowed capital used in the business to earn the income within the meaning of section 5(*b*).
4. That the appellant had no right to have its allowances in respect of depreciation reviewed from the beginning.
5. That what the Minister did prior to the years under review has no bearing on the correctness of his allowances of deductions for such years.
6. That the amount of the depreciation deduction allowance is in the discretion of the Minister and it is not for the Court to review the exercise of his discretion or to substitute its opinion for his. The Minister's allowance is not to be disturbed unless it can be shown that his discretion was wrongfully exercised.
7. That interest on borrowed capital is deductible under s. 5(*b*) only to the extent that it was used in the business to earn the income.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the President of the Court at Vancouver.

J. A. Clark Q.C. and *W. A. Craig* for appellant.

A. H. J. Swencisky and *T. Z. Boles* for respondent.

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

THE PRESIDENT now (March 11, 1954) delivered the following judgment:

The appellant herein appeals against the decision of the Income Tax Appeal Board, dated November 5, 1952, to the extent that it dismissed its appeals against its income tax

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assessments for 1946, 1947 and 1948 and appeals directly to this Court against its income tax assessment for 1945. On the other hand the respondent herein cross-appeals against the said decision to the extent that it allowed the appellant's appeals against the disallowance of certain simple interest.

I must say, at the outset, that the appeal against the assessment for 1945 cannot be entertained. The facts are that on April 4, 1950, the appellant appealed against the assessment to the Minister, that on November 24, 1951, the Minister gave his decision whereby he allowed a deduction of $300 for legal fees which he had previously disallowed on the assessment but otherwise affirmed it and that on December 21, 1951, the appellant gave notice of dissatisfaction. That is as far as the steps went. The Minister had not, at the date of the hearing, made any reply to the notice of dissatisfaction as required by section 62 of the Act. Since the making of a reply is one of the conditions precedent to there being a right of appeal to this Court it follows that the appeal is premature and that the Court has no jurisdiction to hear it. It must, therefore, be dismissed but the dismissal will be without costs and without prejudice to the appellant's right to appeal against the assessment when the necessary precedent steps have been taken.

There was agreement on certain facts. The appellant was incorporated under the laws of British Columbia on November 9, 1928, with an authorized capital of $500,000 divided into 2,500 preference shares and 2,500 common shares of the par value of $100 each and has its head office in Vancouver. It is the registered owner of a property in Vancouver on which there is a large building known as the Stock Exchange Building. By a deed of mortgage and trust, dated February 1, 1929, the appellant conveyed this property to the Toronto General Trusts Corporation as trustee for the bondholders to secure an issue of $550,000 first (closed) mortgage six per cent. fifteen year sinking fund gold bonds. The mortgage deed contained, *inter alia*, the following provisions:

> The Bonds shall bear the interest at the rate of six (6) per cent per annum (after as well as before maturity and after as well as before default and interest on overdue interest at the said rate) payable semi-annually on the first days of February and August in each year during the currency of the Bonds upon surrender of the coupons attached thereto.

Except for the first three years up to the end of 1931 the appellant did not pay the interest on these bonds when it came due. As at December 31, 1932, this interest was in arrears in the sum of $29,384.68. As at December 31, 1946, the arrears amounted to $449,151.93, as at December 31, 1947, $509,050.24 and as at December 31, 1948, $571,527.54. These arrears included compound interest, that is to say, interest on unpaid interest, computed in accordance with the terms of the deed of mortgage and trust. In its income tax returns the appellant claimed this interest, including the compound interest, as an exemption or deduction under section 5(*b*) of the Income War Tax Act, R.S.C. 1927, chapter 97, and its right to do so does not appear to have been challenged prior to 1944. But in assessing the appellant for 1945, 1946, 1947, and 1948 the Minister, as appears from notices of assessment, dated March 6, 1950, disallowed deductions of interest claimed by it in its returns in the amount of $24,361.28 for 1945, $27,602.27 for 1946, $31,040.71 for 1947 and $31,482.10 for 1948. In the assessment for 1948 the Minister also disallowed $901.57 in respect of the depreciation claimed by the appellant. The result of these disallowances showed taxable incomes in the hands of the appellant in each of the years in question instead of the losses reported by it in its returns.

On April 4, 1950, the appellant objected to each of the assessments on certain grounds, to which further reference will be made, and on November 24, 1951, the Minister notified the appellant as follows:

> The Honourable the Minister of National Revenue having reconsidered the assessments and having considered the facts and reasons set forth in the Notices of Objection hereby notifies the taxpayer of his intention to amend the assessment for the 1948 taxation year to disallow an amount of $3,099.52 claimed as a deduction from income in respect of bond discount which was incorrectly allowed on assessment and to reduce the income by an amount of $1,378.51 shown on Exhibit A of the taxpayer's financial statements and hereby confirms the assessments in other respects as having been made in accordance with the provisions of the Act and in particular on the ground that interest amounting to $27,602.27 in 1946, $31,040.71 in 1947 and $34,581.62 in 1948 is not interest on borrowed money used in the business to earn the income within the meaning of paragraph (*b*) of subsection (i) of Section 5 of the Act; that the Minister in his discretion under the provisions of paragraph (*n*) of subsection (1) of section 6 of the Act has allowed amounts of $8,026.20 in 1946, $8,041.20 in 1947 and $15,189.92 in 1948 as deductions from income in respect of depreciation.

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Certain other facts should also be stated. The bonds were issued by the appellant to the public at $99 for each $100 bond. The payment by the public was made to a firm of underwriters acting for the appellant which deducted $9 out of every $99 to cover its charges to the appellant for underwriting the bond issue, leaving it with a net 90 per cent of the face value of the bonds.

It should also be mentioned that the amount of $27,602.27 disallowed for 1946 included $24,395.87 of compound interest, that is to say, interest on unpaid interest, and also $3,206.40 of simple interest on $10 per $100 bond consisting of the $1 per $100 bond discount and the $9 per $100 bond paid to the underwriters. Similarly, the amount of $31,040.71 disallowed for 1947 included $27,834.31 of compound interest and $3,206.40 for simple interest on the $10 per $100 bond. The amount of $31,482.10 disallowed for 1948 was for compound interest to which the Minister added $3,099.52 as interest on what he called bond discount but was really interest on the $10 per $100 bond above referred to.

The appellant then appealed to the Income Tax Appeal Board and the appeal was heard by Mr. W. S. Fisher, Q.C. He dismissed the appeal against the disallowance of the deduction of the compound interest and the claim relating to depreciation but allowed it in respect of the disallowance of the deduction of the simple interest. It is from this decision that the appeal and cross-appeal are taken.

The appellant's main ground of appeal is that the Minister had no right to disallow the deduction of the compound interest that is to say, the interest on the unpaid interest on the bonds. This raises the question whether the interest on the interest on borrowed capital is deductible from what would otherwise be taxable income under section 5(*b*) of the Income War Tax Act, which reads as follows:

> 5. "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—
>
> (*b*) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable;

While the section is not well drafted it is clear that the discretion vested by it in the Minister relates only to the allowance of the rate of interest. When in the exercise of his discretion the Minister has determined the rate which he considers reasonable he has no further discretionary powers under the section. But, of course, this does not mean that he has no other duties under it for he must determine in any case where the deduction of interest is claimed whether such deduction is permissible under the section. But such determination does not involve the exercise of discretion on his part.

In the present case there is no dispute about the rate of interest. It is to be assumed from the facts that the Minister has exercised his discretion in allowing the rate of six per cent. The only issue in this branch of the appeal is whether the Minister was right in holding that the section did not permit the deduction of the interest on the unpaid interest.

The argument of counsel for the appellant on this point may now be summarized. He submitted that interest charges have always been recognized as proper charges against operating revenues, that compound interest has been charged by the appellant and allowed by the Department in previous years, that there is no prohibition in section 6 of the Act against the deduction of compound interest, that the cost of earning the income of the appellant included compound interest, that there was no difference between compound interest and other interest, that the appellant had money on hand with which to pay the interest but that if it had done so it could not have paid its operating expenses and would have had to borrow money for such purposes, that, under the circumstances, the unpaid interest became borrowed capital just as if the interest had been paid and additional capital had been borrowed from the bondholders, that since the money that had not been paid for interest had been used to pay operating expenses the position really was that the money in question was money that belonged to the bondholders but was retained by the appellant and must, therefore, be regarded as capital borrowed from them and that since it had been used to pay the operating expenses it was borrowed capital used in the business to earn the income.

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There are several reasons for rejecting this argument. There is, of course, no merit in the submission that previously to the years in question the appellant charged interest on unpaid interest as an expense against its operating revenues and that this was allowed by the Department. The evidence on this point is that the deduction of the compound interest was not challenged until 1944 and that the first assessment in which it was disallowed was in that made for 1945. The action of the department in the past has no bearing on the question under review. If the deduction of the interest on the unpaid interest was not permissible under the section then the action of the Department in allowing it was not in accordance with the law. The practice of the Department cannot override the law.

Moreover, it is, I think, obvious that if it were not for section 5(*b*) interest on borrowed capital could not be deducted at all. Its deduction would be prohibited by section 6(*b*) of the Act as being a payment on account of capital. It is certainly not contemplated by section 5(*b*) that interest on borrowed capital may be regarded as an operating expense and deductible from operating revenues in the ordinary course of arriving at net profit or gain within the meaning of section 3 of the Act, for it is from "income" as defined in section 3 that the interest on borrowed capital is allowed to be deducted. Moreover, since the section permits the deduction of the specified interest from what would otherwise be taxable income the circumstances under which it may be deducted must be such as to come within its express terms. In *Lumbers* v. *Minister of National Revenue* (1) I expressed the rule governing the construction of an exempting provision of the Income War Tax Ast as follows:

> in respect of what would otherwise be taxable income in his hands a taxpayer cannot succeed in claiming an exemption from income tax unless his claim comes clearly within the provisions of some exempting section of the Income War Tax Act: he must show that every constituent element necessary to the exemption is present in his case and that every condition required by the exempting section has been complied with.

This rule has been consistently applied. To put it in another way, section 5(*b*) confers a benefit or a privilege on a taxpayer which is by way of exception and its ambit must not be extended to cover cases that do not come within its

(1) [1945] Ex. C.R. 202 at 211.

express terms. It is the letter of such an Act as the Income War Tax Act that governs: *vide Partington* v. *Attorney General* (1): *Tennant* v. *Smith* (2).

To bring the interest on the unpaid interest within the ambit of the exemption or deduction permitted by section 5(*b*) it must be shown that the unpaid interest on the bonds was itself borrowed capital used in the business to earn the income within the meaning of the section. That is to say, it must be shown that the unpaid interest was capital, that it was borrowed and that it was used in the business to earn the income. All these conditions must be met in order to make interest on it deductible. Counsel for the appellant contended vigorously that the unpaid interest was borrowed capital and that it had been used in the appellant's business to earn the income.

I do not agree. Certainly, the appellant never dealt with the unpaid interest as if it were capital. In every year, according to the evidence of Mr. A. D. Russell, the appellant's auditor, it charged the interest as it fell due, including the interest on the interest as it fell due, including the interest on the interest, although none of this was ever in fact paid, as an operating expense against its operating revenue. Indeed, it is fanciful to speak of the unpaid interest as capital of the appellant. In *Baymond Corporation Ltd.* v. *Minister of National Revenue* (3) I had occasion to consider the meaning of the word "capital" as used in section 5(*b*). I referred to the fact that the word is used in many senses and cited a statement in Lindley's law of Companies, 6th Edition, at page 543:

> The idea underlying the various meanings of the word capital in connection with a company is that of money obtained or to be obtained for the purpose of commencing or extending a company's business as distinguished from money earned in carrying on its business.

Later, I pointed out that a company may raise capital either by the sale of its shares or by borrowing on the issue of debentures or bonds and then said, at page 15:

> But there is an important difference between the share capital of a company and its borrowed capital: in respect of the latter the company owes a debt to its debenture or bondholders, whereas, in respect of the former, the liability of the company to its shareholders, whatever its nature may be, is clearly not that of debt.

(1) (1869) L.R. 4 H.L. 100 at 122. (2) [1892] A.C. 150 at 154.
(3) [1945] Ex. C.R. 11.

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Then I stated that this is the reason why section 5(*b*) confines the deductibility of interest to interest on borrowed capital for there is no interest payable in respect of share capital. Then, at page 16, I drew a distinction between the capital obtained by the borrowing and the obligation incurred in respect of it:

> It is, I think, inherent in the idea of capital, whether of a company or of an individual, that there is an asset in the form of money or a fund or other property capable of being or becoming a source of income to its owner. Its amount must be distinguished from the obligation or liability incidental to it.

In this sense it is plain that the unpaid interest never became an asset to the appellant in the form of money or a fund or other property that could be or become a source of income to it. The appellant did not acquire an asset by the nonpayment of the interest. What it did by not paying it was to incur the contractual obligation to pay interest on it. Thus the piling up of the unpaid interest, far from being an accumulation of wealth by it, as counsel suggested, was a pyramiding of indebtedness by it. One does not accumulate wealth by going deeper into debt.

Moreover, it cannot be said that the unpaid interest was borrowed from the bondholders and that it was, therefore, borrowed capital. It is essential to the deductibility of interest under section 5(*b*) that it should be payable pursuant to a contract between a borrower and a lender, that is to say, a contract that establishes a *bona fide* borrower-lender relationship between the parties to it. That is, I think, settled by the decision in *J. E. McCool Ltd.* v. *Minister of National Revenue* (1). While that case was primarily concerned with the question of depletion allowance it also dealt with the deductibility of interest under section 5(*b*). The appellant in that case had purchased from McCool certain assets, including timber limits, for which McCool had previously paid $35,000. Pursuant to the agreement for sale the appellant, among other considerations, gave McCool a demand note for $123,097.34 bearing interest at 5 per cent per annum. In its income tax return for 1942 the appellant claimed a depletion allowance on the timber limits on a valuation of $150,000 and also claimed the deduction of interest on the note as an operating expense. The Minister allowed depletion on the basis of the cost of the

(1) [1948] Ex. C.R. 548; [1950] S.C.R. 80.

limits at $35,000 and disallowed the claim for deduction of the interest. In this Court Cameron J. allowed the appeal on the depletion allowance but dismissed it so far as the claim for deduction of the interest was concerned. The Minister appealed to the Supreme Court of Canada from the decision on the depletion allowance and the taxpayer cross-appealed against the decision on the interest. We are not here concerned with the question of the depletion allowance but only with that of the interest. Cameron J. held that on the facts of the case before him the appellant was not a borrower from McCool and that McCool had not lent anything to the appellant, that as between them the relationship of borrower and lender did not exist at any time, the relationship at the time of the sale being that of vendor and purchaser and following the giving of the note that of creditor and debtor. In his reasons for judgment he referred to the judgment of the English Court of Appeal in *Inland Revenue Commissioners* v. *Rowntree & Co. Ltd.* (1). When the case came to the Supreme Court of Canada, while a majority allowed the appeal in the matter of the depletion allowance, the Court was unanimous in dismissing the cross-appeal relating to the interest, holding that the interest paid on the demand note was not "interest on borrowed capital used in the business to earn income" within the meaning of section 5(*b*). Rand J., speaking also for Kerwin J., said that it was misleading to convert a transaction of the kind in question into what was considered to be its equivalent and then to attribute to it special incidents that belong to the latter. At page 84, he said:

> Whether, if the company had raised money by issuing bonds, with which McCool had been paid off I do not stop to consider; that is not what we have before us. There was no borrowing and lending of money and no use of money for which interest would be the compensation. What the vendor did was to sell his property, for the consideration, in addition to the shares of a price plus interest; that interest is part of the capital cost to the company.

And Kellock J. agreed with Cameron J. that there was no relationship of borrower and lender between the appellant and McCool. He emphasized that in order to make the section applicable "there must be a real loan and a real borrowing": *vide Commissioner of Inland Revenue* v. *Port of London Authority* (2). Estey J. was of the same

(1) [1948] 1 All E.R. 482. (2) [1923] A.C. 507 at 514.

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opinion. Before the section could come into play there had to be the relationship of lender and borrower. And Lock J. agreed with Cameron J. that the deduction of the interest on the promissory note could not be allowed. The McCool case has been followed by the Income Tax Appeal Board in several cases: *vide Reinhorn* v. *Minister of National Revenue* (1); *Minshall Organ Limited* v. *Minister of National Revenue* (2); *Spanner Products Limited* v. *Minister of National Revenue* (3); *New Method Cleaners Limited* v. *Minister of National Revenue* (4). In all of these cases the deduction of interest was disallowed on the ground that there was no true relationship of borrower and lender. Here the situation is the same. It is not sufficient to say that the appellant could have paid the interest on the bonds and then borrowed money with which to pay its operating costs. That sort of argument comes within the disapproval voiced by Rand J. in the *McCool* case (*supra*). The Court is not asked to decide on the result of steps that might have been taken. Here it cannot properly be said that when the appellant did not pay the interest on the bonds and thereby incurred the liability of paying interest on it that it borrowed the unpaid interest. It did not do so. When the interest was not paid the relationship between the appellant and its bondholders in respect of the unpaid interest and the liability to pay interest on it was that of debtor and creditor, not that of borrower and lender.

And it is quite unrealistic to argue that the money with which the appellant might have paid the interest on the bonds but which it used to pay its operating expenses was really the bondholders' money but was retained by the appellant to pay its operating expenses and was, consequently, borrowed capital used in the appellant's business to earn the income. This argument is founded on Mr. Russell's statement that if the appellant had used its funds to pay the bond interest it would not have had the money required for its operating expenses and would then have had to borrow money or "go broke". But to proceed from this statement and say, in effect, that this meant that the unpaid interest should be regarded as having been borrowed

(1) (1949-50) 1 T.A.B.C. 279.
(2) (1950-51) 3 T.A.B.C. 172.
(3) (1950-51) 3 T.A.B.C. 273.
(4) (1951) 4 T.A.B.C. 383.

capital used in the business cannot be supported. The money used to pay the operating expenses came out of the appellant's income and never became part of its capital. And certainly, the unpaid interest never did.

I have, therefore, no hesitation in finding that the compound interest sought to be deducted by the appellant, being interest payable on the unpaid interest on the bonds, was not interest on borrowed capital used in the business to earn the income within the meaning of section 5(*b*) of the Act and that the Minister was right in disallowing its deduction.

While this disposes of this branch of the appeal it could have been disposed of on another ground that was not referred to by either of the parties. Since the interest on the interest was not paid it was not deductible: *vide Trapp* v. *Minister of National Revenue* (1). It is fortunate for the appellant that the principle of this case was not applied for if it had been the deduction of all the unpaid interest on the bonds, whether simple or compound, would have been disallowed.

The appellant's second ground of appeal was against the allowances in respect of depreciation permitted by the Minister. It was admitted that in reaching his decision the Minister reviewed the income tax returns made by the appellant for the years 1929 to 1948 and varied the depreciation deductions made by it. Counsel for the defendant submitted that since he had done so the appellant ought to be allowed to recast its accounts and financial statements from the beginning of its operations in 1929 and have its deductions in respect of depreciation allowed in accordance with the practice and rulings of the Department and that if this were done it would be entitled to larger deductions in respect of depreciation in some of the years in question than had been allowed and there would be a larger amount left for future deduction claims. The essence of the complaint was that the Minister had allowed larger deductions in respect of depreciation in the past than he should have done. The particulars of the complaint appear in a table of figures filed as Exhibit 5. This shows for each of the years from 1929 to 1948 three sets of figures. The first was taken from the appellant's books from which it made its

(1) [1946] Ex. C.R. 245 at 262.

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income tax returns and shows the amounts which it claimed in respect of depreciation of the building and the equipment and the total of its claim. The second set shows the amounts allowed by the Department. The third set shows the amounts which the appellant now contends should have been allowed. In 1929 and 1930 the appellant claimed depreciation at 2½ per cent for the building and 10 per cent for the equipment. The Department allowed 2 per cent for the building and 10 per cent for the equipment and the appellant agrees with these allowances. In 1931 the appellant claimed 2½ per cent for the building and 10 per cent for the equipment and these percentages were allowed by the Department but the appellant now contends that the Department should have allowed only 2 per cent for the building because of its type of construction. In 1932 the appellant again claimed 2½ per cent for the building and 10 per cent for the equipment and this was allowed by the Department but the appellant contends that it should have allowed only 1 per cent for the building and 5 per cent for the equipment. This contention was based on Ruling No. 15, to which further reference will be made. In 1933 and 1934 the appellant again claimed 2½ per cent for the building and 5 per cent for the equipment in 1934, no claim being made for it in 1933. The Department allowed 2½ per cent for the building and 5 per cent for the equipment in each year and the appellant now complains that only 2 per cent should have been allowed for the building. From 1935 to 1942 the appellant claimed 1½ per cent for the building and 5 per cent for the equipment and its claims were allowed by the Department but the appellant now says that under Ruling No. 15 it should have allowed only 1 per cent for the building. In 1943 to 1945 the appellant claimed ½ of 1½ per cent for the building and approximately 2½ per cent for the equipment. The Department allowed 1 per cent for the building and 5 per cent for the equipment in 1943 and smaller amounts in 1944 and 1945. The appellant agrees with the allowance for the building but says that 5 per cent should have been allowed for the equipment in each of the three years. This brings us up to the years in question in these proceedings. In 1946 and 1947 the appellant claimed ½ of 1½ per cent for the building and 5 per cent for the equipment or a total of $8,020.80 in 1946

and $8,041.20 in 1947. The Department allowed 1 per cent for the building in each year and only small amounts for equipment but the total amount claimed by the appellant in each year was allowed by the Department. Now the appellant claims that it should have allowed 2 per cent for the building, although it had claimed only ½ of 1½ per cent, and smaller amounts for the equipment, or a total of $16,039.64 in 1946 and $14,986.29 in 1947. In 1948 the appellant claimed 1½ per cent for the building and approximately 5 per cent for the equipment, or a total of $16,091.49. The Department allowed 2 per cent for the building and a small amount for the equipment, or a total of $15,189.92, the difference being $901.57 which the Minister disallowed on the assessment for 1948. For this year the appellant now says that the allowance should have been 2 per cent for the building and a small amount for equipment, making a total of $14,990.76, being less than the amount allowed. The summary of the figures shows that the appellant claimed $233,291.52 for the building and $88,913.43 for the equipment, or a total of $322,204.95, and that the Department allowed $247,615.37 for the building and $89,226.84 for the equipment, or a total of $336,842.21. The appellant's contention is that the Department should have allowed only $194,067.30 for the building, although the appellant had claimed $233,291.52, and $93,457.35 for the equipment, or a total of $287,524.73.

The ruling to which counsel referred read as follows:

RULING No. 15
Depreciation on Plant

(Supplementing and to be read in conjunction with Memorandum of 28th July, 1927).

The Department has been giving consideration to the question of Depreciation in periods in which a taxpayer has no taxable income. It has been found that in many cases the taxpayer's operations have not resulted in a profit owing to the fact that his plant has not been employed to the utmost of its capacity and in such cases it can be deduced that the plant has not suffered depreciation to the same extent as when operated at the maximum.

For this and other reasons the Department has come to the conclusion that some consideration should be given to the taxpayers whose operations in any year have resulted in a loss, or where there is no taxable profit. Accordingly, commencing with the taxation year 1928, you are advised that in such cases the following ruling will apply.

(1) 50% of the normal depreciation allowance will be deemed to have accrued in the periods where no taxable income results and such 50% rate will be taken into account for taxation purposes even though the taxpayer may not have made any charge for depreciation in his accounts during such period.

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(2) If a taxpayer has claimed and charged the maximum depreciation in his books, the consideration given in the preceding clause will only be extended in the event of the taxpayer adjusting his books to agree with the Department's allowance of 50%.

4th January, 1929.

Counsel's main complaints were that in 1931 to 1934 the Department had allowed 2½ per cent depreciation on the building when the practice was to allow only 2 per cent on a re-inforced concrete building such as the appellant's and that in the years from 1932 to 1943 the Department had failed to give the appellant the benefit of 50 per cent of normal depreciation pursuant to Ruling No. 15.

I am unable to find any ground for the appellant's claim that it has the right to have its allowances in respect of depreciation reviewed from the beginning and adjusted as set out in the third set of figures shown in Exhibit 5. What the Minister did prior to 1946 is not before the Court in these proceedings which are concerned with the correctness of the assessments for 1946, 1947 and 1948. The Court is, therefore, not called upon to pass any opinion on the Minister's action in allowing deductions of 2½ per cent for the building for the years 1931 to 1934, instead of only 2 per cent. In any event, what he did then has no bearing on the correctness of his allowances for the years now under review.

Nor can the Court express any opinion on whether the Minister should have applied Ruling No. 15 for the years 1932 to 1943. It may be pointed out, of course, that in the years prior to 1943 the appellant never claimed the benefit of the Ruling and has never adjusted its books. It is no answer to say that the Ruling was not communicated to it or that it was not aware of it. Its auditors must have known of it. Certainly, Mr. Russell did.

The appellant's right to a deduction in respect of depreciation is, for the years in question, governed by section 6(*n*) of the Act which reads in part as follows:

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

(*n*) depreciation, except such amount as the Minister in his discretion may allow, ...

I dealt with the meaning of this section in *Minister of National Revenue* v. *Simpson's Limited* (1) and there discussed the change which it had effected in the previous law.

(1) [1953] Ex. C.R. 93.

The amount that may now be deducted in respect of depreciation is only such amount as the Minister in his discretion may allow. Consequently, it is not for the Court to review the exercise by the Minister of his discretion or to substitute its opinion for his. The Minister's allowance of a deduction in respect of depreciation is not to be disturbed unless it can be shown that his discretion was wrongfully exercised. There was no evidence before me of any wrongful exercise of discretion in the allowances of deductions in respect of depreciation made by the Minister for 1946, 1947 or 1948. In 1946 and 1947 he allowed the total amount claimed by the appellant. If in these years it chose to claim less than it might have done that was its concern and it has no right to say that in failing to allow it a greater deduction the Minister exercised his discretion improperly. He was under no duty to allow a greater deduction than it claimed. And for 1948 the sum of $901.57 was properly disallowed on the ground that the amount allowed was 2 per cent for the building amounting to $14,951.75, regarding which the appellant does not complain, and all that was available for the equipment was $238.17. There was thus no evidence before me to warrant any finding that the Minister did not exercise his discretion properly. This branch of the appeal must, therefore, fall.

I now come to the cross-appeal. The Board allowed the appeals from the assessments to the extent that the Minister had disallowed the deduction of simple interest on the $9.00 per $100 bond which the underwriters had charged to the appellants for their underwriting services. Mr. Fisher held that the Minister had erred in law in disallowing this interest. I am unable to agree. I do not see how it can be said that this $9.00 per $100 bond was "used in the business to earn the income". It was not. It never came into the business. It was the cost to the appellant of its financing and as such was a capital cost and not properly deductible as an operating expense: *vide Montreal Coke and Manufacturing Co.* v *Minister of National Revenue* (1). That being so, it was not borrowed capital "used in the business to earn the income". Consequently, the interest on it is not deductible under section 5(*b*). The situation is really not distinguishable from that which obtained in *Baymond*

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

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Corporation Ltd. v. *Minister of National Revenue* (1), to which I have already referred. In that case, although the company had incurred a liability of $600,000.00 on an issue of second mortgage bonds and had to pay interest on this amount, all that it realized on the sale of the bonds was $157,000.00 and it was allowed to deduct only the interest on this latter amount. I put the reason for this in the following terms, at page 16:

> The expression "used in the business to earn the income" contained in section 5(*b*) of the Income War Tax Act shows in clear and explicit terms that the right of a taxpayer to deduct from what would otherwise be his taxable income interest on borrowed capital is not to be measured by the extent of his obligations in respect thereof but is restricted to only such borrowed capital as has actually been used in his business to earn the income. It is not the obligation incurred through the borrowing but the asset in the form of money or other property received from it and actually put into the business to earn the income that is the measure of the taxpayer's right, once the rate of interest has been allowed. The taxpayer is entitled only to such deduction as the section clearly permits and the expression referred to expressly limits his right in the manner specified. Consequently, whatever the appellant's borrowed capital was, it is clear that all that was used in the business to earn the income was the sum of $157,000. That was all that could have been so used for that was all that the appellant ever received. That is the limit of the amount in respect of which it is entitled to deduct interest.

It may be said that in the present case $99 per $100 bond was received by the appellant. While it is not entirely clear that this was so it does not alter the fact that $9 per $100 bond went to the underwriters as a cost of financing and that only $90 per $100 bond was used in the business to earn the income. Consequently, it is only on $90 per $100 bond that interest is deductible under section 5(*b*). It follows that the cross-appeal must be allowed.

The decision of the Board stands to the extent that it allowed the appeal from the assessment for 1948 in that the Minister had reduced the taxable income of the appellant for that year by $1,378.51. But subject to this the appellant's appeal is dismissed and the respondent's cross-appeal allowed, in each case with costs.

Judgment accordingly.

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(1) [1945] Ex. C.R. 11.