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BETWEEN:

CONSOLIDATED TEXTILES LIMITED, ... } APPELLANT;

AND

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

Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 6 (a) —"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—"The annual net profit or gain or gratuity . . . directly or indirectly received" —Deductible expenses must be those laid out or expended in the year income is received—Appeal dismissed.

Appellant, a manufacturer of lingerie fabrics, in making its income tax return for the year 1939, sought to deduct from its 1939 receipts certain operating expenses incurred in 1938. The deduction was disallowed and on appeal to the Minister of National Revenue the assessment was affirmed. From such assessment the appellant brought its appeal to this Court.

Held: That the word "annual" in s. 3 of the Income War Tax Act as applied to profit or gain or gratuity does not mean that the profit or gain or gratuity must necessarily be of a recurring nature from year to year, but rather that it is the profit or gain or gratuity of or in or during the year in respect of which the assessment is made.

2. That the "net" profit or gain or gratuity "received" is to be determined by deducting from the gross income received in or during the year the deductible disbursements or expenses laid out or expended in or during the same year; the taxable income of the year is the difference between the incoming receipts and the outgoing deductible expenditures of that year.

3. That s. 6 (*a*) of the Income War Tax Act excludes the deduction of disbursements or expenses that were not laid out or expended in or during the taxation year in respect of which the assessment is made.

APPEAL under the provisions of the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Thorson, President of the Court, at Montreal.

Joseph Shapiro, K.C. for appellant;

J. A. Mathewson, K.C. and Miss M. J. Phillips for respondent.

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

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THE PRESIDENT now (January 17, 1947) delivered the following judgment:

In its income tax return for the year ending December 31, 1939, the appellant showed a taxable income of $9,868.38. When the assessment for such period was finally made a number of deductions which the appellant had claimed were disallowed and their amounts added to the amount of taxable income shown on the return. Included therein was the sum of $5,380.79 representing the amount of 1938 operating expenses which the appellant sought to deduct from its 1939 receipts. The appeal is restricted to this item the amount of which is reduced by the sum of $65 representing an expense actually incurred and paid in 1939 but erroneously included in the disallowed amount.

The 1938 expenses sought to be deducted represented 12/14ths of the operating expenses of the appellant during the period between August 27, 1938, and October 14, 1938. The appellant manufactures and sells lingerie fabrics. It was incorporated under the laws of Quebec on August 3, 1938, and organized for business on August 27, 1938, but was not able to go into full production until after it had acquired its plant at Ste. Hyacinthe on October 13, 1938. During the period between August 27 and October 14, 1938, work was done in getting the machinery ready, preparing designs and patterns, weaving samples, arranging for supplies and materials, making sales contracts, generally by way of preparation for production and sale of its products. The operating expenses during this period came to a total of $6,201.71. They included the salaries of the appellant's superintendent, foreman and operating staff in the weaving of samples and designing of patterns and styles, the salary and travelling expenses of its president while engaged in finding sources of raw materials, the salary of its sales manager while occupied with sales promotion, the salary of its secretary and accountant, rental of premises and overhead expenses such as the cost of telegrams, postage, light and power and other items. The particulars of the expenses are set out in exhibit 1. There was a separate ledger account kept for each item.

The appellant's president gave evidence as to the nature of its business. It deals only in fabrics and does most of

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its business with garment manufacturers although it also sells to the retail trade. The business is a seasonal one, there being a spring and fall season. The orders for the 1939 spring season had to be taken between August and October of 1938. If the samples had not then been ready to show to the trade the appellant could not have got the 1939 spring season business. The samples thus served not only for the business of the remaining part of 1938 but also for that of 1939 and to some extent for that of 1940.

Out of the total expense of $6,201.71 the sum of $442.96 was charged as an operating expense in each of the months of November and December, 1938, and the remaining $5,315.79 carried as a deferred expense charge on the balance sheet as at December 31, 1938. This amount was reflected in the appellant's 1939 statement as absorbed in its 1939 operating expenses account, the deferred amounts of the items shown on exhibit 1 being added to the corresponding items for 1939, item for item, in the ledger account for each. The reasons given for this procedure by the appellant's auditor were that it had not gone into active operation or made any sales up to October 14 and had carried on only a limited business for the balance of the year and that he considered it sound accounting practice to apportion the charges for the period from August 27 to October 14 over a fourteen months period, two in 1938 and the remaining twelve in 1939.

On the appeal to the Minister, the assessment was affirmed on the ground that the expenses sought to be deducted were 1938 expenses and not deductible from 1939 income under section 6 (*a*) of the Income War Tax Act, R.S.C. 1927, chap. 97, which reads:

> 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;

Being dissatisfied with the Minister's decision the appellant brought its appeal from the assessment to this Court.

There is no doubt that the expenses in question were of such a nature as to be properly deductible; the only question is as to the year of their deductibility. The issue in the appeal is thus a very narrow one. Counsel for the appellant contended that there was nothing in section 6 (*a*)

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defining the time of the term "laid out or expended"; that if a disbursement or expense was wholly, exclusively and necessarily laid out or expended for the purpose of earning the income it was deductible from such income no matter when it was laid out or expended; that the deduction was allowable by good accounting practice and that since it was not excluded by the section it should be allowed.

There are a number of reasons why the appellant's contention cannot be accepted. I am not at all convinced that the procedure followed by it was wholly in accord with good accounting practice. There might be some justification from an accounting point of view in apportioning the 1938 operating expenses under discussion over the period of the business resulting from their expenditure in order to ascertain the true profit from such business, but if that is so and if the expenditures were made for the purpose of earning the income of 1939 and also of 1940, as the evidence indicates and the appellant claims, then it may be asked why the expenses were not apportioned over a longer period than was the case and a portion dealt with at the end of 1939 as a deferred expense charge and then absorbed in the operating expenses account of 1940. On the appellant's own argument it would not be entitled to the whole amount of the deduction in 1939. Moreover, it is hard to see how the appellant could also be entitled to deduct its 1939 operating expenses for on the basis of its own argument some of such expenses, for example, those made for designing new patterns and styles and weaving new samples, must have been incurred and paid for the purpose of earning the income of 1940 and subsequent years and should have been apportioned accordingly. It is obvious that it would be very difficult, if possible at all, to apportion operating expenses against the income from the business resulting from their expenditure and to allow their deduction only accordingly; at best such apportionment could only be an approximation dependent on the auditor's opinion. I am unable to believe that Parliament could have intended that the deductibility of expenses should depend on such an indefinite factor.

But it is not necessary to settle the question of the soundness of the appellant's accounting practice, for effect

cannot be given to it for income tax purposes, no matter how sound it might be, if the Income War Tax Act provides, as I think it does, a different basis for the computation of income tax liability. Indeed, the very definition of taxable income in section 3 as "the annual net profit or gain or gratuity, . . . directly or indirectly received" is against the appellant's contention. It is settled, I think, that the word "annual" as applied to profit or gain or gratuity does not mean that the profit or gain or gratuity must necessarily be of a recurring nature from year to year, but rather that it is the profit or gain or gratuity of or in or during the year in respect of which the assessment is made. The word may thus include an item of income that may occur only once: *vide Ryall* v. *Hoare* (1); *Martin* v. *Lowry* (2). And when the section speaks of the annual "net" profit or gain or gratuity "received", I think it must mean that the net is to be determined by deducting from the gross income received in or during the year the deductible disbursements or expenses laid out or expended in or during the same year. The taxable income of the year is the difference between the incoming receipts and the outgoing deductible expenditures of that year.

Moreover, there is a fallacy inherent in the appellant's contention that because the 1938 expenses were laid out or expended for the purpose of earning the 1939 income they are deductible from it. It is not a condition of the deductibility of a disbursement or expense that it should result in any particular income or that any income should be traceable to it. It is never necessary to show a causal connection between an expenditure and a receipt. An item of expenditure may be deductible in the year in which it is made although no profit results from it in such year: *Vallambrosa Rubber Company, Limited* v. *Inland Revenue* (3); and even if it is not productive of any profit at all: *Commissioners of Inland Revenue* v. *The Falkirk Iron Co., Ltd.* (4). The reason for the deduction of an item of expenditure is quite a different one. Under the provision of the United Kingdom Act corresponding to section 6 (*a*)

(1) (1923) 2 K.B. 447 at 455.
(2) (1926) 1 K.B. 550.
(3) (1910) 47 Sc. L.R. 488.
(4) (1933) 17 T.C. 625.

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the test of deductibility was laid down by the Lord President (Clyde) of the Scottish Court of Sessions in *Robert Addie & Sons' Collieries, Limited* v. *Commissioners of Inland Revenue* (1) as follows:

> What is "money wholly and exclusively laid out for the purpose of the trade" is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question, Is it a part of the Company's working expenses; is it expenditure laid out as part of the process of profit earning?

This test was approved by the Judicial Committee of the Privy Council in *Tata Hydro Electric Agencies, Bombay* v. *Income Tax Commissioner, Bombay Presidency and Aden* (2) and adopted as applicable to section 6 (*a*) by the Supreme Court of Canada in *Minister of National Revenue* v. *Dominion Natural Gas Co. Ltd.* (3). It completely disposes of the fallacy in the plaintiff's contention to which I have referred, for it is clear that what makes an expenditure deductible is that it is part of the taxpayer's working expenses and that it is laid out as part of the process of profit earning. In my judgment, the statement goes further and disposes of the question in issue, for it follows that an item of expenditure becomes a deductible one when and as soon as it meets the requirements of the test, that is to say, that it is deductible in the year in which it becomes a working expense and part of the process of profit making. The appellant's 1938 operating expenses became its working expenses and part of the process of profit making or, to use the words of section 6 (*a*), part of the process of earning the income in 1938, and, therefore, deductible in that year; that being so, they were not deductible in 1939.

In my opinion, section 6 (*a*) excludes the deduction of disbursements or expenses that were not laid out or expended in or during the taxation year in respect of which the assessment is made. This is, I think, wholly in accord with the general scheme of the Act, dealing as it does with each taxation year from the point of view of the incoming receipts and outgoing expenditures of such year and by the deduction of the latter from the former with a view to

(1) (1924) S.C. 231 at 235.
(2) (1937) A.C. 685 at 696.
(3) (1941) S.C.R. 19.

reaching the net profit or gain or gratuity directly or indirectly received in or during such year as the taxable income of such year. The Minister was, therefore, quite right in disallowing the deduction of the appellant's 1938 expenses from its 1939 income, and no fault can be found with the assessment by reason of his so doing. The appeal from it must be dismissed with costs.

Judgment accordingly.