1941

Nov. 24.

1942

March 31.

BETWEEN:

KELLOGG COMPANY OF CANADA LIMITED ..... } APPELLANT;

AND

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

Revenue—Income—Income War Tax Act, R.S.C., 1927, c. 97, secs. 3, 5 and 6—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—"Any payment on account of capital"—Legal expenses incurred in defending action at law brought to restrain appellant from using certain trade name in connection with the sale of its products—Expenditures properly charged against revenue—Appeal allowed.

Appellant is a manufacturer of cereal products which it sells to customers. One of these customers and appellant were made defendants in an action at law brought by the S. Company which claimed infringement by both defendants of certain trade mark rights of the S Company. The S. Company claimed an injunction and damages and when action was started obtained from appellant an undertaking which had the effect of stopping the alleged wrongful sales of appellant's products until the final disposition of the action. Appellant successfully defended the action on behalf of both defendants.

Appellant in computing its income for the years 1936 and 1937 deducted the sums of money it had paid out for legal expenses on account of the aforesaid action. These deductions were disallowed by the Commissioner of Income Tax. This disallowance was affirmed by the Minister of National Revenue from whose decision an appeal was taken to this Court.

Held: That the payments were made involuntarily in the course of business to enable 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; nor were they made expressly for its permanent benefit or for the purpose of earning future profits; the litigation merely affirmed the common law right which appellant was already entitled to and enjoyed; the payments were, therefore, properly deductible in arriving at appellant's net income.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

The appeal was heard before the Honourable Mr. Justice Maclean, President of the Court, at Ottawa.

O. M. Biggar, K.C., for appellant.

A. A. McGrory for respondent.

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

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THE PRESIDENT, now (March 31st, 1942) delivered the following judgment:

This is an appeal from a decision of the Minister of National Revenue (hereafter called "the Minister"), affirming assessments for income tax levied against Kellogg Company of Canada, Limited (hereafter called "Kellogg"), for the fiscal years ending December 31, 1936, and December 31, 1937, respectively. The appeal relates particularly to two specific amounts which Kellogg claims were expenses laid out and incurred for the purpose of earning its income. It claims that these amounts are proper deductions in computing the assessment of its net income for the taxation periods mentioned.

The facts may be briefly stated. Kellogg carries on business in the City of London, in the Province of Ontario, and its business consists in the manufacture of cereal products and their sale to merchants for resale to customers. Among the products produced and thus marketed was one known as Shredded Wheat which Kellogg sold to, among other persons, one Solomon Bassin, and which Bassin resold to his customers. In 1934 an action was instituted against Kellogg and Bassin by the Canadian Shredded Wheat Company Ld. as plaintiff, in respect of the sales of Shredded Wheat made by Kellogg, and resales made by Bassin. It was claimed by the plaintiff in that action that the sales made by Kellogg and Bassin constituted an infringement of its rights in respect of certain registered trade marks consisting of the words "Shredded Wheat", used in association with biscuits, crackers and cereal foods, produced and sold by the said plaintiff, and which products were claimed to be similar to certain of the products produced and sold by Kellogg. The defendants Kellogg and Bassin contested the action, which was brought in the Supreme Court of Ontario, with the result that the action was dismissed with costs by the trial judge, and on an appeal being taken from the said judgment to the Court of Appeal for Ontario the same was dismissed with costs, and a further appeal taken by the plaintiff to the Judicial Committee of the Privy Council was also dismissed with costs. The net amount of costs incurred and paid by Kellogg in connection with the said action during the year 1936 was $5,392.99, and during the year 1937 was $11,585.72, which said sums were assessed in the said years as part of the income of Kellogg

under the Income War Tax Act. These assessments are the subject of the controversy in this appeal. Apparently, as one would expect, Kellogg felt in duty bound to carry the defence of the said action and save harmless its customer Bassin from any expense or damages in connection therewith.

The Canadian Shredded Wheat Company, in its action claimed, (1) an injunction restraining the defendants from using the words "Shredded Wheat" or "Shredded Whole Wheat", or "Shredded Whole Wheat Biscuit", or any words only colourably differing therefrom, and (2) $25,000 damages, or, in the alternative, profits as the plaintiff might elect. In the judgment of the Judicial Committee of the Privy Council, it is stated that in the year 1934 the defendant Kellogg began to sell in Canada biscuits made of shredded wheat, and that among its customers was a retail grocer, one Bassin (the second defendant in the action), who in turn resold some of the said biscuits to his retail customers, and, further, that when the plaintiff issued the writ in its action it obtained "an undertaking (without prejudice) which had the effect of stopping the alleged wrongful sales until the trial or other final disposition of the action". I assume this undertaking remained effective until after the decision rendered in such action by the Judicial Committee of the Privy Council. It is to be assumed, therefore, that during the interval in which the said undertaking was in force Kellogg made no sales of its shredded wheat biscuits complained of in the action, and consequently in that period no income was earned from any such alleged wrongful sales.

The formal decision of the Minister in this matter was that the legal fees and expenses incurred by Kellogg were not expenses wholly, exclusively and necessarily laid out or expended for the purpose of earning the "income", in other words "net profit or gain", but were "expenses incurred in defence of capital which falls within the specific provisions of section 6 (*b*) of the Act and were properly disallowed as deductions from income for income tax purposes". That means that the Minister maintained the assessments made on the ground that the expenses in question were incurred on account of capital and not of income. This was in substance the position taken by Mr. McGrory, on behalf of the respondent on the hearing of this appeal. He argued:

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That the expenditures in question were made by Kellogg, (1) to preserve its right to carry on a portion of its business, (2) to assert and defend its common law right to manufacture and sell certain cereal products under the descriptive name of such products, (3) to maintain the right to earn future profits as distinguished from current profits, to assure an "asset" or "an advantage or enduring benefit" for its business, by making an expenditure "once and for all", and (4) that the expenses incurred for such purposes were not deductible in computing the annual profits or gains to be assessed for the income tax, and were of a capital nature and properly attributable to capital. It will at once be observed that the grounds advanced by Mr. McGrory are of a familiar character, and that he had in mind a line of well known cases which I shall have occasion to mention later on. On the other hand, Kellogg is claiming that the items of disbursements in question were expenses properly attributable to income.

As has so often been pointed out by the Courts, in dealing with cases of this kind, the Income War Tax Act nowhere contains a definition of what constitutes the balance of the profits or gains of a trade or business, but, as was said by Lord Haldane in *Sun Life Assurance Office* v. *Clark* (1),

> it is plain that the question of what is or what is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when . . . . some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap.

The Income War Tax Act does expressly exclude a number of deductions and allowances, some of which according to ordinary principles of commercial accounting might be allowable, but where these ordinary principles are not invaded by the Act they must be allowed to prevail. Therefore in considering what is an allowable expense, or deduction, we must first enquire whether it is one prohibited by the Act; if it is not prohibited, then we must consider next whether it is of such a nature that, according to the principles of ordinary commercial standards, it is a proper item to be charged against income in a computation of profits or gains, and was expended for earning the same, or,

(1) (1912) A.C. 443 at 455

whether it is an expense that should be charged as a capital expenditure and therefore not deductible in computing the amount of the profit or gain to be assessed.

Again, while the Act describes the sources of income it nowhere defines "income" and nowhere does it define "capital". Inasmuch as there is no statutory definition of "income" or "capital" it is to the decided cases that one must return for light, and, as was said by Lord Macmillan in *Van den Berghs Ld.* v. *Clark* (1),

> while each case is found to turn upon its own facts, and no infallible criterion emerges, nevertheless the decisions are useful as illustrations and as affording indications of the kind of considerations which may relevantly be borne in mind in approaching the problem

of discriminating between an income receipt and a capital receipt and between an income disbursement and a capital disbursement.

I propose therefore, first, to refer to certain of a well known line of cases, to which I was referred, and the first to be mentioned is that of *Vallambrosa Rubber Co. Ltd.* v. *Farmer* (2). In that case a company owned a newly planted rubber estate. Rubber trees do not reach production stage until about six years old, but in the meantime expenditure must be incurred on the immature trees, on weeding and maintenance of the plantation, and on superintendence. Only one-seventh of the estate in question was yielding rubber. The Crown contended that only one-seventh of the expenditure incurred on weeding, maintenance, etc., should be allowed as a revenue charge. It was held that the fact that the balance of the expenses was incurred to earn profit in future years, and was not referable to profits earned in the year in which incurred, did not prevent it from being a proper deduction and that as they were annually recurring expenses they were *prima facie* not capital expenditures but income expenditures, and so fell to be deducted. In that case the Lord President (Lord Dunedin) said that the word "capital" was to be given its common commercial meaning, and that "capital expenditure" as against what is income expenditure is something that is going to be spent "once for all", and income expenditure is something that is going to recur annually. He plainly stated that he did not regard this rule as absolutely final or determinative, but in a "rough

(1) (1935) A C 431 (2) (1910) 5 T.C. 529

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way" he thought it not a bad criterion of what is capital expenditure as against what is income expenditure. The Lord President (Lord Strathclyde) in *Moore* v. *Hare* (1), referred to this rule as "a rough and ready test", and he said that Lord Dunedin did not claim any higher merit for it than that. Lord Dunedin's test of a capital expenditure as a thing that is going to be spent "once and for all", and an income expenditure as a thing that is going to "recur every year" is to be regarded as a broad definition of the position, not true in all cases, for example, it was modified in the case of *Smith* v. *Incorporated Council of Law Reporting for England and Wales* (2). There a reporter of the Council who was in no way entitled to a retiring gratuity, was paid a gratuity on retirement, and it had been a habit of the Council to give a gratuitous pension, or a gratuity, to a reporter who retired after long service, and it was held that the finding of the District Commissioners of Taxes, that the gratuity in question was allowable as a business expense, should be sustained and that the grant must be regarded as a proper deduction. The "once and for all" rule was further modified in *Atherton* v. *British Insulated and Helsby's Cables Ld.* (3), by Lord Cave's doctrine of capital expenditures as being money expended with a view of bringing into existence "an asset or an advantage for the enduring benefit of a trade". There, a company found that owing to the absence of any provision for pensions, valuable employees from time to time left the company and obtained employment elsewhere. A pension fund was accordingly set up by trust deed, the company agreeing to make annual contributions, and an initial contribution of £31,874 was made to provide a nucleus or capital sum in order that past years of service of existing employees might rank for pension, and the question was whether the sum of £31,784 was admissible as a deduction in computing the company's profits. The expenditure was ultimately held to be an expenditure of capital, and not admissible as a deduction. The Crown argued that the sum ought to be attributed to capital on the ground that "it was not in its nature recurrent but was made 'once and for all'." The Lord Chancellor (Lord Cave) in that case said:

(1) (1914) 6 T.C. 572. (2) (1914) 6 T.C. 477.
(3) (1925) 10 T.C. 155.

> . . . when an expenditure was made not only once and for all but with a view of bringing into existence an asset or advantage for the enduring benefit of a trade, I think that is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to a revenue, but to capital.

Lord Atkinson indicated that the word "asset" ought not to be confined to "something material". The "enduring benefit" principle was further modified in *Anglo Persian Oil Co. Ld.* v. *Dale* (1), by the development by Lawrence L.J. of the "enduring benefit" principle by the distinction drawn by him between "fixed" and "circulating capital". There the taxpayer had merely changed its methods of carrying on business by bringing agreements entered into with another company, its business agent in Persia, to an end by paying a sum of £300,000 so that they could carry on their business more economically, and it was held that this sum was an admissible deduction for purposes of income tax. A distinction was drawn between fixed and circulating capital, and in determining whether it was capital or revenue expenditure, the test applied was whether it created an addition to "fixed" as distinct from "circulating capital". Lawrence L.J. said that by "enduring" is meant enduring in the way that fixed capital endures, and the payment in question was allowed as a deduction being a payment in respect of its circulating capital; and Romer L.J. added that the advantage paid for need not be "of a positive character" and that the advantage may consist in the getting rid of an item of fixed capital that is of an onerous character. The Court of Appeal followed this reasoning in *Van Den Berghs Ld.* v. *Clark* (2), where a large sum received in the way of damages for the cancellation of agreements with a rival company for pooling profits was regarded as circulating capital, and was treated as a revenue receipt. The House of Lords apparently did not accept the distinction between fixed and circulating capital. It held that the price paid for the surrender of the rights under the agreements was a capital asset and not a revenue receipt, on the ground that the agreements were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself; they provided the means of making profits, but they themselves did not yield profits. I have

(1) (1932) 1 K.B. 124; (1931) 16 T.C 253. (2) (1934) 19 T.C. 390.

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referred to this line of cases at such length because they discuss or embody the principles advanced by Mr. McGrory in his argument supporting the decision of the Minister in the present case. At the same time they reveal the problem of discriminating between an income disbursement and a capital disbursement.

Then there is a second line of cases, so often referred to in support of cases where the Crown is claiming that the expenditure in question is one of a capital nature and not one made for the purpose of earning profits or gains. I shall refer only to two or three of such cases, and the first one is that of *Addie & Sons Collieries Ld.* v. *Commissioner of Inland Revenue* (1). In that case the taxpayer was the lessee of a coal mining area for a period of years. When the lessee began to work its mine it was obvious that it would require to use a certain amount of the surface of the lessor's estate for certain purposes, such as the making of roads and foot paths. That was one of the conditions precedent to starting work in the mine. The lessee might, if it had thought fit, have purchased the land required for its purposes, or it might have acquired some form of servitude right across the surface owner's property. The lessee did none of these things, but got under the lease the right to use the surface for, *inter alia*, these purposes; and, as the consideration for the right so acquired, the lessee came under obligation, at the end of the lease, to restore the land so occupied to its original agricultural condition, or otherwise to pay to the lessor the equivalent of its agricultural value. The lessee chose to pay a sum of money. It was held that the expenditure was made for the acquisition of an asset in the form of the means of access and passage, which was part of the capital establishment of the lessee. The lessee got the lease on the term of either restoring the land to its original condition, or by paying the value of the land if it were not restored. It was the latter condition which he chose to accept and perform. As was observed by the Lord President, the expenditure was not any less a capital expenditure than, for example, the cost of sinking the shaft. I find it difficult to imagine that this expenditure could be anything else than one made on account of capital. Another case is that of *Tata Hydro-Electric Agencies Limited, Bombay,*

(1) (1924) S.C. 231.

v. *Income Tax Commissioners* (1). The facts of this case are set forth in the early paragraphs of the judgment of Lord Macmillan, and as they are lengthy and difficult of comprehension I shall not repeat them. It was held that the obligation to make the payments in question was taken over by the taxpayer as part of the transaction whereby it acquired the business agency from Tata Sons, Ld. In delivering the judgment of the Judicial Committee Lord Macmillan said:—

> Their Lordships recognize, and the decided cases show, how difficult it is to discriminate between expenditure which is, and expenditure which is not, incurred solely for the purpose of earning profits or gains. In the present case their Lordships have reached the conclusion that the payments in question were not expenditure so incurred by the appellants They were certainly not made in the process of earning their profits; they were not payments to creditors for goods supplied or services rendered to the appellants in their business; they did not arise out of any transactions in the conduct of their business. That they had to make those payments no doubt affected the ultimate yield in money to them from their business, but that is not the statutory criterion. They must have taken this liability into account when they agreed to take over the business. In short, the obligation to make these payments was undertaken by the appellants in consideration of their acquisition of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business.

Accordingly the deductions made were held to be inadmissible. It might be pointed out that the Judicial Committee observed that if the same question had arisen with Tata Sons Ld., they would have been entitled on the facts stated to deduct their payments to Dinshaw Ld., and Smith as being expenditure incurred solely for the purpose of earning their profits and gains, and in fact this was later held in *Commissioner of Income Tax* v. *Tata Sons Ld.* (2). I have referred to those two cases because they were referred to in the case of *The Minister of National Revenue* v. *Dominion Natural Gas Co. Ld.* (3), to which case Mr. McGrory referred in his argument, and to which I must presently make reference. I am unable to see any analogy between the *Addie* and *Tata* cases and the one presently before me, or that any useful aid can be derived from them here.

The present case is somewhat analogous to that of *The Minister* v. *Dominion Natural Gas Co. Ld.* (3), and to

(1) (1937) A.C. 685. (2) (1938) 7 I.T.R. 195
(3) (1941) S.C.R. 19; (1940) 4 D.L.R. 657.

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which I must now refer briefly. In that case an action was brought against the Dominion Natural Gas Co. It put in question its right to maintain in the streets of the City of Hamilton facilities for supplying gas to the inhabitants of that city, and the plaintiff in the action claimed an injunction restraining the respondent from continuing to do so. The Dominion Natural Gas Co. claimed a deduction in the assessment of its income for the amount of legal costs disbursed by it in resisting the action. It was held by the Supreme Court of Canada that the deduction claimed was inadmissible. The judgment of the Chief Justice and Davis J. proceeded on the ground (1) that the expenses in question were not working expenses, that is to say, they were not expenses incurred in "the process of earning the income", and (2) that the expenditure was incurred "once and for all", and "for the purpose and with the effect of procuring for the company "the advantage of an enduring benefit", that is, the right to carry on its undertaking. They held there was no distinction between expenditures incurred in procuring the company's by-laws authorizing the undertaking and the expenses incurred in their litigation with the plaintiff in that action, and that such expenses were therefore of a capital nature. Mr. Justice Crocket proceeded upon the ground that the expenditure was not "incidental to the trade", of the Dominion Natural Gas Co. Kerwin and Hudson JJ. proceeded on the ground that the expenditure was "a payment on account of capital", because it was made "with a view of preserving an asset or advantage for the enduring benefit of the trade". If I understand the view of the Supreme Court to be as I have stated it, then the "advantage of an enduring benefit", and the preservation of "an asset or advantage", must have been intended to relate to the franchise rights or privileges under which the company commenced and continued its undertaking, which comprised the foundation and totality of all its assets, and which rights or privileges were the means of making profits though they themselves did not yield profits, and that therefore the expenses in question were directly related to capital assets. I think there is a distinction between that case and the present case, and as my reasons for thinking so will presently appear in my discussion of the present case, and will, I think, differentiate the two cases, I need not anticipate them just at this stage.

Now turning to the specific question here to be determined. The broad principle laid down by Lord Cave in *British Insulated* v. *Atherton* (1) 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 Cave 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* case, *supra,* 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. No "material" or "positive" advantage or benefit resulted to the trade of Kellogg from the litigation except perhaps a judicial affirmation of an advantage already in existence and enjoyed by Kellogg. I do not think that the Crown can be heard to say that because the litigation affirmed a right which Kellogg, in common with others, was already entitled to and enjoyed that therefore Kellogg acquired something which should be treated as an asset or an enduring advantage to its trade. Such reasoning would lead to many strange and undesirable results. In any event, Kellogg never disbursed any money to acquire something, and it would appear hardly tenable to say that the payment of the legal expenses in question was something paid to acquire an asset or a trade advantage. That was an involuntary expense, not a disburse-

(1) (1926) A.C. 205 at 213.

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ment incurred once and for all, or for the benefit of a trade, within the meaning of such cases as I have earlier discussed. Again, this is not a case of a payment made once and for all in substitution of a "recurring" annual payment, as no such payment was ever made by Kellogg, and equally true is it, I think, that the expenses here were not incurred for the purpose of earning future profits. In all the decided cases I have mentioned the taxpayer voluntarily made specific disbursements, for one reason or other connected with his trade; whether they were held to be attributable to capital or revenue is presently irrelevant, the important and relevant thing being that they were made in pursuance of settled business policy. Kellogg made no such comparable disbursement; the disbursement here was one virtually imposed upon the taxpayer. It is to be remembered that the plaintiff in the action against Kellogg claimed the choice of either an account and payment to it of the profits or income which Kellogg had gained in its trade, or an enquiry as to damages alleged to be occasioned by the wrongful conduct of Kellogg. The profits of Kellogg were made by the sale of certain cereal products in cartons, on which was printed the common name of the product, as, I think, is required by regulations made under the Food and Drugs Act. That is part of the selling mechanism and not of the production mechanism of Kellogg, almost the final step in the selling of the product itself and in the earning of profits, or gains. It was to maintain this trading and profit-making position that Kellogg was obliged to make the expenditure in question. It was against actual sales, the earning of income, that the Canadian Shredded Wheat Company sought an injunction against Kellogg, and also against its customer Bassin to whom it had actually sold its goods for resale.

Nor were the disbursements in question here comparable to those in the case of *Warnes* (1), or the case of *Glehn* (2), where the taxpayers incurred penalties and costs for infringements of the Customs Act, breaches of the law, and the payments of such penalties and costs were held not to be sums laid out for the purposes of the trade of such taxpayers. The present case, I think, closely resembles that of *Noble* v. *Mitchell* (3). There a large sum of

(1) (1919) 12 T.C. 227. (2) (1919) 12 T.C. 232
(3) (1927) 11 T.C. 372.

money was paid by a company to get rid of a managing director and it was held that the payment was properly chargeable to income. The Master of the Rolls there said:

> It is a payment made in the course of business, dealing with a particular difficulty which arose in the course of the year, and was made not in order to secure an actual asset to the company, but to enable them to continue, as they had in the past, to carry on the same type and quality of business,

and Lord Justice Sargent said that

> it is quite impossible to put against the capital account of the company . . . . a payment of this nature. It seems to me that the payment . . . . was not of such a nature; it certainly was not capital withdrawn from the company, or any sum employed or intended to be employed as capital in the business . . . . To my mind, it is essentially different from those various payments in the cases which have been referred to, which were of the nature of adding to, or improving the equipment, or otherwise made for the permanent benefit of the company.

These remarks would appear to be applicable to the present case. 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. I have no doubt but that there are many cases in which legal expenses incurred are properly attributable to capital and not revenue, in computing the profits or gains assessable for the income tax. For example, in the case of *Moore* v. *Hare* (1), a firm of coal masters promoted two Bills in Parliament for the construction of a railway line in consequence of the unsatisfactory facilities afforded by a railway company. The railway company having agreed to grant improved facilities the Bills were dropped. It was held that the expenditure was of a capital nature and not an expenditure out of revenue.

The conclusion which I have reached is that the appeal herein should be allowed, and with costs to the appellant.

Judgment accordingly.

(1) (1914) 6 T.C. 572.