BETWEEN:

LUSCAR COALS LIMITED.....APPELLANT;

AND

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

1948
Dec. 20
1949
Jan. 25

Revenue—Income—Income Tax—Income War Tax Act R.S.C. 1927, c. 97, ss. 2(m), 4(n), 6(1) (a) (b)—"Losses sustained in the process of earning income during the year last preceding the taxation year"—Dividends exempt from income tax received during the year losses incurred in earning the income are not applicable to reduce the amount of such losses—"Losses incurred" means those incurred in operating a business and not net losses—Earned income—Investment income—Appeal allowed.

Appellant in the years 1942 and 1943 was engaged in the business of coal mining in the Province of Alberta. In its income tax return for the taxation year 1943 appellant deducted, *inter alia*, an amount for losses incurred in carrying on its business for the preceding year. Appellant had received in such year a certain amount of money from other companies by way of dividends, such receipts being exempt from income tax in appellant's hands by virtue of s. 4(*n*) of the Income War Tax Act. Respondent deducted such amount of dividends received by appellant from the amount claimed by it for the losses claimed and assessed appellant for income tax accordingly. Appellant appealed to this Court.

Held: That the losses deductible are the losses sustained in the operation of or carrying on the business of the taxpayer and not the net losses of the taxpayer.

APPEAL under the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Cameron at Ottawa.

J. R. Tolmie and *J. M. Coyne* for appellant.

W. R. Jackett and *T. Z. Boles* for respondent.

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

CAMERON J. now (January 25, 1949) delivered the following judgment:

This is an appeal from assessment for income tax and excess profits tax for the taxation year 1943, the fiscal year of the appellant ending on June 30, 1943. The appellant company, both in the year 1943 and the preceding year, was engaged in the business of coal mining in Alberta.

The appeal arises in connection with the interpretation to be placed on section 5 (*p*) of the Income War Tax Act and which for the year in question was as follows:

> 5. "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—
>
> (*p*) losses sustained in the process of earning income during the year last preceding the taxation year by a person carrying on the same business in both of such years, if in the calculation of such losses, no account is taken of any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, or of any disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income, except such amount for depreciation as the Minister may allow.

The appellant, under the provisions of this section, was entitled to a deduction from its 1943 income as it had suffered a loss in its previous fiscal year. The dispute arises because of a difference of opinion between the parties as to how such "losses" for 1942 are to be computed in ascertaining the proper deduction for the fiscal year 1943.

In its tax return for 1943 the appellant showed a taxable income of $73,190.79 after deducting from its income the sum of $21,299.57, which it claimed as the amount of its losses for 1942. The latter figure was arrived at by including as a disbursement the sum of $1,000 in donations made in 1942, and without including in its computation of losses the sum of $10,352.60 received by it in 1942 from other companies incorporated in Canada (the profits of which other companies had been taxed under the Act and which, therefore, under section 4 (*n*) were not subject to tax in 1942 in the hands of the appellant). In assessing the appellant for the year 1943 the respondent:

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(*a*) Disallowed the item of $1,000, representing donations made by the appellant in 1942, as part of its losses in 1942 and the appellant does not appeal from that part of the assessment; and

(*b*) In computing the appellant's losses for 1942 which might be deducted in 1943, has included in the appellant's income for 1942 the sum of $10,352.60 received by it in dividends from other Canadian companies.

Instead, therefore, of allowing to the appellant losses for 1942 aggregating $20,299.57, as now claimed by the appellant, the respondent has allowed only $9,945.97. The sole question for determination, therefore, is whether in computing losses for 1942 under the provisions of section 5 (*p*) the tax-exempt dividends so received by the appellant in that year should be taken into account in ascertaining its taxable income for the year 1943.

Section 5 (*p*) was first introduced into the Act by section 5 (7), ch. 28, of the Statutes of Canada, 1942-3, and made applicable to the taxation year 1942 and subsequent years. The obvious purpose was to ease the tax burden on those who might make a profit in one year, but who had sustained a loss in the last preceding year, by recovery of that loss before tax as assessed in the succeeding profitable year.

Before considering particularly the provisions of clause 5 (*p*) I think it advisable to refer briefly to clause 4 (*n*) of the Act which, for the year in question, was as follows:

> 4. The following incomes shall not be liable to taxation hereunder:—
> (*n*) Dividends paid to an incorporated company by a company incorporated in Canada, the profits of which have been taxed under this Act, except as hereinafter provided by sections 19, 22A and 32A.

The purpose of that section was, I think, to prevent triple taxation of the same profits or gains. If there were no such provision, tax would be levied on the profits of the company in Canada which originally made the profits; a second tax would be applied to the incorporated company which received them from the original company; and finally, when the receiving company distributed profits to its shareholders, the latter would presumably again be subject to personal tax. The exceptions set out in section 4 (*n*) have admittedly here no application and the parties hereto are in

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agreement that in 1942 the said dividends received by the appellant company were not subject to tax. As I have already pointed out the appellant paid no tax in 1942.

The effect of applying the provisions of section 4 (*n*) is, therefore, that in some cases it is possible for a company to show a profit in any given year under ordinary accounting practices and at the same time have no taxable profit or gain under the Income War Tax Act. That would be the case, for example, when the amount of dividends received (but which by the provisions of section 4 (*n*) were not subject to tax) exceeded the losses sustained in all other operations. The dividends so received are undoubtedly "income" of a taxpayer within the provisions of section 3 (1), but under the provisions of section 4 (*n*) are not liable to tax and may therefore be deducted from income in ascertaining the taxable profits or gains. The taxing authorities, therefore, in ascertaining the taxable income of such a company, do not take such dividends into account as they are not liable to taxation.

But, as in the instant case, when the deduction for business losses sustained in the last preceding year is to be considered under section 5 (*p*), the respondent submits that, in ascertaining the amount of losses so to be deducted, the amount of such dividends must be taken into account as part of the income of the appellant in the last preceding year. In effect, it is submitted that in ascertaining "losses," ordinary accounting practices must be followed.

The word "losses" is not defined in the Income War Tax Act, ch. 97, R.S.C. 1927, as amended, (or in the Excess Profits Tax Act) but it is apparent from the provisions of section 5 (*p*) itself that not all "losses" may be deducted, and to the extent that such "losses" are so limited it is possible to interpret the meaning of that word to some extent at least.

The deduction can only be claimed by a person carrying on the same business, both in the taxation year and in the last preceding year, and then only to the extent of such losses as were sustained in the last preceding year. Then certain further limitations are given as to the manner of computing such losses by excluding from the computation capital outlays or losses, and disbursements not wholly, exclusively and necessarily laid out for the purpose of

earning the income (these limitations following almost verbatim the wording of section 6(1) (*a*) and (*b*) relating to deductions from income which are not allowed). A deduction for such depreciation as the Minister may allow is permissible, and in the following year an amendment was made to provide for a similar allowance for depletion.

The subsection, therefore, in general terms lays down what disbursements and outlays may or may not be taken into account in computing "losses", but gives no indication of what is or is not to be taken into account on the other side of the computation—namely, that of income. To ascertain whether there have been "losses" necessarily involves consideration of both sides of the balance sheet.

The appellant's case rests in the main on its contention that the amount which it claims as losses in 1942 ($20,299.57) is, in fact, its "losses sustained in the process of earning income." That is the correct amount of such losses unless the dividend receipts be taken into account, in which case the loss is reduced to $9,946.97. The respondent, on the other hand, contends that the words "losses sustained in the process of earning income" mean the general overall loss and that investment income must therefore enter into the computation in ascertaining the amount of the losses.

I think it is clear that if the words "in the process of earning the income" did not appear in the subsection, the appellant would have no case. Since the words "losses sustained" are not defined in the Act, they would have to be given the ordinary meaning attributed to them in ordinary business accounting in which case the dividends received would of necessity be taken into account. The problem, therefore, narrows down to the determination of what is meant by the words "in the process of earning income," qualifying as they do the preceding words "losses sustained," it being clear that the taxpayer is entitled to deduct all "losses sustained in the process of earning the income" except as limited by the subsequent provisions of the subsection, which limitations do not here affect the appellant.

While the Act gives no definition of the words "in the process of earning the income," the meaning to be attributed

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to them may be gathered from a consideration of certain other parts of the Act. By section 2 (*m*), "earned income" is defined as:

2(*m*). "Earned income" means salary, wages, fees, bonuses, pensions, superannuation allowances, retiring allowances, gratuities, honoraria, and the income from any office or employment of profit held by any person, and any income derived by a person in the carrying on or exercise by such person of a trade, vocation or calling, either alone, or, in the case of a partnership, as a partner actively engaged in the conduct of the business thereof, and includes indemnities or other remuneration paid to members of Dominion, provincial or territorial legislative bodies or municipal councils, but shall not include income derived by way of rents or royalties.

A clear distinction, therefore, is drawn between "earned income," as above defined, and "investment income" which, by section 2 (*n*), is defined as: "investment income includes any income not defined herein as 'earned income,' and also any amount deemed by this Act to be a dividend."

The distinction is in reality between that income which is obtained as a result of labour or effort and that income which is not so obtained. Clearly, the dividends received by the appellant fell within the category of "investment income" and are excluded from "earned income." The purpose of making such a distinction is illustrated by the additional rate of tax charged on investment income by section 9 (3) of the Income War Tax Act as it was in 1943. Further, the words "in the process" seem to indicate something in the nature of an active operation. The mere receipt of dividends involves no outlay of any effort or labour on the part of the recipient.

Judicial consideration has been given to the meaning of section 6 (1) (*a*) of the Act which then 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.*

In the case of *Minister of National Revenue* v. *Dominion Natural Gas Co. Ltd.* (1), Duff, C.J. said at p. 22:

First, in order to fall within the category "disbursements or expenses wholly, exclusively and necessarily laid out or expended for the purpose of earning the income," expenses must, I think, be working expenses; that is to say, expenses incurred in the process of earning "the income."

I interpret that judgment to mean that the words "laid out or expended for the purpose of earning the income" are equivalent to "incurred in the process of earning the

(1) (1941) S.C.R. 19.

income," that is—working expenses. Since, therefore, the words "in the process of earning the income" as applied to expenses mean "working expenses," I see no reason why the almost identical words contained in section 5 (*p*), "in the process of earning income," as applied to losses, should not have a similar connotation. I think that they refer to losses sustained in the operation or carrying on the business of a taxpayer, that of the appellant herein being the business of coal mining.

Counsel for the respondent has referred me to the case of *Inland Revenue Commissioners* v. *Australian Mutual Provident Society* (1). That was a case arising under r. 3 of case III of sch. D. of the Income Tax Act, 1918, by which in the case of certain specified companies "the income of the company from investments of its life assurance fund (excluding the annuity fund, if any) wherever received, shall, to the extent provided in this rule, be deemed to be profits comprised in this schedule and shall be charged under this case." This company was entitled under the Act to exemptions from United Kingdom tax in respect of interest and dividends from securities and investments forming part of its life assurance fund falling with certain rules. A question arose as to the method of computing tax and it was:

HELD, that r. 3 did not tax income from investments, whether exempted or not, but a conventional sum calculated as the rule directed; accordingly the sum to be taxed was not affected, by the fact that one of the factors in the calculation contained income from exempted investments, and there was no reduction of the society's liability on that ground.

Lord Wright said at p. 622:

It was on the contrary a charging provision intended to charge the assurance company on the basis of a fixed percentage of the total income. That was merely a convenient mode of imposing some charge on the assurance company in consideration of the privilege it enjoyed in trading in this country. The charge was a tax on the investment income only as a machinery to tax the general profits of the British business, and as a manner of measuring the charge by an arbitrary figure derived from a percentage of the investment income In this connection it was not material to distinguish between exempted and unexempted income. All that was needed was a yardstick.

I have considered that judgment and in my view it is not helpful in the case at bar. The decision was made under

(1) (1947) A C. 605.

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a special rule which did not tax income from investments whether exempted or not, but a conventional sum computed as the rule directed.

Counsel for the respondent also referred me to a passage in the dissenting judgment of Porter, L.J., in the case of *Absalom* v. *Talbot* (1), in which at p. 650 he said:

> In order to ascertain that balance one has to determine what sums are to be credited and what debited in the annual accounts. No directions are given in the Income Tax Acts as to how those profits are to be ascertained and in default of directing they must, I think, be arrived at on ordinary commercial principles, subject to such provisions of the Income Tax Acts as require a departure from such ordinary principles.

As I have stated above, if the words "in the process of earning the income" were not used in the subsection, then "losses", lacking any direction as to what losses are meant, would have to be given the meaning attributed to it in ordinary commercial practice, in which case I have no doubt that the losses would be reduced by the amount of investment income received. But I regard the use of these words in the subsection as a provision requiring a departure from the ordinary commercial principles, and conferring on the appellant a right to deduct, not the net losses incurred in the prior year, but its losses incurred in the operating of its business of coal mining, that being the only activity in which there was a process of earning income.

I have given careful consideration to the other cases which were cited but have reached the conclusion that they are not here helpful. It has also been brought to my attention that in the Income Tax Act, enacted June 30, 1948, and made applicable to the taxation year 1949, and subsequent years, the word "loss" is so defined as to exclude from the computation dividends of the type here in question. I am quite unable to draw any inference from that section in the new Act as to what was meant by the word "losses" under the Act in effect in 1943.

I was also referred to the provisions of section 5 (1) (*r*) which was enacted in 1943 and made applicable to the taxation year 1944 and subsequent years. That section permitted one whose chief occupation was farming to deduct his farm losses sustained in the process of earning income from the operation of any farm during the two years last preceding the taxation year, and it would appear

(1) (1944) 1 A.E.R. 642.

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that investment income in the years of loss would not be taken into account in computing the losses. The language of that subsection on this point is somewhat more clearly expressed than in section 5 (1) (*p*), and because of the difference in the wording and that it was enacted in the subsequent year, I am unable to see that it throws any light on section 5 (1) (*p*), although the tenor of each subsection is to permit the averaging out of income over years of profit and loss.

On the whole, I have reached the conclusion that the appellant has satisfied the onus cast on it, and the appeal will be allowed with costs. The matter will be referred back to the respondent to re-assess the appellant on the basis of my finding.

Judgment accordingly.