1954
Feb. 4
Mar. 27

BETWEEN:

GEO. T. DAVIE AND SONS LIMITED ....APPELLANT;

AND

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

*Revenue—Income—Income Tax—The Income Tax Act, c. 52 ss. 3 and 4, S. of C. 1948—Shipbuilding contracts—Loans from Canadian Commercial Corporation established under The Canadian Commercial Corporation Act, 10 Geo. VI, c. 40, S. of C. 1946—Trading receipts—Loss assumed by the Crown under shipbuilding contracts—Abatement of capital indebtedness—Whether a subsidy—Whether income—Appeal from Income Tax Appeal Board allowed.*

Appellant, a dry dock owner and shipbuilder, got into financial and technical difficulties while building two small and three large Yangtze River freight and passenger vessels which a Chinese company had purchased with funds derived mainly from loans guaranteed by the Government of Canada. It obtained under a mortgage security advances from the Canadian Commercial Corporation—a Crown company—established under the Canadian Commercial Corporation Act, 10 Geo. VI, c. 40, S. of C. 1946, to which it was already indebted in the amount of $450,000 for previous loans. Upon completion of the shipbuilding contracts appellant's total indebtedness to the Canadian Commercial Corporation under the loan and mortgage deed amounted to $914,000. By an agreement effective November 2, 1949, between the Crown and appellant, the indebtedness of appellant was abated in respect of two amounts: the first of $284,813.83 "being the amount of a payment received by the Canadian Commercial Corporation from the Chinese company, representing the final increase in the price of the three large vessels"; the second of $450,000, "being a portion of the said advances made by the Canadian Commercial Corporation to the shipbuilder and representing the portion of the loss assumed by the Canadian Government under the shipbuilding contract". The payment of $284,813.83 by the Chinese company was taken into appellant's accounts for the year 1949 as a trading receipt but the sum of $450,000 was shown in its income tax return for the same year as an increase to its capital surplus. To appellant's declared income for that year the Minister added the said sum of $450,000 and from the assessment appellant appealed to the Income Tax Appeal Board which dismissed the appeal. An appeal was taken to this Court from the Board's decision. On the facts the Court found that the advances by the Canadian Commercial Corporation to appellant were advances on capital account and the abatement of $450,000 was an abatement of the capital indebtedness.

*Held:* That the direct payment by the Chinese company to the Canadian Commercial Corporation of the sum of $284,813.83 was not a contribution to appellant's losses under the shipbuilding contracts but rather a true trading receipt. The mere fact that the two items of abatement were dealt with in one agreement does not lead to the inference that they were of the same character. They were of a

totally different character. The relationship between appellant and the Chinese company was that of vendor and purchaser; whereas the relationship between appellant and the Canadian Commercial Corporation (or the Crown) was that of debtor and creditor.

2. That the benefit received by appellant by reason of the abatement cannot be considered as a subsidy since appellant's indebtedness to the Canadian Commercial Corporation secured as it was by a mortgage of all its immoveable properties was an indebtedness on capital account. While the advances made by the Canadian Commercial Corporation were used by appellant in building the ships, the Canadian Commercial Corporation itself was in the same position as a banker advancing working capital or as a lender who had advanced capital and had taken security by way of mortgage. It was not a party to the shipbuilding contracts and neither it nor its principal, the Crown, was under any legal obligation to assume or bear any part of appellant's loss. What the Crown did was to enter into a compromise of a capital debt by abating it to the extent stated. The case, therefore, falls to be decided on the law applicable to abatements rather than to that applicable to subsidies.

3. The mere cancellation or abatement of an undisputed trade debt does not give rise to taxable income in the hands of a taxpayer whose trade debt has been cancelled or abated. The abatement of a capital indebtedness cannot give rise to taxable income. *British Mexican Petroleum Co. Ltd.* v. *Jackson (Inspector of Taxes)* 16 T.C. 570; *Income Tax Case No. 455* 11 South Africa T.C. 168 referred to and followed.

4. The benefit conferred on appellant by the abatement of its capital liability was not something received in the course of its normal trading operations. It was outside those operations entirely. It did not in 1949 receive payment of the sum of $450,000 or acquire any right to receive it. The liability was diminished purely as an act of grace. The benefit received was not a profit from appellant's business.

APPEAL from a decision of the Income Tax Appeal Board.

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

*Roger Letourneau, Q.C.* for appellant.

*Paul Taschereau, Q.C.* and *E. S. MacLatchy* for respondent.

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

CAMERON J. now (March 27, 1954) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated January 13, 1953 (reported as *No. 78* v. *M.N.R.*—7 T.A.B.C. 408) dismissing by a majority an

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appeal by the taxpayer from an assessment made upon it for its taxation year 1949. To the appellant's declared income the respondent had added the sum of $450,000, the ground for so doing being stated in the Notification by the Minister as follows:

> The amount of $450,000 received by the taxpayer from Canadian Commercial Corporation has been properly taken into account in computing the income of the taxpayer in accordance with the provisions of the Act.

The facts in the case are not in dispute. The appellant was incorporated as a private company in 1941 under the Dominion Companies Act for the purpose of carrying on generally the business of a dry dock company and the business of building and repairing ships and other vessels. In December, 1946, it entered into a contract with Ming Sung Industrial Co. Ltd. (hereinafter to be called the Chinese Company) whereby it undertook to build and deliver four small Yangtze River Freight and Passenger Vessels at a fixed price per vessel, which price was later increased to a larger sum. In March, 1947 this contract was amended in order to provide that the appellant should deliver only two of such small vessels. At the same time the appellant entered into a further agreement to build and deliver three larger vessels for the Chinese Company at a fixed price. The two smaller vessels were delivered prior to September, 1948 and the last of the three larger vessels in July, 1949.

For the purpose of financing the construction of the said vessels, the Chinese Company had obtained loans from Canadian banks, the repayment of such loans being guaranteed by the Government of China. In March, 1947 under the authority of Part II of the Export Credits Insurance Act (1944-45, 8-9 George VI, c. 39 and Amendments, more particularly those resulting from 10 George VI, c. 49), the Government of Canada had guaranteed the undertaking of the Government of China in this respect.

By August, 1948 the appellant was in such financial difficulties due to increased costs and to certain technical difficulties that it could not fulfil its obligations or complete and deliver the vessels in accordance with its contracts. On September 21, 1948 it entered into a Deed of Loan and Mortgage (Ex. A) with the Canadian Commercial Corporation (hereinafter to be referred to as C.C.C.), established under the Canadian Commercial Corporation Act (1946—

10 George VI, c. 40). Prior to that date the C.C.C. had loaned the appellant sums aggregating $450,000. In that Deed the appellant was referred to as the Borrower and the C.C.C. as the Lender, and the agreement contained the following clause:

> To secure the reimbursement of the said capital sum of $450,000, and in order to guarantee further advances to the extent of an additional amount of one million dollars which the Lender may from time to time advance but does not hereby undertake to advance, the Borrower specially charges and hypothecates in favour of the Lender . . .

the immoveable properties therein described which were in fact all the immoveable properties then owned by the appellant.

By the Appropriation Act, No. 2, 1949 (13 Geo. VI, Vol. I, c. 15) assented to on April 7, 1949, a sum of $850,000 was appropriated by Parliament for the financial year ending March 31, 1949, and the purposes for which the said sum was granted to His Majesty were stated to be as follows:

> Vote No. 638. To reimburse the Canadian Commercial Corporation for amounts advanced by it as working capital under mortgage security to George T. Davie & Sons, Ltd. (losses on which advances cannot yet be estimated) for the purpose of enabling that company to complete and to deliver ships to the Ming Sung Industrial Company, Ltd., which purchased such ships with funds derived mainly from a loan for this purpose guaranteed by Canada under Part II of the Export Credits Insurance Act .....$850,000

Pursuant to the said appropriation, the sum of $850,000 was transferred by the Comptroller of the Treasury to C.C.C. upon requisition of the Minister of Trade and Commerce. On July 31, 1949, upon completion of the shipbuilding agreements, the appellant's total indebtedness to C.C.C. under the aforesaid Deed of Loan and Mortgage amounted to $914,000. By the fall of that year the losses on the Chinese contracts were ascertained to be $1,150,164.05 in all, as admitted by the respondent. The appellant was then in a precarious financial position and quite unable to meet its obligations to C.C.C. In the meantime the Chinese Company had paid direct to C.C.C. the sum of $284,813.83, "as the final increase of contract price in respect of the three larger vessels", thereby reducing the appellant's net overall losses on both types of vessels to $865,350.22. The appellant, having assented to the Deputy Minister's proposal to that effect, that sum of $284,813.83 was applied in

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reduction of the appellant's indebtedness to C.C.C., thus reducing its liability to $629,186.17. That payment of $284,813.83 was taken by the appellant into its trading receipts as being an additional payment on account of the contract price of the three large vessels.

On November 2, 1949, the Deputy Minister of Trade and Commerce wrote the appellant, part of that letter (Ex. R1) being as follows:

> This will confirm that, as a result of recent re-negotiations between officials of your company and officers of this Department, agreement has been reached whereby the Minister is prepared to recommend to the Governor in Council that the amount of the advances due the Canadian Government by your Company at July 31, 1949, be abated by an amount of $450,000 in respect of losses sustained in the construction of the three 270' Yangtze vessels for the Ming Sung Industrial Company Limited.
>
> It is proposed that the foregoing abatement be effected by a reduction of $450,000 in the amount of the advances outstanding at July 31, 1949, which are to be further reduced by an amount of $284,813.83 received by the Canadian Commercial Corporation from the Ming Sung Company as the final increase of contract price in respect of the three larger vessels. *The net result of these credits* will be the reduction of your Government advance account from $914,000 to the amount of $179,186.17.
>
> This indebtedness of $179,186.17 will be secured by First Mortgage held by the Canadian Commercial Corporation on the assets of the Geo. T. Davie & Sons Limited. Security now held by the Canadian Commercial Corporation on the Company's assets may be altered accordingly, if required by either party.

The net result of the foregoing proposals, accepted by the appellant, was to reduce the appellant's indebtedness under the Deed of Loan and Mortgage to the sum of $179,186.17. Later an understanding was reached regarding the terms of repayment and the security to be given in respect of that balance, and an agreement embodying the same and effective on November 2, 1949 (but actually executed on June 29, 1950) was entered into. In that agreement (Ex. A4), the appellant was the party of the first part, and His Majesty the King in Right of Canada (represented by the Minister of Trade and Commerce) was the party of the second part. In draft form it was attached to Order in Council P.C. 145/1111, dated March 4, 1950, which was as follows:

*TRADE AND COMMERCE*

> The Board had under consideration a memorandum from the Right Honourable the Minister of Trade and Commerce reporting:
>
> 'THAT, in March 1947, under authority of Part II of the Export Credits Insurance Act, the Government of Canada guaranteed the undertaking of the Government of China, which latter Government

had guaranteed the repayment of loans by Canadian banks to the Ming Sung Industrial Company Limited for the purpose of financing construction of Yangtze River Freight and Passenger Vessels by Canadian shipyards;

THAT due to increased costs of labour and materials and to certain technical difficulties, it became apparent during August 1948 that George T. Davie & Sons Limited would be unable to complete and deliver vessels in accordance with its contracts with the Ming Sung Industrial Company Limited;

THAT in order to carry out the purposes for which the Canadian Government had originally entered into the transaction and to minimize the possible loss under its guarantee, the Government of Canada acting through the Canadian Commercial Corporation advanced funds under mortgage security to George T. Davie & Sons Limited for working capital to enable the Company to complete and deliver the ships, funds for such purpose being provided by Vote 638 of the Further Supplementary Estimates of 1948-49 in the amount of $850,000, pending completion of the contracts and determination of the actual losses thereon;

THAT the vessels have now been constructed, delivered to, and accepted by the Ming Sung Industrial Company Limited, and the amount of the losses thereon determined;

THAT it is proposed to effect final settlement of advances made in respect of such transactions with George T. Davie and Sons Limited substantially in accordance with the terms of the Agreement annexed hereto as Schedule "A", which provides, inter alia, that the Government of Canada will assume losses to the extent of $450,000 on the Ming Sung contracts;

THAT the matter has been carefully reviewed by officials of this Department and, having regard to all the circumstances, it is considered that the proposed settlement is fair and reasonable and in the public interest.

The undersigned, therefore, has the honour to recommend that authority be given for the execution and delivery of such Agreement and other documents as may be necessary to give effect thereto.'

The Board concur in the above report and recommendation, and submit the same for favourable consideration.

One of the recitals in the said agreement is as follows:

WHEREAS, having regard to the guarantee of the Canadian Government, and all other circumstances, it is considered fair and equitable that the remainder of the loss incurred under the ship building agreement, amounting to $450,000, be assumed by the Canadian Government, and that the amount of the outstanding advances be abated accordingly.

Then Clause 1 of the operative part is as follows:

1. The total advance of Nine Hundred and Fourteen Thousand Dollars ($914,000) made by the Canadian Government to the Shipbuilder shall be and the same is hereby abated by the sum of Seven Hundred and Thirty-Four Thousand, Eight Hundred and Thirteen Dollars and Eighty-Three cents ($734,813.83), made up of the following sums, namely:

(a) the sum of $284,813.83, being the amount of a payment received by the Corporation from Ming Sung representing the increase in the price of the said three (3) vessels; and

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(b) the sum of $450,000, being a portion of the said advances made by the Corporation to the Shipbuilder under mortgage security, and representing the portion of the loss assumed by the Canadian Government under the shipbuilding agreement; and

the repayable portion of the total advance made by the Canadian Government to the Shipbuilder is hereby fixed at the sum of One Hundred and Seventy-Nine Thousand, One Hundred and Eighty-Six Dollars and Seventeen Cents ($179,186.17).

Then followed certain other provisions not here of importance. Clause 4 fixes the time of payment of the balance of the said indebtedness and by Clause 5 the appellant, upon full payment of principal and interest thereof, is to be discharged from all liability. By Clause 6 the appellant agreed to execute a first mortgage to the Canadian Government as collateral security for the said indebtedness, on all its real property, and upon delivery thereof the mortgage given to the C.C.C. on September 21, 1948, was to be discharged.

In the meantime, C.C.C. had paid back to the Comptroller of the Treasury the sum of $400,000 in respect of the original sum of $850,000 advanced to it under Vote 638, and the balance of $450,000 was accounted for by the aforesaid abatement of $450,000 and the agreement of November 2, 1949, above mentioned. The provisions of the said agreement relating to the giving of the new mortgage for the sum of $179,186.17 and the discharge of the former mortgage to C.C.C. were duly carried out.

As I have indicated above, the respondent added to the appellant's declared income for the year 1949 the said sum of $450,000, i.e., the amount by which the indebtedness of the appellant had been abated.

The appellant says that at all relevant times the relationship between it and C.C.C., or the Canadian Government, was that of debtor and creditor on capital account and that the abatement or cancellation of a debt of a capital nature cannot give rise to anything but a capital gain. In his Reply to the Notice of Appeal, the Minister alleges that under the agreement of November 2, 1949, of Order in Council P.C. 145/1111, His Majesty made a grant or subsidy to the appellant in respect of losses sustained by the appellant in the course of carrying on its business, which amount was applied in reducing the amount owed by the appellant to the C.C.C.; and that in adding to the appellant's income for 1949 the sum of $450,000, it did so in

accordance with the provisions of s. 3 and s. 4 of the Income Tax Act, which are as follows:

3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all

(*a*) businesses,

(*b*) property, and

(*c*) offices and employments.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

One of the submissions on behalf of the respondent may be disposed of at once. By the agreement effective November 2, 1949, the indebtedness of the appellant to C.C.C. was abated in respect of two amounts. The first was that of $284,813.23, "being the amount of a payment received by the Corporation (i.e. the C.C.C.) from Ming Sung, representing the increase in the price of the said three vessels". The second abatement was the sum of $450,000, "being a portion of the said advances made by the corporation to the shipbuilder under mortage security, and representing the portion of the loss assumed by the Canadian Government under the shipbuilding agreement." The amount of the first abatement was taken into the accounts of the appellant for the year 1949 as a trading receipt and I think properly so. Counsel for the respondent submits, however, that there is no essential difference between these two items and that if the first abatement is properly a trading receipt, so also is the second. He suggests that owing to the financial difficulties in which the appellant found itself, the losses which it had sustained in respect of the three vessels were made up in part by Ming Sung, and as to another part, by the Crown.

In my view, however, that submission cannot be supported. There is no evidence whatever that in paying the additional sum of $248,813.83, Ming Sung was contributing to the losses of the appellant. The letter of the Deputy Minister dated November 2, 1949, states that that sum "was received by the C.C.C. from Ming Sung as the final increase of contract price in respect of the three large vessels." A statement in para. 28 of the Notice of Appeal —and admitted in the respondent's Reply—was that that sum was taken into the appellant's trading receipts as being an additional payment on account of the contract price of

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the three large vessels. It was therefore, in my opinion, not a contribution to the appellant's losses but rather a true trading receipt. The mere fact that the two items of abatement were dealt with in the one agreement does not lead to the inference that they were of the same character. In my view they were of a totally different character. The relationship between the appellant and Ming Sung was that of vendor and purchaser; whereas the relationship between the appellant and the Crown (or its agent the C.C.C.) was that of debtor and creditor.

In its return for 1949 the appellant did not show the sum of $450,000 as a trading receipt but as an increase in its capital surplus. It is well settled, however, that the mere way in which a company keeps its accounts is not conclusive in the matter.

It is quite clear that the advances by C.C.C. to the appellant were advances on capital account. They are described as "capital" in the mortgage (Ex. A) and as working capital in Vote No. 638 (*supra*). Indeed, counsel for the respondent agreed that they were advances of capital and on the facts they could not be otherwise. They were not taken into the appellant's accounts as trading receipts.

It follows that whatever may have been the reason for the abatement, it was, in fact, an abatement of the capital indebtedness. The substantial question for consideration, therefore, is whether such an abatement can give rise to taxable income. Is it "income" within the meaning of that term in the Income Tax Act—a profit from the appellant's business in 1949?

The respondent endeavours to bring this amount within the purview of the appellant's trading operations by reference to the fact that the abatement arose because or in respect of the appellant's losses in the Ming Sung contract. It cannot be disputed that such is the case, as counsel for the appellant readily admits. Counsel for the respondent goes further and submits that the letter of the Deputy Minister of November 2, 1949, and the contract effective as of that date, are clear indications that the Crown was assuming a portion of the losses sustained by the appellant in the Ming Sung contract, that the abatement in the indebtedness was merely a mode of artifically supplementing the income of the appellant in respect of that contract—

a contract which undoubtedly was within the ambit of the appellant's normal trading operations. He submitted, therefore, that it was in the nature of an income subsidy and so subject to tax. He says that what happened was this. The Crown in order to stimulate the production of goods for export had guaranteed to the Canadian banks the repayment of loans made by them to Ming Sung; that when the appellant got into financial difficulties in carrying out its contract, advances were made to it by the Crown's agent—the C.C.C.; that when the losses were finally established, the Crown, having perhaps a moral obligation to assist the appellant by bearing part of its losses, agreed to abate the appellant's liability to C.C.C.; and that the agreement to reduce the mortgage held by C.C.C. by $450,000 had the same result as if the Crown had paid that sum to the appellant and the appellant had then in turn paid it to C.C.C.

As pointed out by the President of this Court in the *St. John Drydock* case (1), statutory subsidies may be of a capital nature or of a revenue nature. In that case it was held that the payment to the taxpayer was a construction subsidy payable in respect of the capital expenditure and that the taxpayer did not receive it in the course of its trading or business operations or because of them and so was not "income" in the hands of the taxpayer. The case of *Smart (Inspector of Taxes)* v. *The Lincolnshire Sugar Co. Ltd.* (2) is an illustration of the statutory subsidy resulting in taxable income. There the subsidy was paid on sugar manufactured in Great Britain from beet grown there. It was held that in view of the business nature of the sums paid, that they were trading receipts and proper to be taken into account for income tax purposes in the year in which they were received. Another similar case is that of *Charles Brown & Company* v. *C.I.R.* (3).

The submissions so made by counsel for the respondent are substantial, but in view of the facts as I consider them to be I cannot give effect to his argument. In the first place I do not think that the benefit received by the appellant by reason of the abatement can be considered as a subsidy. I was not referred to any statute which would

(1) [1944] Ex. C.R. 186. (2) 20 T.C. 643.
(3) 12 T.C. 1256.

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authorize the payment of any subsidy to the appellant, and in the correspondence and documents filed it is referred to as an abatement and not as a subsidy. Secondly, I think the argument entirely overlooks the fact that the indebtedness of the appellant to C.C.C.—and which was secured by a mortgage of all the immoveable properties of the appellant—was an indebtedness on capital account. I think this is the most important fact in the entire case and counsel for the respondent admitted that it was a formidable barrier in his way.

I think it is of importance also to note that while advances made by C.C.C. were doubtless used by the appellant in building the ships under the Ming Sung contract, the C.C.C. itself was in exactly the same position as a banker advancing working capital or as a lender who had advanced working capital and had taken security by way of mortgage. It was not a party to the Ming Sung contract and neither it nor its principal, the Crown, was under any legal obligation to assume or bear any part of the appellant's loss.

Now, as I view the matter, this is what happened. The appellant owed the C.C.C.—the agent of the Crown—very substantial amounts on capital account. Due to its losses under the contract, the appellant could not pay the debt and was facing bankruptcy. The C.C.C. could have foreclosed the mortgage and might thereby have realized a part of its claim. But the Crown for good and valid reasons preferred not to deal with the matter in that way. It may have felt a moral obligation to bear some part of the losses due to the manner in which it had encouraged the appellant to enter into the contract—as suggested by counsel for the respondent. As a matter of policy it may have decided not to put the appellant into bankruptcy and thereby throw a substantial number of men out of employment. It is clear from the terms of Vote 628 (*supra*) that losses on the advances made by C.C.C. to the appellant were anticipated at that time, the amount of which was not fully determined. What the Crown actually did was to enter into a compromise of the capital debt by abating it to the extent stated. I think, therefore, that the case falls to be decided on the law applicable to abatements rather than to that applicable to subsidies.

The leading case which has to do with the position of a taxpayer whose trade liabilities have been lessened is that of the *British Mexican Petroleum Co. Ltd.* v. *Jackson (Inspector of Taxes)* (1). The facts in that case are briefly as follows:

In 1919 the appellant had entered into a contract with an oil producing company (which held a large interest in the shares of the appellant company) for the purchase of petroleum. By reason of the slump in the petroleum business in 1921, the appellant was unable to meet its obligations under its contract. Accounts of the appellant company's business were made up for the year ended the 30th June, 1921, and for the eighteen months ended the 31st December, 1922. At the 30th June, 1921, the agreed amount owing to the oil-producing company under the contract was £1,073,281; at the 30th September, 1921, the amount was £1,270,232.

Under the terms of an agreement dated the 25th November, 1921, the appellant company paid to the producing company the sum of £325,000 and was released by the producing company from its liability to pay the balance remaining due, namely, £945,232. The amount so released was carried direct to the appellant company's balance sheet and was shown as a separate item under the head 'Reserve' at the 31st December, 1922.

The Crown contended that the amount released should be brought into account in computing the appellant company's profits for purposes of Income Tax and Corporation Profits Tax, either in the account for the eighteen months to the 31st December, 1922, or, alternatively, in the account for the year to the 30th June, 1921, that account being re-opened for the purpose.

The Special Commissioners held that the amount released should be brought into the profit and loss account of the company for the eighteen months to the 31st December, 1922.

Rowlatt, J. reversed the finding of the Special Commissioners, and appeals to the Court of Appeal and to the House of Lords were both dismissed. It was held that the amount remitted should not be included as a receipt in the account for the eighteen months to the 31st of December,

(1) 16 T.C. 570.

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1922, and that the account for the year to the 30th June, 1921, should not be re-opened and adjusted by reference to the remission.

At p. 584 Rowlatt, J. said:

> All these companies are very closely connected—at any rate, two of them are, the oil company and the ship-owning company; the oil company and the ship-owning company are very closely connected with this Company in that they own all the shares, or something of that sort. What they said was: 'We will release this debt or a very large part of it—we will absolutely release it and write it off and you can go on trading on that footing.' They could have wound up the Company and reconstructed it; but they did not do that. They simply carried on releasing the debt. That is what they have done. Under those circumstances the Commissioners have held what Mr. Hills himself finds it difficult to support—on broad business lines it cannot be supported; I do not understand it myself in the least—that in the year of release, when the business entered into a new lease of life and a new bargain was struck, the amount released must be brought into the revenue account . . . They resisted it in the other case, and I have to decide whether or not that is right. I literally cannot understand why they should be entitled to do that. What is chargeable to Income Tax under either the First or Second Case of Schedule D, I forget which it is—the trading case—is the profit which is made by comparing the amount which you receive from selling goods or rendering services, or whatever it is, with the amount which you pay out in putting yourself in a position to do that by buying goods and equipping yourself, finding the expenses for rendering the services or whatever it is—with the necessary adjustments in the account to allow for the stock which is carried over from year to year in the way Mr. Hills drew my attention to—that is what it is, the difference which you enjoy between what you receive and what you have to pay out in the year's trading. How on earth the forgiveness in that year of a past indebtedness can add to those profits I cannot understand. It is not a matter depending upon the form in which the accounts are kept. It is a matter of substance, looking at the thing as it happened, as a man who knows nothing of scientific accountancy might look at it—it is the receipts against payments in trading.

In the Court of Appeal, Lord Hanworth, M.R., speaking for the full Court, placed considerable stress on the fact that in the agreement by which the debt was reduced the parties had agreed that the abatement was to be placed to the credit of the depreciation account and not otherwise. It is significant to note, however, that in the House of Lords, no reference whatever was made to that clause of the agreement, nor was it mentioned in the opinion of Rowlatt, J. Lord Thankerton, whose judgment was concurred in by all the judges in the House of Lords, stated, in part, as follows:

> My Lords, I am of opinion in the present case, that the account to 30th June, 1921, cannot be reopened, as the amount of the liability there stated was correctly stated as the finally agreed amount of the liability and the subsequent release of the Respondents proceeds on the footing of the correctness of that statement.

The Appellant's alternative contention, which was not seriously pressed by the Attorney-General, is equally unsound, in my opinion. I am unable to see how the release from a liability, which liability has been finally dealt with in the preceding account, can form a trading receipt in the account for the year in which it is granted.

Accordingly, I agree with the unanimous decision of the Courts below, who disagreed with the decision of the Special Commissioners, and the appeal should be dismissed.

Lord Macmillan, with whom Lord Warrington of Clyffe concurred, gave additional reasons for dismissing the appeal, stating at p. 593 as follows:

If, then, the accounts for the year to 30th June, 1921, cannot now be gone back upon, still less in my opinion can the Appellant Company be required to enter as a credit item in its accounts for the eighteen months to 31st December, 1922, the sum of £945,232, being the extent to which the Huasteca Company agreed to release the Appellant Company's debt to it. I say so for the short and simple reason that the Appellant Company did not, in those eighteen months, either receive payment of that sum or acquire any right to receive payment of it. I cannot see how the extent to which a debt is forgiven can become a credit item in the trading account for the period within which the concession is made.

I observe that of the Appellant Company's total indebtedness to the Huasteca Company, £196,951 was incurred during the eighteen months covered by the accounts to 31st December, 1922, and that the date on which the Huasteca Company agreed to forgo £945,232 of the Appellant Company's total indebtedness was 25th November, 1921, also within that period of eighteen months. Now it may be that where during the currency of an accounting period a trading debt is incurred, and the creditor agrees during the currency of the same period to accept less than the full amount of the debt due to him, it is only the balance of the debt as exacted, or agreed to be exacted, which ought to enter, as a debit, the debtor's accounts for the period. As to this I say nothing, for the present case has been argued by the Crown on the footing that the whole sum of £945,232 ought either to be dealt with in a reopened account for the year to 30th June, 1921, or credited in the eighteen months' account to 31st December, 1922, and as, in my opinion, neither of these contentions is admissible, I concur in the motion that the appeal be dismissed.

It will be noted that in the second paragraph of Lord Macmillan's opinion, he was careful to reserve the question as to the effect of releasing a *trade* debt in the year in which it was incurred. In the instant case it is clear that much if not all of the indebtedness was incurred in the previous year, and that it has been argued by the Crown on the footing that the whole of the amount abated should be treated as income in the year 1949.

That case was followed in *Income Tax Case No. 455,* (1). The facts there were as follows:

Appellants were three subsidiaries of a company to which they were indebted in certain large amounts, incurred in the course of trading. The

(1) 11 South Africa T.C. 168.

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parent company owned or controlled all the shares in the appellant companies, whose business consisted of the sale of goods purchased by the parent company. The parent company also sold goods produced by the appellant companies. The parent company, during the year of assessment under review, passed resolutions recording its decision to forego a substantial portion of the amounts owing to it by the appellant companies. The amounts of the debts so forgiven by the parent company, which were reflected in the accounts submitted by the appellant companies in support of their returns of income, were included by the Commissioner for Inland Revenue in the respective incomes of the appellant companies subject to normal tax and assessed accordingly.

Dr. M. Nathan, K.C., President of the Court, summarized the position of the parties as follows:

It was contended on behalf of the appellants that these were gratuitous releases, and that they constituted donations. They were not, therefore, subject to tax, being in their nature capital receipts. On behalf of the Commissioner it was said that these releases of indebtedness were made in the course of trading and, therefore, the receipts were trading receipts, and not capital receipts. Counsel for the Commissioner relied upon the fact that the indebtedness of the appellants to the parent company arose out of trading; the remissions by the parent company of the indebtedness increased the prospects of future trading between the companies; and it was suggested that the remissions were rebates or discounts or allowances in reduction of the price paid for goods sold to the appellants, or the remissions were in the nature of remuneratory donations for services rendered to the parent company.

At p. 169 he said:

In our view, the remissions made by the parent company were not rebates or discounts or allowances in reduction of the prices paid for goods sold to the appellants. They cannot be regarded as part of the ordinary trading of the appellant companies, nor were they in the nature of remuneratory donations for services rendered to the parent company. It appears to us that this case is governed by the decision of the English Courts in *British Mexican Petroleum Company Limited* v. *Jackson*.

Then, after adopting what was said by Rowlatt, J. and Lord Hanworth, M.R., and Lord Macmillan in the *British Mexican Petroleum* case, the President said:

It appears to us that this is an identical case. The amounts remitted were not receipts in the course of trading.

The result is that the appeals are allowed, and the assessments must be amended accordingly.

The facts in the *British Mexican Petroleum* case are, of course, somewhat different from those in the instant case. There the debt which was abated was incurred in the ordinary course of trading and it was held that the accounts for the earlier period in which most of the debt had been incurred could not be re-opened and those accounts readjusted because of the abatement; and also that the amount

of the abatement could not be brought into account in the later period in which some part of the debt had been incurred and the abatement made. As I read the judgment of Rowlatt, J., he considered the benefit received by the taxpayer as something quite outside the scope of its trading activities; something which was conferred on it "as an act of grace although business methods were behind it". Lord Macmillan, in disposing of the suggestion that the amount of the abatement should be treated as a revenue item in the taxation period in which the abatement was made, stated his reasons in these few sentences:

> I say so for the short and simple reason that the Appellant Company did not, in those eighteen months, either receive payment of that sum or acquire any right to receive payment of it. I cannot see how the extent to which a debt is forgiven can become a credit item in the trading account for the period within which the concession is made.

In my view, that case is authority for the proposition that the mere cancellation or abatement of an undisputed trade debt does not give rise to taxable income in the hands of a taxpayer whose trade debt has been cancelled or abated, subject perhaps to the question reserved by Lord Macmillan and which I have referred to above. That being so, it cannot be found that the abatement of a capital indebtedness —as in the instant case—can give rise to taxable income.

In my opinion, also, the benefit conferred on the appellant by the abatement of its capital liability was not something received in the course of its normal trading operations. It was outside those operations entirely. Moreover, to adopt the language of Lord Macmillan, it did not in 1949 receive payment of the sum of $450,000 or acquire any right to receive it. The liability was diminished purely as an act of grace, coupled possibly to some extent with matters of public policy and business motives. The benefit received by the appellant was not a profit from its business.

It is of some interest, also, to refer to Income Tax Law and Practice by Newport and Shaw, 25 Ed., where under the heading "Compositions" at p. 120, the following comment appears:

> Where the taxpayer himself makes a composition with his creditors, the Revenue do not normally seek to bring in the 'benefit' as an addition to his profits, or as a deduction from the amount of a corresponding loss.

And reference is made to the *British Mexican Petroleum* case as authority for that statement.

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For these reasons, I think the appeal must be allowed. The decision of the Income Tax Appeal Board will be set aside and the matter referred back to the Minister for the purpose of re-assessing the appellant in accordance with these findings. The appellant is also entitled to be paid his costs after taxation.

*Judgment accordingly.*