1958
Nov. 26
Dec. 12

BETWEEN:

THE MINISTER OF NATIONAL REVENUE .... APPELLANT;

AND

GLADYS (GERALDINE) EVANS ....RESPONDENT.

Revenue—Income—Income Tax Act, R.S.C. 1952, c. 148, s. 12(1)(a)(b)—"An outlay . . . on account of capital" or "an outlay . . . for the purpose of gaining income"—Legal expenses incurred to secure an existing right to income from an estate an outlay on account of capital and non-deductible from income—Appeal allowed.

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Respondent was bequeathed an income for life by the will of her first husband through the exercise of a power of appointment conferred upon him by the will of his father. After the death of her first husband respondent remarried. Her right to continue to receive the income was contested and the trustees of the father's estate applied to the Supreme Court of Ontario for advice and direction on the question of whether or not respondent was entitled to the income bequeathed to her by the exercise of the power of appointment. The matter was finally decided by the Court of last resort in Canada in favour of respondent who was represented by counsel throughout all proceedings. In computing her income tax return for the taxation year 1955 respondent deducted the amount of money she had paid her lawyers in that year for such legal services. That amount was added to her declared income by the Minister of National Revenue and an appeal by respondent to the Income Tax Appeal Board was allowed. From that decision the Minister appealed to this Court.

Held: That the outlay made by respondent and under consideration in this appeal was one made for the purpose of protecting an existing asset from extinction, it was not an expenditure of a recurring nature as the litigation settled for all time the respondent's right to a share in the income.

2. That the outlay was on account of capital and non-deductible by virtue of the provisions of s. 12(1)(b) of the *Income Tax Act.*

APPEAL from a decision of the Income Tax Appeal Board.

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

Donald Guthrie, Q.C. and *D. Andison* for appellant.

Terence Sheard, Q.C. for respondent.

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

CAMERON J. now (December 12, 1958) delivered the following judgment:

This is an appeal by the Minister of National Revenue from a decision of the Income Tax Appeal Board[1] dated March 31, 1958, allowing the appeal of the respondent from a reassessment made upon her for the taxation year 1955 and dated January 10, 1957. In computing her income tax return the respondent deducted the sum of $11,974.93, an amount which she had paid to her lawyers in that year for legal services. In assessing the respondent, that amount was added to her declared income. Mr. Fisher of the Income Tax Appeal Board,

[1] 19 Tax A.B.C. 176.

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being of the opinion that the expenditure was one made for the purpose of gaining income from property and thus within the exception found in s. 12(1)(*a*) of *The Income Tax Act* and not within the prohibiting provisions of s. 12(1)(*b*), allowed her appeal.

The facts are not in dispute. No oral evidence was tendered at the hearing of this appeal, the parties relying on the pleadings and the documentary material before the Income Tax Appeal Board.

The expenditure in question was made under the following circumstances. The respondent's former husband was John Alexander Russell, a son of the late Thomas Alexander Russell, a wealthy manufacturer and executive who died testate on December 29, 1940. By his father's last Will and Testament and Codicils thereto, the said son John Alexander Russell became entitled to one-third of the residue, one-half of which was payable at the "period of division", namely the date of his mother's death, and the remaining one-half thereof five years from the "period of division", with certain rights of income therefrom in the meantime. The Will further gave John Alexander Russell certain powers of appointment to his issue if he died before receiving the corpus of his share. His father's Will also provided:

> Provided if he leaves a widow him surviving, he may leave the income from the whole or any part of such share to his widow during any part of the remainder of her lifetime.

John Alexander Russell died on August 8, 1950, prior to the death of Mrs. T. A. Russell who died on September 20, 1953. He left no issue him surviving. By his Will the income from his estate with certain powers of encroachment on capital was left to his widow, the respondent herein. Further by his Will, he referred to his estate as including any property over which he had any power of appointment and including all benefits derived or accruing to him under the Will of his late father.

Following the death of the widow of Thomas Alexander Russell and the re-marriage of the respondent, the trustees of the father's estate were concerned as to the right of respondent to receive further income from that estate, and, acting upon the advice of their solicitors, a motion was

launched before the Supreme Court of Ontario under the provisions of Rule 600 of the Rules of Practice and Procedure, for the advice and direction of the Court on the following questions:

(1) What is the extent of the power of appointment given by the donor, the late Thomas Alexander Russell by the said Will to the late John Alexander Russell in respect of the disposition of income on the share of the said John Alexander Russell? and

(2) Has the said John Alexander Russell as donee of the power properly appointed and executed the same under the terms of his Will?

The motion was heard by Mr. Justice LeBel who held as follows:

(2) This Court doth declare that the power of appointment given to John Alexander Russell of the income from his share of the estate of Thomas Alexander Russell, deceased, under para. 9(e) of the last Will and Testament of Thomas Alexander Russell was validly exercised by the last Will and Testament of the said John Alexander Russell AND DOTH ORDER AND ADJUDGE THE SAME ACCORDINGLY.

Upon appeals to the Appellate Division of the Supreme Court of Ontario and to the Supreme Court of Canada that decision was upheld.

The party and party costs of the respondent in that litigation were paid out of the estate of Thomas Alexander Russell. In addition, however, the respondent was called upon to pay and did pay her solicitors the sum of $11,974.93 as solicitor-and-client costs. It is the deductibility of that amount that is now questioned.

Before turning to a consideration of the applicable law, it will be convenient to summarize briefly the basic facts, none of which are in dispute. The respondent's right to a portion of the income from the residue of her father-in-law's estate came into existence at the time of her husband's death although like her husband she was not entitled to any benefit from that right until the "period of division", namely upon the death of Mrs. T. A. Russell. Her right did not come into being as a result of the litigation to which I have referred, the Court's decision merely affirming such right. Similarly, her right did not arise from the expenditure of the amount in question; such expenditures were incurred in defending an already existing right, one of her husband's family having disputed her right to benefit in any way from the income of her father-in-law's estate.

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The question is to be determined by a consideration of these facts and of the provisions of paras. (*a*) and (*b*) of s-s. (1) of s. 12 of *The Income Tax Act*, R.S.C. 1952, c. 148 which read as follows:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
>
> (*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this part.

Mr. Sheard, counsel for the respondent, on whom the burden lies, submits that the outlay in question falls within the exception in para. (*a*) as one having been made for the purpose of gaining or producing income from property; that it was not a payment on account of capital and therefore is not excluded from deduction by reason of para. (*b*).

Mr. Guthrie, counsel for the Minister, takes the contrary view and submits that the expenditure was a payment on account of capital and is therefore non-deductible. Alternatively, he says that it is not an outlay for the purpose of gaining income from property and consequently is barred by the terms of para. (*a*).

Counsel agreed, and I think rightly so, that if the expenditure were barred by the provisions of para. (*b*) that would end the matter and para. (*a*) need not be considered. (See *Thompson Construction (Chemong) Ltd. v. M. N. R.*[1]).

In my view, the only part of para. (*b*) that would have any application to this case is the phrase "a payment on account of capital", and the question narrows down to this: "Were these legal expenses a payment on account of capital?"

The term "capital" is, of course, not defined in *The Income Tax Act*. Lord Atkinson in *Scottish North American Trust v. Farmer*[2] said that "Capital when used in these statutes, unless the context does not otherwise require, should be construed in its ordinary sense and meaning".

[1] [1957] Ex. C.R. 96 at 101. [2] 5 T.C. 693 at 706.

The answer to the question which I have posed depends upon the nature and quality of the right which the respondent had and in the defence of which the outlay was made. If it was a capital asset I am bound, I think, by the decision of the Supreme Court of Canada in *Dominion Natural Gas Co. Ltd. v. M. N. R.*[3], to find that such outlay was one on account of capital and therefore non-deductible. Further reference to that case will be made later.

Upon first consideration and since Mrs. Evans received only income from her right, the expenditures might seem to have been made not on account of capital but on account of income. That would, I think, have been the case had she in any year found it necessary to lay out money for legal expenses to enforce payment of the quarterly or annual income when the right to receive it was not in question but the trustees had failed to pay it over. Such a case would have been similar to one in which a landlord was required to pay legal expenses in collecting his rent. That, however, was not the case here. What was in dispute was not the *amount* of income to which she was entitled but whether or not she was entitled to anything. It was her right to income which was disputed on the ground that her father-in-law's Will did not confer on her husband the power to appoint the income to her in the circumstances; and even if it had done so the power was not validly exercised. In my opinion, what the respondent had was a life estate or a life interest in the income from a portion of the residue of her father-in-law's estate. That right must be distinguished from the income which flowed therefrom to her as a result of her ownership of the right. While it was an intangible right, I think it would normally be considered a proprietary right—something which the respondent possessed to the exclusion of all others and quite apart from the fact that by the provisions of s. 139(1)(*ag*) the word "property" includes "a right of any kind whatsoever". That right was something capable of evaluation as, for example, by the succession duty officers or by actuaries. It could be sold or pledged. Had that right been purchased, for example, by an investment corporation, the right in its

[3] [1941] S.C.R. 19.

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hands would, I think, have been considered as a capital asset. In my view, it was a capital asset and the source of her income.

Mr. Sheard, counsel for the respondent, contends, however, that even if Mrs. Evans' right is a capital asset, the outlay in question, on the authorities which he cited, should not be found to be one on account of capital. His main point is that the expenditure did not bring into existence or in any way affect the capital asset which was something she had from the moment of her husband's death. It was, he said, an outlay made to preserve something which Mrs. Evans already had and that is undoubtedly so.

The English and Canadian authorities are not in agreement as to the manner in which such outlay should be treated for the purpose of income tax. Mr. Sheard relies mainly on the case of *Southern v. Borax Consolidated Ltd.*[1]. There the taxpayer incurred legal expenses in defending the title to real estate in California owned by one of its subsidiaries but which for income tax purposes was considered to be carrying on the business of the taxpayer. The General Commissioners held that the sum in question was wholly and exclusively laid out for the purpose of the trade. On appeal Lawrence J. held that the decision of the Commissioners was right. He said in part at p. 116:

> In my opinion the principle which is to be deduced from the cases is that when a sum of money is laid out for the acquisition or the improvement of a fixed capital asset it is attributable to capital, but that if no alteration is made of a fixed capital asset by the plaintiff, then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the Company.

And at p. 120 he added:

> It appears to me that the legal expenses which were incurred by the respondent company did not create any new asset at all but were expenses which were incurred in the ordinary course of maintaining the assets of the company, and the fact that it was maintaining the title and not the value of the company's business does not, in my opinion, make it any different.

[1] [1941] 1 K.B. 111.

In the *Borax* case Lawrence J. quoted with approval the statement of Sargant L. J. in *B. W. Noble's* case[1]:

> The object (of the expenditure) was that of preserving the status and the reputation of the Company which the directors felt might be imperilled . . . To avoid that and to preserve the status and dividend earning power of the Company seems to me to be a purpose which is well within the ordinary purposes of the trade . . . of this Company.

Counsel for the respondent also referred to *Morgan v. Tate and Lyle Ltd.*[2]. There the taxpayer had expended large sums of money in a campaign opposing the nationalization of its sugar business. It was held that the sums were deductible as monies spent to preserve the very existence of the company's trade.

Under the Canadian taxing Acts the decisions, with one exception, have been to the contrary. The leading case on this point is that of the Supreme Court of Canada in *Dominion Natural Gas Co. Ltd. v. M. N. R.*[3]. There the taxpayer had expended a large sum of money in successfully defending its right—a franchise from the city of Hamilton to distribute gas. The right of the company to earn income from the franchise was attacked but the expenses were disallowed as being "an outlay on account of capital".

Again in *Siscoe Gold Mines v. M. N. R.*[4], the taxpayer incurred legal expenses in defending its title to certain mining properties. In his judgment the learned President of this Court declined to follow the decision in the *Borax* case and stated at p. 265:

> In my view it is established that legal expenses incurred by a taxpayer in maintaining the title to his property or protecting his income when earned, or in connection with the financing of his business, are not directly related to the earning of his income and are not allowed as deductions in computing the gain or profit to be assessed.

In reaching that conclusion the President followed the principles laid down in the *Dominion Natural Gas* case.

One Canadian case, however, was decided in favour of the taxpayer. I refer to the case of *Hudson's Bay Co. v. M. N. R.*[5]. There the Hudson's Bay Co. incurred legal and other expenses in an action brought by it in the United States against a company—the Hudson's Bay Fur Co.

[1] [1927] 1 K.B. 719.
[2] [1955] A.C. 21.
[3] [1941] S.C.R. 19.
[4] [1945] Ex. C.R. 257.
[5] [1947] Ex. C.R. 130.

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Inc.—for damages and an injunction to restrain it from carrying on business in that or any similar name. The outlay was therefore one incurred for the purpose of protecting its trade name—an asset of great value. It was held that the expenses were deductible. So far as I am aware, that decision has not been followed in any other case.

In the case of *Kellogg Co. of Canada Ltd. v. M. N. R.*[1], the taxpayer had paid certain legal fees in an action brought against it for damages because of its user of a registered trade mark of a competitor. The late President of this Court distinguished that case from the *Dominion Natural Gas* case by pointing out that there the expenses were not incurred "in the process of earning the income" but rather for the preservation of "an asset or advantage".

In the *Kellogg* case, however, he was of the opinion that the taxpayer had incurred a business difficulty which it had to get rid of if possible in order to continue the sales of its products as it had in the past. The decision was upheld in the Supreme Court of Canada[2], but on other grounds, Duff C. J. C. stating:

> The right upon which the respondent relied was not a right of property, or an exclusive right of any description, but the right (in common with all other members of the public) to describe their goods in the manner in which they were describing them.

While that decision is not directly in point, it suggests strongly that had the expenditure been made in defending a property right its deduction would have been disallowed as being an outlay on account of capital.

While the decisions in the *Dominion Natural Gas* and the *Siscoe Gold Mines* cases were referable to the provisions of s. 6 of *The Income War Tax Act,* I am of the opinion that they are equally applicable to the section of *The Income Tax Act* now under consideration so far as the facts of this case are concerned.

Being of the opinion as stated above, that the right which Mrs. Evans had was a capital asset and considering that the principles laid down in the *Dominion Natural Gas* case are binding upon me, I have come to the conclusion that the outlay here in question was one made for the

[1] [1942] Ex. C.R. 33. [2] [1943] S.C.R. 58.

purpose of protecting an existing asset from extinction. The expenditure was not of a recurring nature as the litigation settled for all time the respondent's right to a share in the income. Consequently, it was an outlay on account of capital and is barred from deduction by the provisions of s. 12(1)(*b*) of the Act.

In view of this finding, it becomes unnecessary to consider whether or not the payment falls within para. (*a*) of that subsection.

In the result, the appeal of the Minister will be allowed, the decision of the Income Tax Appeal Board set aside and the re-assessment made upon the respondent affirmed, the whole with costs.

Judgment accordingly.