BETWEEN:

BEDFORD OVERSEAS FREIGHTERS LIMITED ..... APPELLANT;

AND

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

*Revenue—Income tax—Income Tax Act 1948, S. of C. 1948 c. 52, s. 12(1)(a)—"An outlay or expense made for the purpose of gaining or producing income from a property or a business of the taxpayer"—Money paid to obtain cancellation of a charter party to escape the incurrence of losses by a company engaged solely in business of chartering ships for hire held properly deductible from income—Appeal allowed.*

Appellant is an incorporated company whose only business is that of chartering ships for hire. One vessel owned by it, namely, the *Bedford Prince* was chartered to Alpina Steamship Co. Inc. for a minimum period of ten months and a maximum period of twelve months from the date of delivery about August 16, 1951, at Tel Aviv, Israel. After loading in Turkish ports the *Bedford Prince* set out for Baltimore, Maryland. Due to the necessity of urgent major repairs to the ship causing delay with loss of use and damages for loss of freight and other matters, the appellant arranged with

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the Alpina Company for annulment of the charter party on certain conditions and in 1952 paid to Alpina Company the sum of $130,203.44 as covenanted in the agreement of annulment. This sum was treated by appellant as an operating expenditure chargeable against revenue and was claimed as such by appellant in computing its income tax for 1952. This claim was disallowed by the Minister of National Revenue and an appeal from such disallowance to the Income Tax Appeal Board was dismissed. Appellant now appeals to this Court.

*Held:* That the sum paid by appellant for cancellation of the charter party was one made "for the purpose of gaining or producing income from the property or a business of the taxpayer" within s. 12(1)(*a*) of the *Income Tax Act*.

2. That a forfeit payment of such nature is a normal risk integrated with appellant's regular marine operations.

3. That the amount paid by appellant to Alpina Steamship Co. is properly deductible from appellant's income tax for 1952 and the appeal is allowed.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Dumoulin at Halifax.

*H. B. Rhude* for appellant.

*A. G. Cooper, Q.C.*, and *W. R. Latimer* for respondent.

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

DUMOULIN J. now (December 22, 1958) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board[1] dismissing appellant's appeal against the income tax assessment for the year 1952.

Those facts, from which the instant litigation arose, are accurately set out in a well prepared memorandum, including also the complete text of the argument submitted to the Court by appellant's counsel. I may, therefore, closely adhere to that recital insofar, of course, as it does not overstep the line of uncontested points.

[1] 17 Tax A.B.C. 452.

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Bedford Overseas Freighters Limited (hereinafter called the "Bedford Company") obtained corporate powers under the laws of Nova Scotia in 1950. Its objects, duly stated in the Memorandum of Association (ex. 1), comprise those of owning and chartering ships for hire. With this end in view, the Bedford Company, shortly after its formation, acquired three cargo vessels, of which, the *Bedford Prince,* constitutes the subject-matter of this case. These ships, as alleged, "were owned solely for the purpose of being chartered to others and all revenues which the Bedford Company has ever received have been in the form of charter hire".

From 1950 to 1955 inclusive, Bedford Company "entered into fifty-six separate charters in respect of these vessels", and it is accurate to hold that chartering ships for hire was the only business carried on by the Company.

"On April 18th, 1951, the Bedford Company chartered the *Bedford Prince* to Alpina Steamship Co. Inc. for a minimum period of ten months and a maximum period of twelve months from the date of delivery", which eventually occurred at Tel Aviv, Israel, about August 16, 1951 (ex. 4). More accurately this contract was implemented through Petmar Agencies Inc., as agents for the appellant.

This ship, after loading in Turkish ports, weighed anchor for Baltimore, Md. From then on, some quite untoward happenings set in. The boilers operated inefficiently, making a refuelling stop at Bizerta, Tunisia, imperative, and this predicament worsened to such an extent that "at one point the engines did not develop sufficient power to give the vessel steerage-way".

Beyond Gibraltar, the *Bedford Prince* had to put into Horta for temporary repairs, which failed to remedy the crippling disability. It then became apparent that extensive reconditioning was required, pending which the vessel simply could not continue in service. It is also mentioned, and quite plausible, that continual complaints about the ship's unseaworthiness were received from her charterers, Alpina Steamship Company.

Since major and protracted repairs had become unescapable, the owners saw only one way out of what otherwise would prove to be a most costly complication (claims for loss of use of the ship; damages for loss of freight; off-hire, etc.) and that consisted in obtaining a cancellation of the charter-party.

Negotiations to this effect were initiated, culminating in the agreement of November 23, 1951, (ex. 7), whereby the Bedford Company and Alpina Steamship Co. Inc. annulled the charter-party on the following conditions, reproduced from page 4 of appellant's précis:

(*a*) That the Charter Party be terminated and the ship redelivered to the Bedford Company when its cargo was discharged at Baltimore instead of at the normal termination of the Charter Party; and

(*b*) That the Bedford Company pay to Alpina Steamship Co. Inc. the sum of $130,000.00 (United States currency) on redelivery of the ship to it in Baltimore.

The pertinent indenture, exhibit 7, also provided for the contingency of total loss before redelivery to owners, one of the two contracting parties being Petmar Agencies, Inc. "as Agents for Owners".

Redelivery of the *Bedford Prince* took place on or about February 16, 1952, and the Bedford Company duly paid the covenanted sum to Alpina Steamship Co. Inc. by a cheque (ex. 10) for $130,203.44, Canadian currency. Thence originates the difficulty. Figuring its income for the taxation year 1952, appellant treated this payment of $130,203.44 as an operating expenditure chargeable against revenue. This assumption met with departmental disallowance, on the grounds that such an outlay was not incurred for the purpose of gaining or producing income, within the purview of s. 12 of the Act, para. (a), ss. (1), but constituted a capital expense within the meaning of para. (*b*), ss. (1) of said s. 12.

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Among several reasons in support of its appeal, the Bedford Company submits that (*vide* Notice of Appeal, p. 6) this payment

> 27 . . .
>
> (*a*) was made in the ordinary course of business of the Appellant;
>
> (*b*) is properly deductible from income by the ordinary principle of commercial trading and accepted business and accounting practice;
>
> (*c*) was an outlay or expense made or incurred by the Appellant for the purpose of gaining or producing income from its business;
>
> * * *
>
> 28 . . . was made to effect a saving to the Appellant's working expense, to avoid "off-hire" claims and to earn income.

In para. 20, it is mentioned that from May 31, 1952, until August of that year, ". . . the Vessel carried out a number of profitable voyage charters". This fact, maturing many months after the cancellation could have no direct bearing on it and, I presume, serves as a little "extra trimming".

The issue, as joined, hinges on whether this indemnity of $130,203.44 (Canadian) was, or was not, really incidental to appellant's regular line of business.

An approach to this problem is concisely formulated in re: *The Royal Trust Co. v. The Minister of National Revenue*[1], wherein Thorson P. applying anew those dicta set out in *Imperial Oil Limited v. The Minister of National Revenue*[2], wrote that:

> . . . it may be stated categorically that in a case under *The Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of section 12(1)(*a*) of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of section 12(1)(*a*) and, therefore, within its prohibition.

[1] (1957) 11 D.T.C. 1055 at 1060. [2] [1947] Ex. C.R. 527 at 531.

The pronouncement above is moreover quite in line with those of Lord Halsbury L. C. and Earl Loreburn, of several decades past. In *Gresham Life Assurance Society v. Styles*[1] the then Lord Chancellor spoke thus:

> Profits and gains must be ascertained on ordinary principles of commercial trading.

And in *Usher's Wiltshire Brewery, Limited v. Bruce*[2], Earl Loreburn approved the statement that:

> profits and gains must be estimated on ordinary principles of commercial trading by setting against the income earned the cost of earning it.

Evidence on this score was adduced by Messrs. George M. Murray, a Chartered Accountant, connected with the Halifax firm of Nightingale, Hayman & Co., and James R. McGrath, a shipbroker from Richwood, New Jersey.

Appellant's fiscal year ends on August 31; Mr. Murray audited the Company's books for 1952. Informed by his clients, Bedford Freighters Ltd., that a forfeit of $130,203.44 (Canadian) had been paid to excuse the S. S. *Bedford Prince* from its charter-party, due to her defective condition and with the expectation, after repairs, of entering upon still more remunerative business, Murray mentally deducted this outlay from the Company's Profit and Loss Statement, p. 5 of ex. 13, where the extension appears as $134,909.94, the increased total of no bearing on the issue.

James R. McGrath describes his calling, shipbroker, as a brokerage agent engaged in procuring cargoes or charter-parties for ship-owners, acting as intermediary between lessors and prospective charterers or lessees. Since 1948, he belongs to a partnership known as Meridian Marine Company. "On an average," testifies McGrath, "my company concludes about one hundred charter parties per year, with a cancellation percentage of approximately two per centum".

This witness mentions four recent cancellations of charter-parties, of which the latest concerned the SS. *Delphi,* subsituted to S.S. *Roxiana.* He points out that should a ship prove unseaworthy or otherwise unfit for some stipulated voyage and conditions, "such as becoming too slow or consuming excessive quantities of fuel, then her charterers would doubtless apply for commensurate relief, possibly extending to formal cancellation".

[1] [1892] A.C. 309 at 316. [2] [1915] A.C. 433 at 444.

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Accordingly, Mr. McGrath views this actual annulment of the charter-party in the light of "a proper and admissible business practice".

It should be added that inferentially I could not see my way clear to any other interpretation. Even one untrained to the complexities of scientific bookkeeping knows that any profit, accruing from a property lease, constitutes an operating gain automatically written into the revenue column. Correlatively all losses from the same source are chargeable against income. Credits and debits of like origin correspondingly offset each other in parallel entries.

I therefore hold this amount was correctly deducted from revenue, a subtraction in no wise inconsistent with ordinary principles of commercial trading and well accepted rules of accounting practice.

Section 12(1)(a) of the 1948, *Income Tax Act* (S.C. c. 52) reads thus:

> 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,

The taxing enactment being such, we must now seek to ascertain whether or not this compensatory "outlay or expense . . . was incurred by the taxpayer" for those purposes foreseen by statute as constituting a "saving" exception. Respondent's counsel relied on a cross-examination of witnesses, that failed to disprove any material disclosure, and upon his construction of the law, about which, henceforth, I need be solely concerned. Before so doing, however, I would briefly restate the matter in closer connexity to its second stage, namely as an outlay made within the statutory exception.

Confronted with the financially unfathomable predicament of footing damage claims, consequent upon the lease of an unseaworthy vessel, Bedford Overseas Freighters Limited preferred, and one might think advisedly so, to cancel it through payment—or loss—of a large sum, $130,203.44. Had the charter-party run out its normal course, no doubt subsists that all net receipts therefrom would be profits taxable as such. But instead of profits a heavy expenditure ensued, in order to curtail more dire

results. Then an even measure of appreciation must obtain: since gains are fit subject-matter for taxation, losses also should be deductible from a taxpayer's yearly income. Such is, I believe, the view-point of the law. References to a few authoritative decisions will focus the issue in a clearer light.

Port Elizabeth Electric Tramway Ltd., a South African company, had to pay compensation to the widow of a motorman accidentally killed. The company likewise incurred litigation costs which it sought to deduct. On appeal, from the Commissioner's adverse finding, to the Cape Provincial Division of the Supreme Court[1], Watermeyer A. J. P. partly reversing the decision, said, at p. 16:

> Income is produced by the performance of a series of acts, and attendant upon them are expenses. Such expenses are deductible expenses, provided they are so closely linked to such acts as to be regarded as part of the cost of performing them.

And at p. 17:

> All expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

Closer still to our purpose is the exhaustive review in re: *Imperial Oil Limited v. Minister of National Revenue*[2]. In that case, the Court allowed appellant a deduction of $526,995.35, amount paid by it in settlement of damages arising out of a collision at sea between one of its oil tankers, the motorship *Reginalite*, and the steamship *Craster Hall*, owned by United States Steel Products Company.

Thorson P. held that:

> if a particular disbursement or expense is not within the express terms of the excluding provisions of section 6(*a*), its deduction ought to be allowed if such deduction would otherwise be in accordance with the ordinary principles of commercial trading or well accepted principles of business and accounting practice.

For all practical ends of this litigation, should any notional distinction differentiate a collision at sea from a disability at sea?

[1] [1935] 8 S.A. Tax Cases 13. [2] [1947] Ex. C.R. 527.

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The fortuitous occurrence of a deficit instead of a profit leaves the legal climate unaltered; to this effect, I will again quote two excerpts from the President's speech in the lawsuit just mentioned, at pp. 543 and 545.

*Page 543:*

> . . . while the section [6(*a*)] by implication prescribes that the expenditure should be made for the purpose of earning the income it is not a condition of its deductibility that it should actually earn any income. The view that an item of expenditure is not deductible unless it can be shown that it earned some income is quite erroneous. It is never necessary to show a causal connection between an expenditure and a receipt. An item of expenditure may properly be deductible even if it is not productive of any income at all and even if it results in a loss: *Commissioners of Inland Revenue v. The Falkirk Iron Co. Ltd.* ([1933] 17 T.C. 625).

And at *p. 545:*

> These are the disbursements or expenses referred to in section 6(*a*) [-(section 12(1)(*a*) of 1948 S.C. c. 52),-] namely, those that are laid out or expended as part of the operations, transactions or services by which the taxpayer earned the income. They are properly, therefore, described as disbursements or expenses laid out or expended as part of the process of earning the income. This means that the deductibility of a particular item of expenditure is not to be determined by isolating it. It must be looked at in the light of its connection with the operation, transaction or service in respect of which it was made so that it may be decided whether it was made not only in the course of earning the income but as part of the process of doing so.

A renewed application of this line of thought was made in *The Royal Trust Company v. Minister of National Revenue*[1] whereby the appellant firm successfully claimed as a deductible expense its practice of paying social club dues and initiation fees for executives and senior personnel.

At the argument, I gathered the impression that respondent's counsel had some doubts on the score of reconciling the transaction at bar with the prohibitory language of s. 12(1)(*a*). His submissions in the matter, albeit not lacking in originality, struck me as rather odd withal. They appear *in extenso* on pp. 3 and 4 of a memorandum on behalf of respondent and apply in two other cognate cases, hence the plural form. In brief, it is contended that:

> (*c*) the ships formed part of the fixed capital of the Appellants;
>
> (*d*) . . . the fixed capital of the Appellants as represented by the ships was encumbered by these Charter-parties;
>
> * * *

[1] (1957) 11 D.T.C. 1055.

(*f*) the Appellants *voluntarily* chose to bring the charterparties to an end before the expiration of their terms.

* * *

7. The effect of doing so was that the Appellants acquired or reacquired their fixed assets, namely, the ships.

8. It is clear that money laid out to acquire fixed assets is a capital outlay. For example, money paid in the first instance to acquire ships, or a building, or any other fixed asset, is without question a capital outlay. . . .

A conclusion follows which would be unassailable, if only the premises had painted a different picture. I quote:

It is submitted that money paid to reacquire fixed assets *or* to regain assets parted with can be in no different category. The ships were fixed assets when they were first acquired; they retained their character of fixed assets; in effect, an interest in them was sold by the charterparties . . . when that interest is reacquired the money spent in the reacquisition is a capital outlay.

So circuitous a reasoning seems to lead up a blind alley; at all events it fails to smooth an apparently hoped-for access to the haven of ss. (1)(*b*) of s. 12, which I need not reproduce.

Suffice it to point out, if needs must, that Bedford Overseas Freighters Limited, upon leasing the *Bedford Prince* to Alpina Steamship Co., never parted with their ownership but merely with the temporary management and use of this steamer. How then could appellants reacquire an asset which at all material times remained their undoubted property and, moreover, who would then be deeding an acquisition title to whom?

The Court can find no distinguishing factor between this case and those copiously referred to *supra*.

A practically unescapable cancellation of the charterparty necessitated by the urgency of major repairs was obtained and paid for, at a price of $130,203.44, within the ambit of the permissive clause in s. 12(1)(*a*), namely "for the purpose of gaining or producing income from property or a business of the taxpayer."

A forfeit payment of this nature is a normal risk integrated with appellants' regular marine operations.

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For the reasons given, the amount of $130,203.44 (Canadian currency) is properly deductible from appellant's income for 1952. This sum was incorrectly added to the assessment which should be amended accordingly. The appeal must, therefore, be allowed with costs.

*Judgment accordingly.*