1957
April 15
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Sept. 4

DISTILLERS CORPORATION SEAGRAMS LIMITED ..... APPELLANT;

AND

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

Revenue—Income tax—Holding company's income derived from income and interest paid by subsidiaries—How deduction of expense determined—The Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(a) and 12(1)(c), 127(1)(n).

Section 12(1) of *The Income Tax Act* provides that in computing income no deduction shall be made in respect of

(*a*) an . . . expense except to the extent that it was made . . . by the taxpayer for the purpose of producing income from a business of the taxpayer;

(*c*) an . . . expense to the extent that it may reasonably be regarded as having been made for the purpose of producing exempt income in connection with property the income from which should be exempt.

Section 127(1)(*n*) of the Act defines "exempt income" as "money . . . received or acquired by a person in such circumstances that [it is] by reason of any provision of Part I, not included in computing his income."

The appellant, a holding company, derived over 90% of its income from shares held in other companies, mostly wholly-owned subsidiaries, and the remainder from interest on debentures and loans to them, plus a small amount of exchange profits. In filing its income tax returns for 1950, 1951 it deducted annual expenses incurred in the general administration of its business less a small fraction which it attributed to dividends from companies it did not control. The Minister apportioned the expenses between the dividend and other income in proportion to the respective amounts of such income and disallowed the portion of the expenses attributed to the dividend income. On an appeal from a judgment of the Income Tax Appeal Board affirming the assessment.

Held: That under both ss. 12(1)(a) and 12(1)(*c*) of *The Income Tax Act* the limitation imposed on the deductibility of an expense is determined by the purpose for which it was incurred, rather than by the result.

2. That the deductibility or non-deductibility of an expense is not dependent on its having, produced or not produced, or even been calculated or likely to produce income, but rather by consideration of how the income was to be produced from the appellant's business.

3. That the appellant's capital was invested in shares and loans to subsidiaries and was thus empolyed for the purpose of gaining income in the form of dividends and interest.

4. That the expenses in question were incurred generally for the same purpose and, an apportionment being necessary to determine that portion of them which may reasonably be regarded as having been incurred for the purpose of gaining income, that proportion of them which the appellant's investment holdings in shares bears to its total investment may reasonably be regarded as having been incurred for the purpose of producing dividend income.

5. That such basis meets the test of s. 12(1)(*c*) and that applied by the Minister does not.

APPEAL from a decision of the Income Tax Appeal Board[1].

The appeal was heard before the Honourable Mr. Justice Thurlow at Montreal.

Lazarus Phillips, Q.C. and *Philip Vineberg* for appellant.

Maurice Paquin, Q.C. and *Paul Ollivier* for respondent.

THURLOW J.:—This is an appeal from the judgment of the Income Tax Appeal Board[1], dismissing an appeal by the appellant against income tax assessments for 1950 and 1951.

[1] 12 Tax A.B.C. 36; 55 D.T.C. 18.

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The matter in issue is the right of the appellant in computing its income for income tax purposes to deduct certain expenses incurred by the appellant in each of the years in question. In both years the bulk of the appellant's income (more than ninety per cent of it) was from dividends on shares which the appellant held in other companies, most of which were wholly owned subsidiaries of the appellant. These dividends were all exempt from tax under s. 27 of *The Income Tax Act,* S. of C. 1948, c. 52, as amended by s. 12 of S. of C. 1949 (2nd Sess.), c. 25. The remainder of the appellant's income was interest on debentures of and loans to some of the appellant's subsidiary companies and some small amounts of exchange profits. In each of the years in question, annual expenses were incurred for a number of items pertaining to the general administration of the appellant corporation and in reporting its income in its income tax returns, the appellant deducted the expenses so incurred (less a small fraction which it attributed to dividends from companies which it did not control) from its gross income receipts. The Minister, in making the assessments, apportioned the expenses between the dividend and other income in proportion to the respective amounts of such income and disallowed as a deduction the portion of the expenses so attributed to the dividend income. The appellant appealed to the Income Tax Appeal Board, and it is from the judgment of the Board dismissing such appeal that the present appeal is brought. The issue in the appeal is whether or not, in computing the appellant's income for the years in question for the purposes of *The Income Tax Act,* the appellant is entitled to deduct any portion of the amount so disallowed.

The nature of the activities or means by which the appellant's income was obtained is outlined as follows in paragraph 2 of the notice of appeal, which was admitted by the Minister in his reply:

> 2. The Appellant is a holding company which has in its virtually static portfolio the shares, debentures and other securities, of its wholly-owned or controlled subsidiaries. The status of the Appellant in this respect has been unchanged since it was organized. No measures are ever taken by the Appellant to change or switch any share investments or security holdings. Any changes in the holding of securities have been brought about merely through re-organizations from time to time of its subsidiaries by way of merger or consolidation, or as a result of the acquisition of shares of wholly-owned or controlled subsidiaries. These

subsidiaries are engaged in the alcoholic beverage business only, and there is no diversification of any investment portfolio in the sense applicable to investment trusts or other holding or security companies organized for the purpose of acquiring ownership of securities in a series of operating companies whose operations may be dissimilar, and as a rule are dissimilar one from the other. The Appellant is a holding company whose assets are more or less frozen and of a permanent nature. The Appellant as such is not engaged in the business of buying and selling securities, or even of acquiring securities of a diversified nature or otherwise for investment purposes.

This description was somewhat amplified by evidence that in 1950 the appellant neither acquired nor sold any shares and that in 1951 it sold no shares but invested $7,500 in shares of a subsidiary company. In the latter year its shareholdings declined as a result of the redemption by a subsidiary of a large block of redeemable shares held by the appellant. In 1950 loans totalling $610,523.67 were made to subsidiary companies and in 1951 new loans totalling $2,315,607.89 were made, bringing the total of monies on loan to subsidiaries to $17,983,615.17. The appellant's gross income receipts for the two years in question were as follows:

	1950	*1951*
Dividends	11,381,978.40	15,160,119.76
Interest	657,856.19	477,816.71
Exchange profits	1,096.79	78.59
	$ 12,040,931.38	$ 15,638,015.06

From these receipts the appellant sought in each year to deduct the following less the proportion thereof which the dividends from companies other than subsidiary companies bore to the whole income.

	1950	*1951*
1. General expense	288.87	1,167.65
2. Directors' fees	2,000.00	2,000.00
3. Provincial Capital Tax	1,550.10	1,550.00
4. Audit fees	5,275.32	7,622.65
5. Interest on bank loans	79,321.85	63,994.11
6. Legal fees	130.00	1,036.71
7. Stock transfer expense	49,585.42	69,079.59
8. Listing fee for common stock	3,987.50	3,842.50
9. Printing and Stationery	31,128.64	34,126.60
10. Proxy expense	429.87	298.02
	$173,697.57	$184,717.83

Of these total amounts the Minister, in assessing the appellant's income, disallowed as deductions from gross income $164,191.80 for 1950 and $179,072.88 for 1951 on the

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ground that they were applicable to non-taxable income. In each year the amount so disallowed was the proportion of the total expenses which the dividend income of the appellant bore to the total gross income receipts.

On the trial of the appeal, no witnesses were called by either party, but by agreement the evidence taken before the Income Tax Appeal Board was put in as evidence. This included the evidence of Mr. Andrew Maxwell Henderson, a chartered accountant who was the Secretary-Treasurer of the appellant company and who gave it as his opinion that all of the expenses in question were incurred to earn taxable income and none of them to earn inter-company dividends. Mr. Frank E. Sandilands, a chartered accountant associated with the appellant's auditors, on the other hand, expressed the opinion that the expenses in question were ordinary corporate expenses that a company must incur in corporate set-up when its shares are listed on various stock exchanges and that, according to accounting practice, they were properly deductible from income. It was his opinion that the audit expenses should not be attributed specifically to the earning of either the dividend or the interest income of the appellant and, when questioned as to the stock transfer expenses, he said that the item had as much to do with the earning of interest as it had to do with dividends from subsidiaries.

Briefly summarized, the evidence relating to the several specific items was as follows:

1. *General expense.* For 1950 this item included minor filing fees, charges on dividend cheques, and travelling expenses of directors in connection with the indebtedness of an American company to the appellant. No details of the amount spent on such travelling expenses was given. When asked as to the item of general expense for 1951, Mr. Henderson said: "That again consists of travelling on Distillers Corporation Seagrams Limited business principally with our American company in connection with interest and what-have-you that they are paying us—the paper work and what not required in connection therewith." He also said that no travelling was ever required in connection with the dividend income.

2. *Director's fees.* These were fees paid to two of the appellant's directors.

3. *Provincial Capital Tax.* These items were for taxes paid to the Province of Quebec under what was referred to as the *Quebec Corporate Tax Act.* The *Corporation Tax Act,* Statutes of Quebec 1947, c. 33, which I think is the statute referred to, imposes tax on corporations which carry on business in that province.

4. *Audit fees.* These were fees paid to the appellant's auditors.

5. *Interest on bank loans.* These items were for interest paid on the unpaid balance of two loans totalling $8,000,000 made in 1946 to assist in the redemption of preferred stock. No further detail was given as to what the sum borrowed was in fact used for.

6. *Legal fees.* For 1950 this item was for legal advice relating to Quebec succession duties, obtained for the benefit of certain non-resident shareholders. No explanation was given as to what the item was incurred for in 1951.

7. *Stock transfer expenses.* These were sums paid to two trust companies for their services as transfer agents and registrars of the appellant company's capital stock and to dividend disbursing agents for their services as such.

8. *Listing fees for common stock.* These were annual fees paid to the New York Stock Exchange for listing the appellant's common stock.

9. *Printing and stationery.* This item was for printing the annual report of the appellant to its shareholders and similar expense incurred in complying with extensive requirements of the New York Stock Exchange and the Security Exchange Commission.

10. *Proxy expenses.* These were sums paid to brokers for sending out proxies and annual report material to shareholders.

The Income Tax Act contains the following provisions relating to the deduction of expenses in computing income for income tax purposes:

> 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,
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> * * *

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(c) an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt.

Exempt income is defined as follows by s. 127(1)(n):

(n) "exempt income" means money, rights or things received or acquired by a person in such circumstances that they are, by reason of any provision in Part I, not included in computing his income and includes amounts deductible under section 27.

The position taken by counsel for the Minister in support of the disallowance was that all the expenses were incurred by the appellant in order to enable it to continue as a corporation, that without incurring them the appellant would have been unable to continue as a holding company and would accordingly have been unable to earn its income, that the expenses were thus incurred to earn income from the appellant's business of holding investments but cannot be traced exclusively to one type of income or another, that in this situation s. 12(1)(c) applies to prohibit the deduction of such proportion of the expenses as can reasonably be regarded as having been incurred for the purpose of gaining the dividend income which is exempt from tax, and that the portion of the expenses which can reasonably be regarded as having been incurred for the purpose of gaining or producing the dividend income is the proportion of them which the dividend income bears to the whole income.

In my opinion, the matter cannot be resolved in this way, nor can all of the expenses be dealt with in the same way. Both the position so taken and the assessment itself involve the underlying assumption or admission that, as claimed by the appellant, all of the expenses were incurred in fact for the purpose of gaining or producing income from the appellant's business. But for such an assumption or admission, no part of any of them could be allowed as a deduction for the deduction of the whole of them would be prohibited by s. 12(1)(a). Now, in my view, the evidence does not contradict or disprove this assumed fact in so far as it relates to the first five items of expense, that is to say, those for general expenses, directors' fees, Provincial Capital Tax, audit fees, and interest on bank loans, and to the legal fees as well for 1951. All of such expenses may very well have been incurred for the purpose of gaining or producing income from the appellant's business, and the evidence, so far as it goes, tends to support the fact so assumed.

In this situation, two questions arise on s. 12(1)(*c*); first, can these expenses reasonably be regarded as having been incurred to any extent for the purpose of gaining or producing exempt income, that is to say, dividends; and, secondly, if so, to what extent may they reasonably be so regarded?

In my opinion, the answer to the first of these questions is that, in the circumstances, these expenses can reasonably be regarded as having been incurred to some extent for the purpose of gaining or producing exempt income. Save in respect of travelling expenses, the amount of which was not given in evidence, I think the view of Mr. Sandilands that these items have as much to do with dividends as with interest income is preferable to that of Mr. Henderson, for I am unable to see how any of these expenses except the travelling expenses can be regarded as having been incurred for the purpose of gaining or producing interest income alone or dividend income alone. The fact is that they were incurred generally in the pursuit of income from the appellant's business, and, the purpose of that business being to gain income in the form of dividends from shares and interest from loans, it follows in my view that in the circumstances these expenses may reasonably be regarded as having been incurred to some extent for the purpose of gaining dividend income.

This brings me to the question of the extent to which these expenses may reasonably be so regarded. The Minister, as previously mentioned, apportioned the expenses between the interest and dividend income in proportion to their respective amounts. In so doing, he did not depart in principle from the method of apportionment which the appellant had used in calculating its income in its income tax return. But the appellant, in calculating its taxable income, had simply followed a formula which had been used and accepted in earlier years, and while the Minister was not bound to follow what was done in earlier years if it was not in accordance with *The Income Tax Act,* neither in my view is any inference of an admission as to the reasonableness of that method to be drawn against the appellant. The principle so followed, in my view, is not an appropriate one for determining the extent to which these expenses may reasonably be regarded as having been incurred for the purpose of gaining dividend income. It seems to me that

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the principle so applied involves and is based on the assumption that in some way the income of the appellant has been produced by or resulted from the incurring of the expense, an incident which is neither true in fact nor necessary in point of law. Under both ss. 12(1)(*a*) and 12(1)(*c*) the limitation imposed on the deductibility of an expense is determined by the purpose for which it was incurred, rather than by the result. Nor is the deductibility or non-deductibility of an expense dependent on its having produced or not produced or even been calculated or likely to produce income. In my opinion, the extent to which these expenses may reasonably be regarded as having been incurred for the purpose of gaining dividend income cannot be resolved by reference to the appellant's income receipts, but I think it can be resolved in a rough way by consideration of how income was to be produced from the appellant's business. The appellant's capital was invested in shares and in loans to subsidiary companies and was thus employed for the purpose of gaining income in the form of dividends and interest. The means of obtaining this income was that of holding the investments and receiving the income as it accrued. The expenses in question were incurred generally for the same purpose and in the same pursuit. An apportionment being necessary to determine, that portion of them which may reasonably be regarded as having been incurred for the purpose of gaining dividend income, I am of the opinion that the proportion of them which the appellant's investment holdings in shares bears to its total investment holdings may reasonably be regarded as the extent to which these expenses have been incurred for the purpose of producing dividend income. There may be other bases on which the apportionment might also be reasonably made, but in my view the one suggested meets the test of s. 12(1)(*c*), while that applied by the Minister does not.

Different considerations apply to the remaining items of expense, namely the legal expense for 1950, incurred for legal advice for the benefit of certain shareholders, and the stock transfer expense, listing fees for common stock, printing and stationery in connection with the annual meeting of shareholders and proxy expense. The purpose for which these expenses were incurred appears from the evidence, and I am quite unable to understand on what basis it can be

said that any of them was incurred for the purpose of gaining or producing income from the appellant's business or in the pursuit of its income-gaining activities. No doubt they are expenses which, as Mr. Sandilands said, must be incurred by a corporation whose shares are listed on the stock exchanges, but they are incurred in the course of the appellant's dealings with its own shareholders as shareholders and in connection with the administration incident to the capital structure and arrangements of the appellant, rather than in carrying out activities which form any part of the business or process or function or means by which the appellant's income is gained or produced. In my opinion, the evidence as to these expenses disproves the assumed fact on which the assessment was based because it shows that they were not incurred to any extent for the purpose of gaining or producing income from the appellant's business. Their deduction is, accordingly, prohibited by s. 12(1)(*a*), and not only a fraction but the whole of them should be disallowed as deductions.

In this view, it is unnecessary to consider whether or not the deduction of any of them is also prohibited by s. 12(1)(*b*).

In the result, the appellant is entitled to deduct the whole of the travelling expenses forming part of the items for general expense. The remainder of the items for general expense and the items for director's fees, provincial capital tax, audit fees, interest on bank loans, and legal expense for 1951 should be apportioned on the basis mentioned, and the appellant should be allowed to deduct the portion thereof not attributed to the investment holdings in shares, the dividends on which would be exempt from tax. No portion of the remaining items should be allowed as a deduction.

The appeal will be allowed and the assessments referred back to the Minister for revision in accordance with these reasons. As in the result the appellant obtains some of the relief sought, it is entitled to its costs of the appeal.

Judgment accordingly.