1951
Nov. 30
1953
Nov. 30

BETWEEN:

ELI LILLY AND COMPANY (CANADA) LIMITED ..... } APPELLANT;

AND

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

Revenue—Income Tax—The Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 5(jj)—Foreign exchange profit—Validity of assessment—Profit from trade or business.

The appellant bought all its raw material from its parent company in the United States and for the period from Sept. 15, 1939, to Dec. 31, 1945, its indebtedness amounted to $640,978.29 in United States dollars. During this period the United States dollar was at a premium of 10½ per cent over the Canadian dollar, the total amount of the exchange necessary to bring the indebtedness in United States dollars up to the indebtedness in Canadian dollars being $67,302.77. On July 5, 1946, the Canadian dollar rose to parity with the United States dollar and on October 22, 1946, the appellant was able to pay the above indebtedness with $640,978.29 in Canadian dollars, by the issue of additional shares, without payment of any exchange. In its profit and loss statement for 1946 the appellant showed the exchange as an item of income but in its income tax return claimed it as a deductible capital profit. The Minister in assessing the appellant for 1946 added the exchange back to the amount reported by it in its income tax return as an item of taxable income. An appeal to the Income Tax Appeal Board was dismissed and an appeal from its decision to this Court was taken.

Held: That the validity of an assessment does not rest on what a taxpayer has done in the past or what the taxing authorities have allowed him to do but must be determined in the light of the existing facts and the applicable law.

2. That the foreign exchange profit was received by the appellant in 1946 as a profit from its trade or business within the meaning of section 3 of the Income War Tax Act and was properly added back as an item of taxable income to the amount reported by it on its income tax return.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the President of the Court at Toronto.

R. B. Law, Q.C. for appellant.

J. Singer, Q.C. and *Miss H. Currie* for respondent.

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

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THE PRESIDENT now (November 30, 1953) delivered the following judgment:

This is an appeal from the decision of the Income Tax Appeal Board, *sub nom. No. 12* v. *Minister of National Revenue* (1), dated February 16, 1951, which, except for two items, dismissed the appellant's appeal from its income tax assessment for 1946.

In assessing the appellant the Minister added back to the amount reported by it on its income tax return, *inter alia,* the sum of $99,339.48 as foreign exchange profit and the sum of $3,145.00 as donations in excess of the 1940-41 average. The sum of $99,339.48 was made up of four items of foreign exchange on the indebtedness of the appellant, namely, $67,302.77 on its indebtedness to its parent company, Eli Lilly and Company of Indianapolis in the State of Indiana, one of the United States of America, for goods purchased from it in the period from September 15, 1939, when Foreign Exchange Control came into effect, to December 31, 1945, on open account, $3,140.21 on its indebtednes to its parent company for goods purchased from it in the period prior to September 15, 1939, on a prior account, $3,675.00 on its indebtedness to its parent company for money lent by it on its loan account and $25,084.16 on its indebtedness to another United States company, the Eli Lilly International Corporation for goods purchased from it during the year 1946. The Income Tax Appeal Board allowed the appellant's appeal to it in respect of the item of $3,675.00 and referred the item of $3,140.21 back to the Minister for reconsideration. On this appeal it is admitted that these two items should not have been included in the assessment. And counsel for the appellant abandoned its appeal in respect of the item of $25,084.16, so that the only amount of foreign exchange remaining in dispute in this appeal is the sum of $67,302.77.

The appellant also appealed against the addition of $3,145.00 to its assessment only to the extent that it included the sum of $2,500.00 which it paid in 1946 to the Foundation for the Advancement of Pharmacy. On the hearing of the appeal it was submitted that it had the right to claim this amount as an operating expense although it had never made any such claim in its income tax return

(1) (1950-51) 3 T.A.B.C. 387.

and could not, in view of Mr. Forster's evidence, have sustained such a claim if it had made one. It was plainly a donation. That being so, it was beyond the limit of the deductible donations allowed by section 5(jj) of the Income War Tax Act, R.S.C. 1927, chapter 97, and properly disallowed as a deduction.

Thus the only matter now in dispute is whether the sum of $67,302.77 was properly included in the appellant's assessment for 1946 as an item of taxable profit. This issue is a narrow one and the facts giving rise to it may be stated briefly. The appellant was incorporated on July 12, 1938, for the purpose of manufacturing, importing and selling drugs and chemical and biological products. Except for the qualifying shares of its directors it is the wholly owned subsidiary of Eli Lilly and Company of Indianapolis in the State of Indiana, one of the United States of America, which owned 45 shares in it of the par value of $100 each. Up to the end of the year 1945 it bought all its raw materials from its parent company and also borrowed some money from it. The purchases were in two accounts, one called the prior account, for the period up to September 15, 1939, and the other called the open account, for the period from September 15, 1939, to the end of 1945. As at December 31, 1945, the indebtedness of the appellant stood at $29,907.57 in its prior account, $640,978.29 in its open account and $46,646.86 in its loan account, making a total indebtedness of $717,532.72. The amounts of these items of indebtedness are all stated in terms of United States dollars. In this appeal only the indebtedness of $640,978.29 need be considered.

During the period of the open account in which this indebtedness was incurred the United States dollar was at a premium of 10½ per cent over the Canadian dollar. The build-up of the indebtedness is given in detail in Exhibit 1. This shows the indebtedness of the appellant to its parent company in each of the years 1939 to 1945 inclusive in Canadian dollars, in United States dollars and the amount of exchange necessary to bring the indebtedness in United States dollars up to the indebtedness in Canadian dollars. In its financial statements for these years the appellant showed its indebtedness to its parent company in United States dollars plus the exchange at 10½ per cent necessary

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to show it in Canadian dollars. In each of its income tax returns for these years it claimed the amount of this exchange as a deductible operating expense and this deduction was allowed by the taxing authorities although no expenditure was actually made. As at December 31, 1945, the total amount of the items of exchange thus claimed as deductible operating expenses came to $67,302.77. On that date the indebtedness of the appellant to its parent company amounted to $640,978.29 in United States dollars which, with the exchange, meant an indebtedness of $708,281.06 in Canadian dollars.

On July 5, 1946, the Canadian dollar rose to parity with the United States dollar and the appellant could then, if it had had the money, have paid its indebtedness to its parent company with $640,978.28 in Canadian dollars without any exchange. Instead, it allotted additional shares to its parent company in payment of its indebtedness and for a further advance of cash. On October 22, 1946, it allotted 7,450 shares of its capital stock to its parent company at the par value of $100 each making a total of $745,000. This paid off its total indebtedness of $717,532.72, which included the indebtedness of $640,978.29 on its open account, and a cash advance of $27,467.28. The appellant thus paid its indebtedness to its parent company with $640,978.28 in Canadian dollars. In its profit and loss statement for 1946, which it filed with its income tax return, it showed the sum of $99,339.48, which included the sum of $67,302.77, as an item of income under the head of "Foreign exchange premium reduction" but on its income tax return it claimed that it was entitled to deduct this amount as a capital profit from what would otherwise have been its taxable income. Then, as I have stated, the Minister added the sum of $99,339.48 back as an item of taxable income. The appellant objected to this on the ground that the rise in the Canadian dollar was in the nature of a fortuitous gain or a gain of a capital nature and the appellant then appealed to the Income Tax Appeal Board with the result which I have stated.

Counsel for the appellant contended that its indebtedness to its parent company was in United States dollars and that it paid this in kind with the issue of shares, that there were

no business transactions between it and its parent company in 1946, that the rise in value of the Canadian dollar in 1946 had nothing to do with its business in that year and was not a trade or business profit, that whatever benefit it received from exchange was in the years prior to 1946 when it was able to deduct the exchange as an operating expense and that it received no benefit in 1946. He also submitted that if the appellant did receive any benefit it was not a trading or business profit or an item of taxable income within the meaning of section 3 of the Income War Tax Act but a fortuitous or capital gain. He also urged that what the parent company did in 1946 in taking shares in the appellant since it already owned all its issued shares, except the qualifying ones, really amounted to a forgiveness of its indebtedness and was not income to it.

Counsel for the appellant relied strongly on the decision in *The British Mexican Petroleum Company Limited* v. *Jackson* (1) and, indeed, based his case on it. The appellant in that case in 1919 entered into a contract with an oil-producing company in Mexico for the purchase of petroleum for a minimum period of 20 years. It was adversely affected by the slump in the petroleum business in 1921 and unable to meet its liability under the contract. Its accounts were made up for the year ending June 30, 1921, and for the 18 months ending December 31, 1922. As at June 30, 1921, it owed the oil producing company £1,073,281 and by September 30, 1921 this had grown to £1,270,232. Under an agreement dated November 25, 1921, it paid the oil-producing company the sum of £325,000 and was released from its liability to pay the balance of £945,232. The Crown contended that the released amount should be brought into account in computing the appellant's profits either in the account for the 18 months ending December 31, 1922 or, alternatively, in the account for the year ending June 30, 1921, that account to be reopened for the purpose. The Special Commissioners held that the released amount should be brought into the appellant's profit and loss account for the 18 months ending December 31, 1922, but their decision was reversed by Rowlatt J. in the Kings Bench Division who held that the forgiveness in the 18 months period of a past indebtedness could not add to the

(1) (1929-32) 16 T.C. 570.

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profits of the 18 months period and that there was no justification for reopening the account of the year ending June 30, 1921. His decision was unanimously confirmed by the Court of Appeal and the House of Lords. Lord Thankerton was of the opinion that the account for the year ending June 30, 1921. could not be reopened since the amount of the liability there stated was correctly stated and he was unable to see how the release from a liability, which had been finally dealt with in the previous account, could form a trading receipt in the account for the year in which it was granted. Viscount Dunedin and Lord Atkin concurred in his opinion. Lord Macmillan was of the view that the circumstance that the appellant's creditor forgave part of its debt did not justify the reopening of the account for the year in which it was legally incurred and he could not see how the extent to which a debt was forgiven could become a credit item in the trading account for the period within which the concession was made. Thus the decision stands as authority for the proposition that the forgiveness or release of an admitted past indebtedness does not justify the reopening of the account of the debtor for the period in which the indebtedness was lawfully incurred or constituted a trading receipt of the debtor in the year of the forgiveness or release.

In my judgment, the decision in this case is not applicable to the facts of the case at bar. Here there was no release or forgiveness of an indebtedness by a creditor. The appellant paid its indebtedness to its parent company in full without any remission. When the appellant issued additional shares of its capital stock to its parent company in full payment of its indebtedness of $717,532.72, which included the indebtedness of $640,978.29 in its open account, its transactions were in terms of Canadian dollars which had increased in value to parity with United States dollars. The position is the same as if the appellant had sold the additional shares to some one other than the parent company and then paid it with the Canadian dollar proceeds of the sale which Canadian dollars had then become equal in value to United States dollars. It is plain, therefore, that the appellant received no concession or release from its parent company. To the extent, therefore, that its case is based on the applicability of the *British Mexican Petroleum Company* case (*supra*) it falls to the ground.

Nor can the submission that the appellant received no profit from the rise in value of the Canadian dollar in 1946 be accepted. In its own profit and loss statement for the year 1946 it admitted the receipt of $99,339.48, which included the sum of $67,302.77, as an item of income under the head of "Foreign exchange premium reduction" and it should not now be heard to say that it did not receive any such income. Then in its income tax return it claimed a deduction of this amount from what would otherwise have been its taxable income treating it as an item of capital profit. It has, therefore, admitted that it received a profit in 1946 from the rise in value of the Canadian dollar. Indeed, it never had any doubt that it did so. That being so, the only question in issue is the nature of the profit so received.

In my judgment, the answer to this question ought not to depend on the fact that in the years prior to 1946 the appellant received a benefit from the fact that it was allowed to deduct not only the cost of the goods which it bought from its parent company in United States dollars but also the amount of the exchange necessary to bring such cost up to the cost in Canadian dollars as operating expenses, notwithstanding that they were not actually laid out or expended, for the right to such deduction could have been challenged: *vide Trapp* v. *Minister of National Revenue* (1). The validity of an assessment does not rest on what a taxpayer has done in the past or what the taxing authorities have allowed him to do. I am, therefore, not impressed with the argument advanced for the Minister that because the appellant received a tax benefit in the year when foreign exchange was against it it should carry a tax burden when the exchange is in its favor for, otherwise, through blowing hot and cold, it would be unjustly enriched. The validity of the assessment must be determined in the light of the existing facts and the applicable law.

Thus the matter resolves itself into the question whether the profit of $67,302.77 which the appellant received in 1946 was an item of taxable income within the meaning of section 3 of the Income War Tax Act. This question is not free from difficulty and I have not been able to find any Canadian or English decisions that are directly helpful.

(1) [1946] Ex. C.R. 245.

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There are United States decisions, although not directly in point, such as that of the Supreme Court of the United States in *United States* v. *Kirby Lumber Co.* (1), which indicate that such a profit as the appellant received in this case would be considered taxable income: *vide* also Magill on Taxable Income, Revised Edition, page 256.

I am unable to accept the contention for the appellant that its profit was a fortuitous or capital gain and had nothing to do with its trade or business. The fact is that it was the result of the rise in value of the Canadian dollar as compared with the United States dollar and came to the appellant in the course of its business. It realized the profit when it was able, in the course of its business, to discharge its indebtedness to its parent company of $708,281.06 in Canadian dollars with $640,978.29 in Canadian dollars with their enhanced value or, to put it otherwise, was able to discharge its indebtedness of $640,978.29 in United States dollars with the same number of Canadian dollars without payment of any exchange. By eliminating the exchange it increased the amount of its distributable profits without affecting its capital position. The fact that its indebtedness was incurred prior to 1946 makes no difference in view of the improvement in its Canadian dollar position since it was incurred, with which the parent company had nothing to do. It does not matter that it did not purchase any goods from its parent company in 1946. That did not end its trading transactions with it for it still had to pay its indebtedness for the goods supplied to it and it paid this indebtedness in full in 1946 with fewer Canadian dollars than would have been required if the Canadian dollar had not risen to parity with the United States dollar. In so doing it realized a profit of $67,302.77. In my judgment, this profit, which might well be called a foreign exchange profit, as the Minister described it, was received by the appellant in 1946 as a profit from its trade or business within the meaning of section 3 of the Income War Tax Act and was properly added back as an item of taxable income to the amount reported by it on its income tax return. That being so, the appeal must be dismissed with costs.

Judgment accordingly.

(1) (1931) 284 U.S. 1.