1955
Mar. 21
Apr. 23

BETWEEN:

THE MINISTER OF NATIONAL REVENUE .... APPELLANT;

AND

TIP TOP TAILORS LIMITED .... RESPONDENT.

Revenue—Income Tax—The Income Tax Act, 1948, S. of C. 1948, c. 52, s. 3, 4 and 27(1)(e)—Profit made on devaluation of pound sterling—Income or capital gain—Profit made in course of taxpayer's business—Appeal from Income Tax Appeal Board allowed.

Through the devaluation of the pound sterling a profit accrued to the respondent on account of its financial transactions with a London.

(1) [1948] 2 K.B. 436 at 441, 442. (2) (1910) 15 B.C.R. 66.

England, Bank. Anticipating that the pound would be devalued, the respondent deliberately incurred a large overdraft with the London Bank which was used in paying accounts in England. After the devaluation of the pound sterling the respondent paid its overdraft to the London Bank at the reduced rate and its resulting profit amounted to a considerable sum of money. The cost of goods to the respondent was carried on its books at the rate of the pound sterling before devaluation.

The Income Tax Appeal Board held that this profit was a capital gain. The Minister of National Revenue appealed to this Court.

Held: That the profit received by respondent was one made in the course of its normal business operations while carrying out a scheme for profit-making.

2. That the use of the overdraft was a scheme for profit-making in one part of the respondent's trading operations, namely, the purchase of sterling funds, an essential part of an integrated commercial operation, namely, the purchase of supplies and the payment thereof by the method adopted by respondent.

3. That the loan by the bank was used to pay trade accounts and was circulating capital used in the trade; the fixed capital of the respondent was at no time employed in the transactions and the profit when made did not affect the capital structure of respondent in any way but was an increase in its trading profit and available for distribution to its shareholders.

APPEAL from the Income Tax Appeal Board.

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

D. W. Mundell, Q.C. and *T. Z. Boles* for appellant.

Lazarus Phillips, Q.C. and *Philip F. Vineberg* for respondent.

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

CAMERON J. now (April 23, 1955) delivered the following judgment:

This is an appeal by the Minister from a decision of the Income Tax Appeal Board dated January 8, 1954, allowing the appeal of the respondent from an assessment made upon it for its 1949 taxation year. In computing its taxable income, the respondent had deducted an item of $169,614.96 entitled "Capital profit arising in sterling exchange, September 20, 1949". In the assessment dated March 14, 1951, that deduction was disallowed and the full amount thereof added to the respondent's declared income. The appeal to the Income Tax Appeal Board was heard by Mr. Fisher who

was of the opinion that the profit so realized was a capital profit and did not arise out of the trading operations of the respondent.

At the hearing of the appeal it was agreed that the evidence set out in the transcript of proceedings before the Income Tax Appeal Board, and the exhibits therein filed, should be evidence in this Court; that evidence was supplemented by a further cross-examination of the witness O'Halloran who had also given evidence before the Board.

The facts are not in dispute. The respondent is in the business of manufacturing and selling clothing at retail. It purchases very large quantities of cloth and other supplies and for many years it has followed a practice of paying for such goods immediately after their receipt. Its purchases in Canada are paid for by cheques sent direct to the suppliers. A very substantial part of its purchases are made in the United Kingdom and for many years the suppliers there had been paid in a somewhat different manner. The accounts of these suppliers are all payable in sterling funds and it was therefore necessary for the respondent to purchase and remit sterling funds. The respondent transacts a substantial part of its business with the Canadian Bank of Commerce which has a London agency—which I shall refer to as the London Bank. Arrangements were entered into by which upon the receipt of the goods from the United Kingdom, the respondent purchased sterling funds and remitted them to the London Bank with a letter of instructions to the latter to pay the suppliers. It seems that even prior to November 1947, the respondent had a line of credit with the London Bank and that at times its account there was overdrawn as the result of the remittances being less than the total of the accounts paid by the Bank.

For some years prior to November 1947, the pound sterling had a value of $4.04 Canadian. The respondent's officials were of the opinion that it would be devalued sooner or later and that it would be profitable to the company, if such an event occurred, to build up in the meantime a substantial overdraft at the London Bank. Mr. Clayton, the secretary and controller of the respondent, in

reply to a question as to why the company did not use its credit balances in Canada to discharge the liabilities to the Bank, said:

> Because it was felt that the pound sterling would be devalued, and after discussing the matter fully with the President and other top officials in the company we decided to deliberately pursue this policy of running a large overdraft in England in the hope of gaining a capital profit on devaluation.

Following that decision the respondent, through the Canadian Bank of Commerce, arranged for an extended line of credit at its London agency in a sum not exceeding £250,000. It was not required to provide any collateral security for such part of the line of credit as it might use and no restriction was placed on the use to be made of the funds advanced thereunder.

The proposed policy was immediately put into effect. The United Kingdom suppliers' accounts were paid promptly and in exactly the same manner as theretofore, namely, by the London Bank upon the written directions of the respondent. The respondent continued to make substantial remittances in sterling to the London Bank, but in amounts less than sufficient to take care of the suppliers' accounts in full. In the result, the overdraft at the London Bank was progressively increased and on September 20, 1949, when the pound sterling was devalued and in terms of dollars was reduced from $4.04 to $3.0875, the overdraft amounted to just over £178,073. Up to that date, the liability to the bank had been shown in the respondent's books not only in sterling funds, but in Canadian funds at the rate of $4.04 to the pound. In its income tax returns for all relevant years, the latter of these two sets of figures was used and allowed as reflecting the cost of goods. In October of that year the respondent decided to pay its liability to the London Bank and by purchasing sterling at the reduced rate and remitting funds to the Bank, it settled its liability to the latter at $169,614.96 less than it would have been required to pay had the pound sterling not been devalued.

It is admitted that a profit thereby accrued to the respondent and the question is whether that profit is a capital profit or a revenue profit. It is admitted that the full amount of the overdraft was used in payment of supplies purchased by the respondent in the United Kingdom.

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Immediately after the settlement of its overdraft with the London Bank, the respondent resumed and has since continued the same policy in paying its United Kingdom suppliers as it had followed prior to November 1947.

It will be observed that the only difference between the policy followed in the period prior to November 1947, and that adopted for the period from November 1947, to October 1949, was that in the latter period the respondent remitted to the London Bank less sterling funds than were required to pay the suppliers' accounts in full. It may be noted here, also, that in each of the taxation years 1948 and 1949, the interest charges paid to the London Bank in respect of the overdraft were claimed and allowed as ordinary operating expenses.

For the appellant it is submitted that the profit so received was a profit from the respondent's business or, alternatively, that it was received from an adventure in the nature of a trade. He relies on sections 3, 4 and 127(1) (*e*) of the Income Tax Act 1948, which were 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
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> (*a*) businesses,
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> (*b*) property, and
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> (*c*) offices and employments.
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> (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.
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> 127. (1) In this Act,
>
> (*c*) "business" includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment;

Notwithstanding that the respondent was successful in its appeal to the Income Tax Appeal Board, the onus is on it to establish that the assessment is incorrect, either in fact or in law (*Minister of National Revenue* v. *Simpson's Ltd.* (1)).

Counsel for the respondent concedes that if the profit on foreign exchange had been made in remitting sterling to the firms which had supplied it with materials, such profit would have been on revenue account as one arising in the

(1) [1953] Ex. C.R. 93.

operation of its business (*Eli Lilly & Co. (Canada) Ltd.* v. *Minister of National Revenue* (1)). He submits, however, that as the suppliers had been paid in full, the trading operations of the respondent were at an end; that the profit resulted from incurring and payment of a bank loan which was of a capital nature and therefore non-taxable. He says that there was no trading relationship with the London Bank; that the relationship between them was not that of buyer and seller, but rather that of debtor and creditor. Finally, he says that this is a casual profit resulting from something over which the respondent had no control—namely, the devaluation of the pound; that the respondent is not engaged in the business of speculating in foreign exchange and that this "speculation" in foreign exchange was the only transaction of that character undertaken by it.

In *Atlantic Sugar Refineries Ltd.* v. *Minister of National Revenue* (2), it was held that if the profit was one made in an operation of a taxpayer's business, or made in an operation of business in carrying out a scheme for profit-making, it was a revenue profit and therefore subject to tax. In that case the business of the taxpayer was the purchase of raw sugar, refining and selling it at wholesale. Because of certain conditions, it speculated in raw sugar futures on the stock exchange and made a profit thereon. It was held that, even if it were the only transaction of that character, in the light of all the evidence, it was a part of the taxpayer's business and therefore a profit from its business or calling within the meaning of section 3 of the Income War Tax Act.

No question as to foreign exchange profit arose in that case but it seems to me that the tests there stated are of general application in considering whether a profit is of a capital or income nature. Applying these tests to the facts of the instant case, it seems to me that the profit here realized was one made in the course of the respondent's normal business operations while carrying out a scheme for profit-making.

Business operations are carried out in a great variety of ways. In the case of the respondent, its normal operations required it to purchase goods in the United Kingdom and to

(1) [1953] Ex. C.R. 269. (2) [1949] S.C.R. 706.

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pay for such purchases in sterling funds. Its normal practice was to buy sterling in Canada, remit the funds to the London Bank with instructions to pay the suppliers even if the payments resulted in an overdraft. That was its customary way of operating its business and the profit it realized arose out of that mode of doing business. In my view, the mere fact that the overdraft was deliberately incurred cannot assist the respondent. That was done in the hope that if the pound were devalued, the actual amounts which the respondent would ultimately be required to pay in respect of the goods which it had purchased would be less and its profits therefore greater. In my view, it was a scheme for profit-making in one part of the respondent's trading operations, namely, the purchase of sterling funds. The purchase of sterling funds in October 1949 was an essential part of an integrated commercial operation, namely, the purchase of supplies and the payment thereof by the method adopted by the respondent.

Counsel for both parties referred me to a case decided in the English Court of Appeal—*Davies* v. *The Shell Company of China, Ltd.* (1). The facts are set out in the headnote as follows:

The Company was a British company which sold and distributed petroleum products in China. The Company made a practice of requiring its agents to deposit with the Company a sum of money, usually in Chinese dollars, which was repayable when the agency came to an end. Previously the Company had left on deposit with banks in Shanghai amounts approximately equal to the agency deposits, but because of the hostilities between China and Japan the Company transferred these sums to the United Kingdom and deposited the sterling equivalents with its parent company, which acted as its banker. Owing to the subsequent depreciation of the Chinese dollar with respect to sterling, the amounts eventually required to repay agency deposits in Chinese currency were much less than the sums held by the Company to meet the claims, and a substantial profit accrued to the Company.

On appeal to the Special Commissioners against assessments to Income Tax under Case 1 of Schedule D, the Company contended that the deposits received from its agents had been used as fixed capital and not as circulating capital, and that the profit on exchange was a capital profit not subject to Income Tax. For the Crown it was contended that the deposits, to which the Company could have recourse in the event of default by the agent, were circulating capital and that the exchange profit was made in the course of the Company's business and must be included in the computation of its profits for Income Tax purposes. The Commissioners found that the exchange profit was a capital profit not subject to Income Tax.

(1) (1951) 32 T.C. 133.

Held, that the Special Commissioners' decision was correct.

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Counsel for the Minister in the instant case relied on the following statement by Jenkins L. J.—and concurred in by all the other judges—at page 151.

> As regard the law to be applied there is a considerable measure of agreement between the parties. Mr. Grant for the Company does not dispute that where a British company in the course of its trade engages in a trading transaction such as the purchase of goods abroad, which involves, as a necessary incident of the transaction itself, the purchase of currency of the foreign country concerned, then any profit resulting from an appreciation or loss resulting from a depreciation of the foreign currency embarked in the transaction as compared with sterling will *prima facie* be a trading profit or a trading loss for Income Tax purposes as an integral part of the trading transaction. That concession or admission by Mr. Grant is amply justified by the cases to which we have been referred. There is the case of *Landes Brothers* v. *Simpson,* 19 T.C. 62, which is a decision of my brother Singleton as a Judge of first instance. There the appellants, who carried on business as fur and skin merchants and as agents, were appointed sole commission agents of a company for the sale in Britain and elsewhere of furs exported from Russia on the terms, *inter alia,* that they should advance to the company a part of the value of each consignment. All the transactions between the appellants and the company were conducted on a dollar basis and owing to fluctuations in the rate of exchange between the dates when advances in dollars were made by the appellants to the company against goods consigned and the dates when the appellants recouped themselves for the advances on the sales of the goods, a profit accrued to the appellants on the conversion of repaid advances into sterling. The decision was that the exchange profits arose directly in the course of the appellants' business with the company and formed part of the appellants' trading receipts for the purpose of computing their profits assessable to Income Tax under Case 1 of Schedule D. My brother Singleton, on page 69 of the report, cited the case of *McKinlay* v. *H. T. Jenkins and Sons, Ltd.,* 10 T.C. 372, to which I will refer in a moment, and then made this comment upon it: "I pause there to say that in my view the profit which arises in the present case is a profit arising directly from the business which had to be done, because, as is found in paragraph 6 of the Case, the business was conducted on a dollar basis and the Appellants had, therefore, to buy dollars in order to make the advances against the goods as prescribed by the agreements. The profit accrued in this case because they had to do that, thereafter as a trading concern in this country re-transferring or re-exchanging into sterling." That is accepted by both parties as correctly stating the law, and if I may say so in my view it was clearly a right decision on the facts of that case. The question is whether it can be said to have any bearing on the very different facts of the present case.

Counsel for the respondent stressed the fact that in the instant case the repayment to the London Bank was a repayment of a loan; he relies on the finding in the *Shell* case that the deposits there were held to be a loan to the company and thus receipts of a capital nature. In that case Jenkins L. J., after stating that the real issue was whether

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the taking of each deposit on the terms of the relative deposit agreement was a trading transaction or not, said at p. 155 that the question resolved itself into this:

> On the facts of this case, were these deposits trading receipts received by the Company in the course of its trade, and giving rise to corresponding trade liabilities in the form of the Company's obligation as to repayment, or should they be regarded simply as loans received by the Company and thus as receipts of a capital nature giving rise to a corresponding indebtedness on capital account and not forming part of the Company's trading receipts or liabilities at all?

And at page 157, his conclusions are stated in these words:

> After paying the best attention I can to the arguments for the Crown and those for the Respondent Company, I find nothing in the facts of this case to divest those deposits of the character which it seems to me they originally bore, that is to say the character of loans by the agents to the Company, given no doubt to provide the Company with a security, but nevertheless loans. As loans it seems to me they must *prima facie* be loans on capital not revenue account; which perhaps is only another way of saying that they must *prima facie* be considered as part of the Company's fixed and not of its circulating capital. As appears from what I have said above, the evidence does not show that there was anything in the Company's mode of dealing with the deposits when received to displace this *prima facie* conclusion.
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> In my view, therefore, the conversion of the Company's balances of Chinese dollars into sterling and the subsequent re-purchase of Chinese dollars at a lower rate, which enable the Company to pay off its agents' deposits at a smaller cost in sterling than the amount it had realised by converting the deposits into sterling, was not a trading profit, but it was simply the equivalent of an appreciation in a capital asset not forming part of the assets employed as circulating capital in the trade. That being so it was a profit of the nature not properly taxable under Schedule D, and the Special Commissioners in my view came to a right conclusion, which was rightly affirmed by the learned Judge, and I would therefore dismiss the appeal.

In my opinion, the conclusion in that case can be of no assistance to the respondent here. There the finding was based on the fact that the deposits or loans were *prima facie* loans on capital and not on revenue account, which might be considered as part of the taxpayer's fixed and not of its circulating capital, and that there was nothing in the evidence to show that there was anything in the taxpayer's mode of dealing with the deposits when received to displace that *prima facie* conclusion; that the profit received was simply the equivalent of an appreciation of a capital asset *not forming part of the assets employed as circulating capital in the trade.* The facts in the instant case are quite different. Here the loan by the bank was

used to pay trade accounts and was, in my opinion, circulating capital used in the trade. The fixed capital of the respondent was at no time employed in the transaction and the profit when made did not affect the capital structure of the respondent in any way, but was an increase in its trading profit and available for distribution to its shareholders.

Counsel for the respondent also referred me to the case of *McKinlay* v. *H. T. Jenkins & Son, Ltd.* (1). The facts are stated in the headnote as follows:

Under an Agreement dated the 8th March, 1921, for the supply of a quantity of marble by a Torquay Company of marble and stone merchants to certain building contractors, the contractors agreed, on receipt of a guarantee for the fulfilment of the contract, to advance £20,000 of the price, percentage deductions being made from the amount due on each consignment of marble until the advance had been repaid. On the 17th March, 1921, the £20,000 was paid to the Company and was credited to an account at a London bank in the joint names of nominees of an insurance company, acting as guarantor, and of the Torquay Company, the nominee of the latter being its controlling shareholder.

In anticipation of the required marble being purchased in Italy—though not till the autumn of 1921—the Company at once arranged for the conversion of the greater part of the £20,000 into lire at 103 to the £, and a lira account in the same joint names was opened. In May, 1921, the lira had appreciated in value, and, as the money was not yet required by the Torquay Company, its nominee, on the 25th May, 1921, without the Company's knowledge or authority, but with the consent of the nominee of the insurance company, directed the sale of the balance of the lira joint account. At 72 to the £ the lire realised £22,870 (for which a further account in the joint names was opened), a profit on their original purchase price (103 to the £) of £6,707, which was received by the Torquay Company. The lire were subsequently repurchased for the purposes of the contract for £19,386, which was allowed as a deduction from the Company's profits for Income Tax purposes.

In computing the Company's profits for the purposes of assessment to Income Tax for the year 1922-23, the said sum of £6,707 arising from the exchange transaction was included as a profit but the Special Commissioners on appeal decided that it was not a profit assessable to Income Tax.

Held, that the said sum of £6,707 was not a profit arising out of the contract for the supply of marble, but was merely an appreciation of a temporary investment, and was not assessable to Income Tax as part of the profits of the Company's trade.

In agreeing with the findings of the Commissioners, Rowlatt J. said at page 405:

It seems to me that this profit out of the change from currency to currency three times does not touch the question of what the profit on the contract was at all. The profit on the contract is the difference between

(1) (1926) 10 T.C. 372.

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the sum they received and what it cost them to supply the marble, and this intermediate use that was made of the sum which they happened to have because they had got this contract has nothing to do with the profits of the contract, I think, at all. It was an accident that this sum can be identified, as I have already explained, as coming from the contract, but it has nothing to do with the profit of the contract. If that is so, what is it? It seems to me it is the mere appreciation of an investment into which they had put their money temporarily; an appreciation of something, if you like to look at it one way, that they had bought forward, because they would want it later, namely, the lire; a temporary appreciation of which they took advantage. If you look at it the other way, it was a profit which they had made by buying forward, instead of waiting until they had to provide the money. I do not think it has anything to do with the profit of the contract itself. It was, as I say, a mere appreciation of something which they had got in hand, and I think the Commissioners were bound to hold (because I see no evidence at all to the contrary) that it was not merged in a business of the Company.

That case, I think, is readily distinguishable from the instant case. It is of particular importance to note that the profit there in question arose out of the purchase and sale of foreign exchange which in the opinion of Rowlatt J. was quite unconnected with the actual purchase of marble which the taxpayer was required to buy in fulfillment of its contract and which it did buy at a later date. He found the transaction was a mere appreciation of an investment into which the taxpayer had put its money temporarily and that the asset "was not merged in the business of the company". In the present case, if the arrangements by which the respondent could overdraw its account can be considered as the acquisition of sterling funds, such funds were at once used in the respondent's trading operations to pay its trading liabilities and were therefore merged in its business.

One other case was referred to by counsel for the respondent. It is *Income Tax Case No. 308* (1), a decision of the Special Courts for Hearing Income Tax Appeals in South Africa. The facts are stated in the headnote as follows:

Appellant company, which carried on business in the Union, where it had its headquarters and its accounts were framed, had for many years financed its operations by an overdraft with a bank in London.

On the 21st September, 1931, when the United Kingdom left the gold standard, the company owed various sums of money in England, partly in respect of the overdraft at its bank and partly on bills given for goods supplied for the business of the company.

(1) 8 S.A. Tax Cases 99.

Taking advantage of the favourable rate of exchange resulting from the maintenance of the gold standard by the Union, the company discharged its liabilities under the overdraft and the trade bills for an amount in South African pounds substantially less than the nominal amount of these debts expressed in sterling.

The difference between those items of indebtedness as expressed in pounds sterling and the amount in South African pounds required to discharge them was shown by the company in its profit and loss account as credit, "By Bank Exchange."

In assessing the company for Income Tax purposes, the Commissioner for Inland Revenue included in its taxable income this credit derived from exchange. To this the company took objection, on the grounds that the gain made by exchange in discharging these liabilities was a gain of a capital nature.

On appeal:

Held, that inasmuch as the debt due to the bank on overdraft was of the nature of a loan and therefore a capital liability, any gain made by exchange in discharging that liability was also of a capital nature, but on the other hand the gain made in the discharge of bills given in the course of trading for goods was to be connected with the trade carried on by the company and was properly included in the taxable income.

The facts in that case, in so far as they relate to the bank overdraft, closely parallel the instant case. That decision is, of course, not binding on me and with respect I must decline to follow it as I have found it impossible to reconcile it with the decision in the *Shell* case (*supra*). It may be noted, also, that the profit made in the *South African* case was a purely fortuitous one whereas in the instant case the profit was made as the result of a deliberate scheme for profit-making in the course of the respondent's trade.

In addition to the cases I have mentioned, reference may also be made to *Imperial Tobacco Co. Ltd.* v. *Kelly* (1) and to *Willard Halburn Inc.* v. *Commissioner of Internal Revenue* (2).

My conclusion, therefore, is that the profit made in the instant case was one made in the ordinary course of the respondent's business operations and while engaged therein on a scheme for profit-making. For the reasons which I have stated, the appeal will be allowed, the decision of the Income Tax Appeal Board set aside, and the assessment made upon the respondent affirmed. The appellant is entitled to his costs after taxation.

Judgment accordingly.

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(1) [1943] 2 A.E.R. 119. (2) (1954) 214 F. 2d 815.