BETWEEN: 1945 Oct. 30

IMPERIAL OIL LIMITED,.....APPELLANT,

AND 1947 Oct. 31

MINISTER OF NATIONAL REVENUE, RESPONDENT.

Revenue—Income tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 6 (a)—Meaning of words "for the purpose of earning the income"—Payment of damages and costs for negligence deductible when liability really incidental to business.

Appellant sought to deduct amount paid in settlement of damage claims arising out of a collision at sea between one of its oil tankers and another vessel, causing the latter vessel to sink, the collision resulting from negligence on the part of the appellant's seamen. The deduction was disallowed and the amount included in the appellant's assessment, from which it appealed. The appeal was allowed.

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.

2. That the words "disbursements or expenses . . . . laid out or expended for the purpose of earning the income" in section 6 (*a*) mean "disbursements or expenses . . . . laid out or expended as part of the process of earning the income".

3. That it is never necessary to show a causal connection between an expenditure and a receipt.

4. That where income is earned from certain operations, all the expenses wholly, exclusively and necessarily incidental to such operations must be deducted as the total cost thereof in order that the amount of the profits or gains from such operations that are to be assessed may be computed. Such cost includes not only all the ordinary operations costs but also all moneys paid in discharge of the liabilities normally incurred in the operations. When the nature of the operations is such that the risk of negligence on the part of the taxpayer's servants in the course of their duties or employment is really incidental to such operations, with its consequential liability to pay damages and costs, then the amount of such damages and costs is properly included as one of the items of the total cost of such operations and may properly be described as a disbursement or expense that is wholly, exclusively and necessarily laid out as part of the process of earning the income from such operations.

APPEAL under the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice Thorson, President of the Court, at Ottawa.

H. C. F. Mockridge for appellant.

T. N. Phelan K.C. and *E. S. MacLatchy* for respondent.

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

THE PRESIDENT now (October 31, 1947) delivered the following judgment:

The issue in this appeal under the Income War Tax Act, R.S.C. 1927, chap. 97, is whether in computing the amount of its profits or gains to be assessed for the year 1930 a deduction of $526,995.35 should be allowed, this being the amount which the appellant was obliged to pay in settlement of damage claims arising out of a collision at sea between its motorship *Reginalite* and the steamship *Craster Hall* owned by the United States Steel Products Company. Although the collision occurred on June 19, 1927, the total amount of the appellant's liability was not ascertained until 1930 when it was charged by it to profit and loss in that year. On the notice of assessment for 1930, dated December 24, 1942, this deduction was disallowed and the amount, together with other items, was added to the taxable income declared by the appellant on its income tax return. An appeal from the assessment, confined to this item, was taken to the Minister who affirmed the assessment on the ground that the amount paid was not an expense wholly, exclusively and necessarily laid out or expended for the purpose of earning the income within the meaning of section 6 (*a*) of the Act. Being dissatisfied with the Minister's decision the appellant now brings its appeal from the assessment to this Court.

The appellant's business is described on its return as the manufacturing and marketing of petroleum products. In addition to producing and refining petroleum it is engaged in the transportation of petroleum and petroleum products. It has a fleet of 20 oil tankers plying on the Great Lakes and in coastal and ocean going operations. These are handled under the supervision of its marine department. This was first established in 1912 when only Great Lakes vessels were operated, but in 1921 it was expanded and ocean going tankers were acquired. The greater part of the crude oil refined in Canada by the appellant comes from South America and is carried from there to Canadian ports in oil tankers. In 1927, it had 9 ocean going oil

tankers in operation including the *Reginalite*. For the most part they carried its own oil but also, on occasion, oil for others on voyage charters. Its marine operations were an important and profitable part of its business.

The facts relating to the collision and the payment of damages are not disputed. On June 19, 1927, the appellant's vessel, the motorship *Reginalite* had loaded a cargo of bunker fuel oil and commercial Diesel oil for the International Petroleum Company Limited and was leaving the harbour of Talara in Peru bound for a port in Chile. The steamship *Craster Hall* was lying at anchor at the customary anchorage for vessels outside the harbour proper and was apparently swinging at her anchor slightly out into the channel. The *Reginalite* was headed out to sea and as she approached the *Craster Hall* the men on her bridge observed that she inclined to swing towards the *Craster Hall*. An endeavour was made to correct this swing but it was not successful and she continued to swing. Then although the engines were reversed and the anchors dropped she collided with the *Craster Hall*, which later sank and became a total loss. The *Reginalite* suffered practically no damage. The owners of the *Craster Hall* took proceedings in the United States against both the appellant and the *Reginalite*. The damages originally claimed were estimated at $2,000,000. Negotiations for settlement continued from 1927 to 1930 when the claims were finally settled for $526,995.35, including fees, as shown by a statement of particular average (Exhibit 3) and a summary of disbursements (Exhibit 4). It is admitted that the collision was due to fault on the part of the *Reginalite* and that the amount paid was for damages resulting therefrom. The summary (Exhibit 4) shows some disbursements made prior to 1930. The appellant did not charge disbursements to profit and loss in the year in which they were made if the claim for damages was not settled in such year, but carried them forward in a suspense account until the claim was settled and then charged the full amount of the settlement to profit and loss in the year in which the settlement was made. The same practice was followed in the present case. While there may be some question as to the correctness of such

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practice as a matter of law, no argument was made on it and I proceed on the assumption that the amount claimed as a deduction, if deductible at all, was deductible in 1930, the year in which the total amount of the appellant's liability was ascertained.

The issue turns upon whether the amount sought to be deducted is excluded from deduction by section 6 (*a*) of the Act, which provides:

> 6. In computing the amount of the profits or gains to be assessed a deduction shall not be allowed in respect of
>
> (*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;

The profits or gains to be assessed are the net profits or gains described in section 3 as being taxable income, subject to section 6 with which section 3 must be read. The principles for the computation of such profits or gains are not defined in the Act but are stated in judicial decisions. In *Gresham Life Assurance Society* v. *Styles* (1) Lord Halsbury L.C. said:

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

The same view has often been expressed; for example, 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,

and then pointed out that this was subject to the limitations prescribed by the Act, one of which was the rule in the English Act corresponding to section 6 (*a*).

The section is couched in negative terms. It is not primarily concerned with what disbursements or expenses may be deducted and does not define them, so that their deductibility is determinable only by inference. But it is concerned with and does define the disbursements or expenses whose deduction is not allowed. It is a specific instruction to the Minister that in his assessment operation he is not to allow the deduction of disbursements or expenses that are "not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income". The section directs that such disbursements or expenses are not to be deducted, even although they might be

(1) (1892) A.C. 309 at 316. (2) (1915) A.C. 433 at 444.

deductible according to ordinary principles of commercial trading or, as it has been suggested "well accepted principles of business and accounting practice". The range of deductibility according to such principles may be wider than that which is inferentially permitted under the section. To that extent they must give way to the express terms of the section, which must, of course, prevail. The result is that the deductibility of disbursements or expenses is to be determined according to the ordinary principles of commercial trading or well accepted principles of business and accounting practice unless their deduction is prohibited by reason of their coming within the express terms of the excluding provisions of the section. These provisions were, no doubt, inserted in the interests of the revenue as a protecting safeguard against deductions which might otherwise be made but, while it is necessary to enforce the prohibitions of the section, it is not proper to go beyond its express requirements. The section ought not, in my opinion, to be read with a view to trying to bring a particular disbursement or expense within the scope of its excluding provisions. If it is not within the express terms of the exclusions 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.

Counsel for the appellant argued that the transporting of petroleum and petroleum products was part of the appellant's business, that the income from its marine operations was part of the income earned by it, that the ordinary risks and hazards of that business must be accepted as part thereof including the possibilities of loss inherent in it, that the risk of collision at sea was an ordinary hazard of a shipping company and that negligence on the part of its seamen resulting in damage to another ship was a contingency that was to be expected, and that, while the amount of damage done in the present case was large, the accident was not extraordinary or unusual. His contention was that, under the circumstances, the amount which the appellant had to pay was a proper expense wholly and exclusively incurred in the course of and for the purpose of the marine operations portion of its business

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and the earning of income therefrom, and representing a liability inherent in such business which it was obliged to meet, that it was not a capital item but an operating one, that it was properly deductible as a matter of accounting practice and that it was not excluded from deduction by section 6 (*a*). I think that counsel's position was well taken, both on the facts and as a matter of law.

The case is of considerable importance in view of the fact that there are no Canadian decisions on the question whether the amount of damages paid by a taxpayer on account of the negligence of his servants, such as that sought to be deducted by the appellant, is a deductible item of expenditure under section 6 (*a*). Counsel had, therefore, to rely upon decisions in other jurisdictions.

The leading English authority is *Strong & Co., Limited* v. *Woodifield* (1). There the appellants were a brewery company who owned an inn and conducted it through a manager. A customer sleeping in the inn was injured by the falling of a chimney upon him, and the appellants had to pay £1490 in damages and costs because the fall of the chimney was due to the negligence of their servants, whose duty it was to see that the premises were in proper condition. The appellants sought to deduct this sum from the amount of their profits and gains assessable to income tax. The Commissioners thought that the deduction could not be allowed but stated a case for the opinion of the Court and Phillimore J. allowed it. His judgment was reversed by the Court of Appeal and an appeal from their decision was dismissed by the House of Lords. Section 100 of the Income Tax Act, 1842, (5 & 6 Vict. chap. 35), provided by Schedule D, First Case, Third Rule, as follows:

> In estimating the Balance of Profits and Gains chargeable . . ., no Sum shall be set against or deducted from, or allowed to be set against or deducted from, such Profits or Gains . . ., on account of Loss not connected with or arising out of such Trade, Manufacture, Adventure or Concern . . .

and by Schedule D, First and Second Cases, First Rule, as follows:

> In estimating the Balance of the Profits or Gains to be charged . . ., no Sum shall be set against or deducted from, or allowed to be set against or deducted from such Profits or Gains, for any Disbursements or

(1)) (1905) 2 K.B. 350; (1906) A.C. 448.

Expenses whatever, not being Money wholly and exclusively laid out or expended for the Purposes of such Trade, Manufacture, Adventure or Concern . . .

In the course of his speech in the House of Lords, Lord Loreburn L.C., with whose views the majority of the other Lords concurred, summarized the English law on the subject, at page 452, as follows:

> In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade, or it may be connected with something else quite as much or even more than with the trade. I think only such losses can be deducted as are connected with in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered. To give an illustration, losses sustained by a railway company in compensating passengers for accidents in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which the house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted. Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise. In the present case I think that the loss sustained by the appellants was not really incidental to their trade as innkeepers, and fell upon them in their character not of traders, but of householders. Accordingly I think that this appeal must be dismissed.

The reason for disallowing the deduction was "that the loss sustained by the appellants was not really incidental to their trade as innkeepers, and fell upon them in their character not of traders, but of householders". The decision turned on whether the loss was or was not really incidental to the business. If it had been it seems clear beyond doubt that the deduction would have been allowed. The case is, therefore, strong authority for the statement that if a trader has to pay damages for the negligence of his servants under such circumstances that the loss is really incidental to his trade then the amount so paid is deductible.

The same principle runs through the other cases cited. Two Australian cases were referred to. In *Todd* v. *Commissioners of Taxation* (1) a ferry company paid damages to passengers in respect of injuries received and claimed it as a loss incurred in the production of the company's income. Section 16 (1) (*e*) of the Income Tax (Management) Act,

(1) (1913) N.S.W. Court of Review Decisions 6.

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1912, of New South Wales required the Commissioners to deduct from the income of the taxpayer the following moneys and expenses, namely,

(e) Losses, outgoings, including commission, discount, travelling expenses, and expenses actually incurred in New South Wales by the taxpayer in the production of his income;

The Commissioners having disallowed the deduction, an appeal was taken and Murray D. C. J. allowed it. At page 7, he said:

The question is whether this is a loss incurred by the taxpayer in the production of his income. These words mean as I suggested just now, what is more fully expressed by the words "loss incurred by the taxpayer in the course of the production of his income."

The course of the production in this case is partly disembarking and embarking passengers. This was a loss that happened quite accidentally. There was misconduct on the part of some employee; but so far as the company is concerned, it was purely accidental; and it did occur as a loss which might reasonably be contemplated to happen at some time or other in the course of events which were a necessary incident to the production of the income; because part of the carrying of passengers, for which they pay, is their embarkation and disembarkation.

Therefore, I think that this is a loss which does come within the words of the section.

The other Australian case was *Herald and Weekly Times Limited* v. *Federal Commissioner of Taxation* (1), a decision of the High Court of Australia. There the appellant, the proprietor and publisher of an evening newspaper, claimed to deduct from its assessable income moneys paid by way of compensation, either before or after judgment, to persons claiming damages in respect of libels published in that paper, and amounts representing the costs of contesting the claims or of obtaining advice in regard thereto. There section 23 (1) (*a*) of the Income Tax Assessment Act, 1922-1929, of the Commonwealth of Australia, provided:

23. (1.) In calculating the taxable income of a taxpayer the total assessable income derived by the taxpayer from all sources in Australia shall be taken as a basis, and from it there shall be deducted—

(*a*) all losses and outgoings (not being in the nature of losses and outgoings of capital) including commission, discount, travelling expenses, interest and expenses actually incurred in gaining or producing the assessable income;

And section 25 (*e*) provided:

25. A deduction shall not, in any case, be made in respect of any of the following matters:—

(*e*) Money not wholly and exclusively laid out or expended for the production of assessable income;

(1) (1932) 48 C.L.R. 113.

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The Commissioner disallowed the deduction and the Supreme Court of Victoria dismissed an appeal from his ruling (1), Mann J. being of the opinion that although the expenditure was an unavoidable consequence of the business of publishing the newspaper it was not in any sense a productive expenditure directly or indirectly, and that the sums paid were not "wholly and exclusively laid out or expended for the production of assessable income." The High Court of Australia reversed this judgment and allowed the deduction. At page 118, Gavan Duffy C.J. and Dixon J. said:

> None of the libels or supposed libels was published with any other object in view than the sale of the newspaper. The liability to damages was incurred, or the claim was encountered, because of the very act of publishing the newspaper. The thing which produced the assessable income was the thing which exposed the taxpayer to the liability or claim discharged by the expenditure. It is true that when the sums were paid the taxpayer was actuated in paying them, not by any desire to produce income, but, in the case of damages or compensation, by the necessity of satisfying a claim or liability to which it had become subject, and, in the case of law costs, by the desirability or urgency of defeating or diminishing such a claim. But this expenditure flows as a necessary or a natural consequence from the inclusion of the alleged defamatory matter in the newspaper and its publication.

Counsel also relied upon a number of South African decisions. There the relevant sections of the Income Tax Act, 1925, of the Union of South Africa, being Act No. 40 of 1925, provided that certain deductions from income for the purpose of determining taxable income should be made, as follows:

> 11. (2) The deductions allowed shall be—
>
> (*a*) expenditures and losses actually incurred in the Union in the production of the income, provided such expenditure and losses are not of a capital nature.

And also that certain deductions should not be made, as follows:

> 13. No deduction shall, as regards income derived from any trade, be made in respect of any of the following matters:—
>
> (*b*) any moneys not wholly or exclusively laid out or expended for the purposes of trade.

The first case referred to was *Income Tax Case No. 8* (2). There a tramway company in the course of its business found it necessary to pay compensation for injuries to persons and properties resulting from collisions, from

(1) (1932) V.L.R. 317.

(2) (1923) 1 S.A. Tax Cases 57.

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accidents in connection with broken trolley wires and excavations made in the roadway, and from accidents due to passengers alighting while the trains were still in motion. The Company also incurred expenditure in obtaining legal advice in respect of such claims. The Commissioner disallowed a claim to deduct these expenses but his decision was reversed. Ingram P. held, on the facts, as follows:

> It appeared from the evidence that in the carrying on of an undertaking of this character expenditure in compensation up to a certain amount is inevitable, and that this is so even where every precaution may be taken to guard against accident or the negligence of the servants of the company. It is a recurrent loss which has to be taken into consideration as a factor in the undertaking itself and having a direct bearing on the profit earning capacity.

and then said, at page 58:

> In the case of *Lockie Bros.* v. *Commissioner for Inland Revenue* (1), Mason J., interpreted the words "losses and outgoings actually incurred in the production of the income" as meaning "expenditures incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business". When applying this construction each case must, of course, depend on its own merits, and in certain instances the dividing line may not be easy to demarcate; but in this particular case these items, on the evidence placed before us, certainly seem to be in the nature of such expenditure. The occurrences they represent were not extraordinary or abnormal. They were incidental and pursuant to the course of the operations which produced the profits and formed a necessary risk undertaken to earn the profits. Such being the case they were losses incurred on income account * * *. As regards the fees paid to attorneys in connection with claims arising out of such damages, such expenditure must be equally as inevitable as the actual damages and compensation to which it relates, and is also attributable to the ordinary operations of the company.

A similar view was expressed in *Income Tax Case No. 49* (2). There the appellant sold petrol lamps, each subject to a guarantee. One of the lamps so sold exploded and caused injuries to the purchaser for which the appellant had to pay damages and costs. His claim for the deduction of the amounts so paid was disallowed by the Commissioner but on appeal it was held that the expenditure was incurred in the course of the appellant's business and arose out of it and was, therefore, to be regarded as having been incurred in the production of income. So also in *Income Tax Case No. 233* (3). There the appellants carried on business in partnership as stevedores. In the course of such business they were unloading cargo from a vessel and while a portion

(1) (1922) T.P.D. 42.
(2) (1926) 2 S.A. Tax Cases 122
(3) (1932) 6 S.A. Tax Cases 259.

of the cargo was being transferred in a net attached to a crane an article fell out of the net and killed a passer-by. The heirs of the person killed claimed damages from the appellants on the grounds that the accident was due to the negligence of their servants. On the advice of counsel they settled the claim and sought to deduct the amount paid. It was held on an appeal from the Commissioner that damage or loss of this kind must be regarded as incidental to a business such as stevedoring and therefore as a legitimate expense in connection with the earning of the appellants' income as stevedores. Dr. Nathan P. expressed the view that the principle was that laid down by the Lord Chancellor in *Strong* v. *Woodifield* (*supra*), namely, that a loss can be deducted only if it is really incidental to the trade, and held that in the present case the loss was really incidental. His statement is an illuminating one. At page 260, he said:

> Now in this particular case we have come to the conclusion on the evidence, that damage or loss of this kind must be regarded as incidental to the business of stevedoring. It is true that there may be only isolated cases, just as it is possible that many cases of accident in the case of the railways are settled without litigation, but in this particular case we find that in the business of loading and unloading it is a very likely and indeed almost foreseeable consequence, if not an inevitable consequence, that packages or other articles may fall out of nets handled by stevedores and injure passers-by, just as in the case of a builder bricks or similar articles may fall from the buildings during the course of building operations and injure passers underneath. That being the case, if such an injury is incidental to the business of stevedoring, as we find it is, then without going into remote questions of liability such as whether the man in question was guilty of contributory negligence, we find, broadly speaking, that this was a legitimate expense in connection with the earning of the income of the appellants.

And the same principle is further illustrated by *Port Elizabeth Electric Tramway Company, Ltd.* v. *Commissioner for Inland Revenue* (1). There the appellant carried on business as a tramway company. The driver of one of its tramcars lost control of it while it was descending a steep gradient and it ran into a building with the result that the driver suffered injuries from which he subsequently died. The appellant had to pay compensation to his widow under the Workmen's Compensation Act and also incurred costs in the litigation. It sought to deduct the amounts so paid. The Commissioner disallowed the claim and his decision

(1) (1935) 8 S.A. Tax Cases 13.

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was affirmed by the Special Court but, on a case being stated to the Cape Provincial Division of the Supreme Court, the decision was in part reversed. Watermeyer A.J.P. said, at page 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 page 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.

And then held that, since the employment of drivers was necessary in carrying on the business of the tramway company and such employment carried with it as a necessary consequence a potential liability to pay compensation if such drivers should be injured in the course of their employment, the payment made by the company to the widow should be regarded as part of the company's operation for the purpose of earning income and, therefore, deductible under the Act. Then, for reasons which I find hard to follow, he disallowed the deduction of the costs.

If the present case were being determined under the law in force in any of the jurisdictions referred to I have no doubt that the deduction sought by the appellant would be allowed. The issue of fact is whether the payment made was in respect of a liability for a happening that was really incidental to the business. In my view, there is no doubt that it was. The undisputed evidence is that the transportation of petroleum and petroleum products by sea was part of the marine operations of the appellant and part of the business from which it earned its income, that the risk of collision between vessels is a normal and ordinary hazard of marine operations generally, and that, while the amount of the appellant's liability in the present case was unusually large, there was nothing abnormal or unusual about the nature of the collision itself. Negligence on the part of the appellant's servants in the operation of its vessels, with its consequential liability to pay damages

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for a collision resulting therefrom, was a normal and ordinary risk of the marine operations part of the appellant's business and really incidental to it.

That being so, the question is whether the law under section 6 (*a*) of the Income War Tax Act is so fundamentally different from that of the other jurisdictions referred to as to exclude deductibility of the amount claimed. I have come to the conclusion that it is not. The kind of disbursement or expense that is deductible under the corresponding section in England was defined by Lord Davey in *Strong & Co., Limited* v. *Woodifield* (1) in terms frequently cited:

> It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits.

The citation should start further back in order to explain what is meant by the last sentence for, obviously, a disbursement by itself cannot accomplish the purpose of earning profits. Lord Davey gave the necessary explanation when, in speaking of disbursements "for the purpose of the trade", he said:

> These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements are such as are made for that purpose.

What is meant is that the disbursement must be made for the purpose of enabling a person to earn the profits in the trade. Lord Davey's statement was approved by the Lord President (Clyde) of the Scottish Court of Session in *Robert Addie & Sons' Collieries, Limited* v. *Commissioners of Inland Revenue* (2) where the following test was laid down:

> What is "money wholly and exclusively laid out for the purpose of the trade" is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question. Is it a part of the Company's working expenses: is it expenditure laid out as part of the process of profit earning?

This test was adopted by the Judicial Committee of the Privy Council in *Tata Hydro-Electric Agencies, Bombay* v. *Income Tax Commissioner, Bombay Presidency and Aden* (3) and applied to the construction of section 10 (2)

(1) (1906) A.C. 448 at 453.
(2) (1924) S C. 231 at 235.
(3) (1937) A C. 685 at 696.

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of the Indian Income-Tax Act which provided that the profits and gains of any business carried on by the assessee were to be computed after making allowance for

> (ix) any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning such profits or gains.

This wording is indistinguishable in principle from that of section 6 (*a*). The test in the *Addie* case (*supra*) was, therefore, just as applicable to the Canadian Act as it was to the Indian one and it was adopted as being so applicable by the Supreme Court of Canada in *Minister of National Revenue* v. *Dominion Natural Gas Co. Ltd.* (1). In that case the respondent company had incurred legal expenses in defending its right to supply gas in the City of Hamilton and sought to deduct such expenses from its income. The Supreme Court of Canada, reversing the judgment of this Court, held that it was not entitled to do so. All the judges were agreed that the expenditure did not meet the test laid down by Lord President Clyde in the *Addie* case (*supra*). Duff C. J., for himself and Davis J, held the legal expenses to be not deductible on two grounds; one, that they were not expenses incurred in the process of earning "the income", and the other, that the expenditure was a capital expenditure incurred "once and for all" for the purpose and with the effect of procuring for the company "the advantage of an enduring benefit". Crocket J. considered the test laid down in the *Addie* case (*supra*) and approved in the *Tata* case (*supra*) binding and held that the expenditure did not fall within it. Kerwin J., speaking for Hudson J. as well, also held that the test referred to was applicable and that the payment of the costs was not an expenditure laid out as part of the process of profit earning. His view was that it was a "payment on account of capital" made "with a view of preserving an asset or advantage for the enduring benefit of a trade". Apart from the decision as to the non-deductibility of the kind of item of expenditure considered in that case, with which we are not here concerned, I think it is clear that, by its adoption of the test in the *Addie* case (*supra*) as being applicable in the construction of section 6 (*a*), the Supreme Court of Canada decided that the words "for the purpose of earning the income" in section 6 (*a*) have substantially

(1) (1941) S.C.R. 19.

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the same meaning as the words "for the purposes of the trade" in the corresponding rule under the English Act. It is interesting to note that just as Lord President Clyde read the words "for the purposes of the trade" as meaning "as part of the process of profit earning", so Duff C.J. read the words "for the purpose of earning the income" as meaning "in the process of earning the income". With respect I suggest that his paraphrasing would have been more precise, and more in line with the statement in the *Addie* case (*supra*), if he had read them as meaning "as part of the process of earning the income". Moreover, that would have been more in accord with the judgments delivered by Crocket J. and Kerwin J. who adopted the test in the *Addie* case (*supra*) without any paraphrasing of it. Under the circumstances, I think it may fairly be said that the words "disbursements or expenses * * * laid out or expended for the purpose of earning the income" in section 6 (*a*) mean "disbursements or expenses * * * laid out or expended as part of the process of earning the income". Leave to appeal to the Judicial Committee of the Privy Council from the decision of the Supreme Court of Canada in the *Dominion Natural Gas Company* case (*supra*) was refused. But, a few years later the Judicial Committee was called upon to consider section 6 (*a*) and particularly the words "for the purpose of earning the income" in *Montreal Coke and Manufacturing Co.* v. *Minister of National Revenue* (1). In that case the appellant had redeemed certain bonds prior to their maturity and issued other bonds at reduced rates of interest, with a resulting increase in its net revenues, and sought to deduct the expenses of these financial operations from its income. The Judicial Committee, affirming the judgment of the Supreme Court of Canada, which in turn by a majority had affirmed the judgment of this Court, held that such expenses were not deductible. At page 133, Lord Macmillan said:

> If the expenditure sought to be deducted is not for the purpose of earning the income, and wholly, exclusively and necessarily for that purpose, then it is disallowed as a deduction.

And later, on the same page, gave the reasons for not allowing the deduction of the expenses of the financial

(1) (1944) A.C. 130.

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operations, even although they resulted in an increase of income, as follows:

> If the statute permitted the deduction of expenditure incurred for the purpose of increasing income the appellants might well have prevailed, but such a criterion would have opened a very wide door. It is obvious that there can be many forms of expenditure designed to increase income which would not be appropriate deductions in ascertaining annual net profit or gain. The statutory criterion is a much narrower one. Expenditure, to be deductible, must be directly related to the earning of income. The earnings of a trader are the product of the trading operations which he conducts. These operations involve outgoings as well as receipts, and the net profit or gain which the trader earns is the balance of his trade receipts over his trade outgoings. It is not the business of either of the appellants to engage in financial operations. The nature of their businesses is sufficiently indicated by their titles. It is to those businesses that they look for their earnings. Of course, like other business people, they must have capital to enable them to conduct their enterprises, but their financial arrangements are quite distinct from the activities by which they earn their income. No doubt the way in which they finance their business will, or may, reflect itself favourably or unfavourably in their annual accounts, but expenditures incurred in relation to the financing of their business is not, in their Lordships' opinion, expenditure incurred in the earning of their income within the statutory meaning.

The argument of counsel for the respondent against allowing the deduction claimed by the appellant was strongly and clearly put. It can be summarized briefly. His first contention was that the test of the deductibility of an expenditure is whether it was wholly, exclusively and necessarily laid out for the purpose of earning the income, that each expenditure has to be isolated and the question asked, what income did it wholly, exclusively and necessarily earn? And he answered his own question with regard to the expenditure under review by saying that it did not earn income either in 1927 when the collision occurred or in 1930 when the amount of the appellant's liability was finally ascertained and paid, and that since it did not earn any income it was not deductible. Counsel also took the position that there was a radical and fundamental difference between the wording of section 6 (*a*) and that of the corresponding section in the English Act, and that there was a larger measure of deduction under the English Act than under the Canadian one. In this connection he went so far as to urge that the decision of the Supreme Court of Canada in the *Dominion Natural Gas Company* case (*supra*) in applying the test in the

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Addie case (*supra*) to section 6 (*a*) was wrong, that the statement of Duff C.J. in that case to the effect that the words "for the purpose of earning the income" in section 6 (*a*) meant "in the process of earning the income" was inconsistent with the language of the section and had been overruled by the Judicial Committee in the *Montreal Coke Company* case (*supra*) and that the definition given by him must be disregarded in the light of Lord Macmillan's statement that, to be deductible, an expenditure "must be directly related to the earning of income". From this premise counsel then argued that the expenditure was not primarily for the purpose of earning income but primarily for the purpose of settling a legal liability, that the liability was for the negligence of the appellant's servants which could not be related to the earning of its income, that the expenditure was not laid out for the purpose of earning profit at all but solely to satisfy a legal liability and thus keep the sheriff away from the appellant's door and that since this was the true purpose of the expenditure it could not be regarded as being directly related to the earning of the income. Then, in addition, counsel took a position similar to that taken by Collins M.R. in the Court of Appeal in *Strong & Co., Limited* v. *Woodifield* (*supra*) that the expenditure was not deductible because it was not laid out for the purpose of earning profits but was made out of profits after they were earned.

I am unable to accept any of the contentions thus put forward. In my judgment, counsel assigned a much narrower range of permissible deductibility under section 6 (*a*) than its language warrants. For example, while the section 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.* (1). I

(1) (1933) 17 T.C. 625.

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might say, in passing, that, in my opinion, there is no need of a specific provision in the Act permitting the deduction of losses sustained as part of the process of earning the income, such as is contained in some of the Acts in the other jurisdictions. Nor does the statement of Lord Macmillan in the *Montreal Coke Company* case (*supra*) that "expenditure, to be deductible, must be directly related to the earning of income" imply any causal connection between expenditure and income. It is a mistake to take a sentence out of a judgment and construe it as if it were a sentence in a statute. It is no such thing, and has no binding effect apart from its context. By itself, the sentence referred to is not a precise statement of what is intended, with the result that the inference of the suggested causal connection might possibly be drawn from it, but when it is read with its context there is no doubt as to its meaning. Lord Macmillan was not concerned at all with any causal connection between expenditure and income. He was dealing with the statutory criterion for the deductibility of expenditures set in section 6 (*a*) through the use of the words "for the purpose of *earning* the income" and drew a sharp distinction between two classes of expenditures, namely, those connected with the financial operations of the appellants and those connected with their business. If causal connection between expenditure and income were a condition of deductibility the former would be no less entitled to deduction than the latter for the appellants received income from their financial operations as well as from their business. But since it was only through their business that they *earned* income, Lord Macmillan concluded that under section 6 (*a*) only the latter class of expenditures could be deducted; those connected with the appellants' financial operations, not being related to the business from which alone the appellants *earned* income, were held to be excluded from deduction. Lord Macmillan meant no more than this. He did not, in my view, lay down any new test of what is meant by the words "for the purpose of earning the income" different from that used in the *Dominion Natural Gas Company* case (*supra*) through the application of the test in the *Addie* case (*supra*). It

would, indeed, be strange if he had done so, for he had delivered the judgment of the Judicial Committee in the *Tata* case (*supra*) in which he applied the test in the *Addie* case (*supra*) to the section of the Indian Income Tax Act corresponding to section 6 (*a*) and indistinguishable in principle from it. There is, therefore, no substance in the argument that the *Montreal Coke Company* case (*supra*) overruled the *Dominion Natural Gas Company* case (*supra*). I can find nothing in Lord Macmillan's judgment that is inconsistent with it. Its authority that the test in the *Addie* case (*supra*) is applicable in the construction of section 6 (*a*) remains unimpaired. The result is that the law as to the deductibility of an expenditure such as that sought to be deducted by the appellant is the same under section 6 (*a*) as under the corresponding sections of the English, Australian and South African Acts.

Even apart from the decisions it is a reasonable interpretation of section 6 (*a*) that it should be so, even although there are some differences of language. It is obvious that the words "for the purpose of earning the income" in section 6 (*a*), as applied to disbursements or expenses, cannot be construed literally, for the laying out or expending of a disbursement or expense cannot by itself ever accomplish the purpose of earning the income. As Watermeyer A. J. P. pointed out in *Port Elizabeth Electric Tramway Company* v. *Commissioner for Inland Revenue* (*supra*), income is earned not by the making of expenditures but by various operations and transactions in which the taxpayer has been engaged or the services he has rendered, in the course of which expenditures may have been made. These are the disbursements or expenses referred to in section 6 (*a*), 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

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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.

It is no answer to say that an item of expenditure is not deductible on the ground that it was not made primarily to earn the income but primarily to satisfy a legal liability. This was the kind of argument that was expressly rejected by the High Court of Australia in the *Herald & Weekly Times, Ltd.* case (*supra*), and it should be rejected here. In a sense, all disbursements are made primarily to satisfy legal liabilities. The fact that a legal liability was being satisfied has, by itself, no bearing on the matter. It is necessary to look behind the payment and enquire whether the liability which made it necessary—and it makes no difference whether such liability was contractual or delictual —was incurred as part of the operation by which the taxpayer earned his income. Where income is earned from certain operations, as it was by the appellant from its marine operations, all the expenses wholly, exclusively and necessarily incidental to such operations must be deducted as the total cost thereof in order that the amount of the profits or gains from such operations that are to be assessed may be computed. Such cost includes not only all the ordinary operations costs but also all moneys paid in discharge of the liabilities normally incurred in the operations. When the nature of the operations is such that the risk of negligence on the part of the taxpayer's servants in the course of their duties or employment is really incidental to such operations, as was the fact in the present case, with its consequential liability to pay damages and costs, then the amount of such damages and costs is properly included as one of the items of the total cost of such operations. It may, therefore, properly be described as a disbursement or expense that is wholly, exclusively and necessarily laid out as part of the process of earning the income from such operations. It cannot be said, under the circumstances, that the payment of such damages and costs is made out of profits. It is no such thing. Being an item of the total cost of the operations

it must be deducted, along with the other items of cost, before the amount of the profits from the operations can be ascertained.

For the reasons given I have no hesitation in finding that the amount sought to be deducted by the appellant would properly be deductible according to the ordinary principles of commercial trading and well established principles of business and accounting practice as an item in the total cost of its marine operations, and that it falls outside the excluding provisions of section 6 (*a*). The amount was, therefore, improperly added to the assessment and it should be amended accordingly. The appeal must, therefore, be allowed with costs.

Judgment accordingly.