
BETWEEN: 1939

DOMINION NATURAL GAS CO. LTD....APPELLANT; Nov. 21.

1940
Jan. 3.

AND

MINISTER OF NATIONAL REVENUE..RESPONDENT.

Revenue—Income—Income War Tax Act, R.S.C., 1927, c. 97, secs. 3, 5 and 6—"Outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence"—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—Legal expenses incurred in defending action at law to protect franchise—Charge against revenue—Appeal allowed.

Appellant owned a franchise to supply gas to the inhabitants of the City of Hamilton and elsewhere. In 1931 an action at law was begun against appellant by the United Gas and Fuel Company of Hamilton

1940

DOMINION NATURAL GAS CO LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

Ltd., which company attacked the franchise rights and privileges of appellant Appellant successfully defended the action and deducted from its taxable income for the year 1934 the sum of $48,560 94 being the legal expenses incurred by it. This deduction was disallowed by the Commissioner of Income Tax whose decision was affirmed by the Minister of National Revenue.

Held: That the advantages and benefits accruing from the successful defence of the action were of a revenue character, and the cost of the action was a necessary expense in carrying on the trade and in earning the annual net profit and gain of appellant.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

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

Hon. George Lynch-Staunton, K.C. for appellant.

J. J. Hunt, K.C., M. McLean and *A. A. McGrory* for respondent.

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

THE PRESIDENT, now (January 3, 1940) delivered the following judgment:

This is an appeal from the decision of the Minister of National Revenue and relates to a claim for deduction on an assessment for income tax, for the fiscal year ended December 31, 1934.

The facts may be briefly stated. The appellant, hereinafter called "the Dominion Company," was possessed of a franchise to supply gas to the inhabitants of the City of Hamilton and elsewhere, and the United Gas and Fuel Company of Hamilton, Ltd., hereinafter called "the United Company," also had a franchise to supply gas to the inhabitants of the City of Hamilton. In 1931, the United Company brought an action against the Dominion Company claiming (1) a declaration that the Dominion Company was wrongfully maintaining its mains in the streets of the City of Hamilton and wrongfully supplying gas to the inhabitants of that city, (2) an injunction restraining the Dominion Company from continuing so to use the streets of the city and from continuing to supply gas to the inhabitants, (3) a mandatory order requiring

the Dominion Company to remove its mains and other property from the streets and elsewhere in the city, and (4) damages. The Dominion Company, as might be expected, considered this as a very serious attack upon its franchise rights and privileges, and its trade, and its directing officers were of the view that it was obliged to contest the action.

In due course the action came on for trial before the Supreme Court of Ontario, and the action was dismissed. An appeal was then taken by the United Company from the decision of the trial Court to the Appellate Division of the Supreme Court of Ontario and the appeal was dismissed. The United Company then appealed to the Judicial Committee of the Privy Council, and again it was unsuccessful. All this litigation cost the Dominion Company $48,560.94, in addition to any taxed costs recovered against the United Company.

There came a time when the Dominion Company was required to file its income tax return for the year 1934, which it did, showing its taxable income to be $202,326.86, but this was later increased by the taxing authorities to $250,890.80, and this resulted from the disallowance as an item of trade expense the said sum of $48,560.94, the legal expenses incurred by the Dominion Company in resisting the action of the United Company. And the question for decision is whether the said sum is allowable as a deduction in computing the taxable income of the Dominion Company for the taxation period in question.

The Dominion Company contends that the said sum disbursed for legal expenses was a necessary one in the conduct of its trade, and that it is an allowable deduction under the provisions of the Income War Tax Act. On behalf of the Minister it was conceded that the said legal expenses were incurred by the Dominion Company in defending the said action, and that the said sum was so expended, but, it is contended, that the same was not an expense wholly, exclusively and necessarily laid out or expended by the Dominion Company for the purpose of earning its income, and was in fact an expense incurred with a view to preventing the extinction or partial extinction of a profit earning enterprise; and that the sum expended as legal fees by the Dominion Company was an application of earned profits for the purpose of earning future

1940

DOMINION NATURAL GAS CO. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

profits, and therefore an expenditure on account of capital, one not permissible as a deduction in computing the Dominion Company's assessable income under the Act.

The sections of the Income War Tax Act which are at all relevant here may at once be referred to. First, s. 3 defines "income" to mean the "annual net profit or gain or gratuity . . . . or as being profits from a trade or commercial or financial or other business or calling . . ." Then, s. 5 provides that "income," as defined by the Act, shall be subject to certain exemptions and deductions, and they are therein enumerated. Then, s. 6, the important section in this case, enumerates a number of cases in which deductions are not to be allowed in computing the amount of the profits or gains to be assessed. Sec. 6 in part reads thus:

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;

(*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act.

As I shall have occasion later to mention, the deductions that are permitted to a trader in computing his profits or gains are not affirmatively stated in the Act. They are to be ascertained by an examination of the deductions which are not allowed.

As a number of English decisions were cited before me it may be desirable to refer briefly to the provisions of the English Income Tax Acts which correspond to s. 6 (*a*) and (*b*) of the Income War Tax Act. The English Acts prohibit deductions in respect of "any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purpose of the trade, profession, employment or vocation." This provision corresponds closely to s. 6 (*a*) of the Canadian Act. The Acts provide that any capital withdrawn from, or any sum employed or intended to be employed as capital in the trade, is not deductible, and also any capital employed in improvements of premises occupied for the purposes of the trade. It is of course fundamental that any profit made from the sale or realization of a capital asset is not a receipt of the trade. In England, capital is treated as being

either fixed or circulating. A fixed capital asset is described as an asset which it is intended to keep and use in a trade, and a circulating asset is an asset which is acquired or manufactured for the purpose of being turned over or sold in the course of carrying on trade. Outgoings which result in the acquisition of a fixed capital asset, or which produce an advantage of a permanent and enduring nature are not deductible, but such advantage must be analogous to an asset. For example, the following items have been held by the English Courts not to be deductible: The expenses of removal to new premises or the fitting up of new shops; the cost of conversion of premises; the cost of dredging a deep-water channel; the cost of improvement of the permanent way of a railway; the payment for surface damage by a colliery; the cost of a surrender of leases; the cost of draining a mine in preparation for new operations; the payment to an insurance company for a policy to underwrite the liability of a trader to pay pensions; a sum paid for an option to purchase fixed capital assets; the expenses of an issue of debentures; and the loss on shares acquired for business purposes. Several of these examples were cited before me by counsel for the Minister as illustrative of the capital nature of the legal expenses in question here.

As I propose referring later to some American cases it will be as appropriate here as elsewhere to refer to two or three provisions of the statute there in force in respect of the income tax. The Revenue Laws of the United States provide that in computing net income there shall be allowed as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." That provision is the one corresponding to s. 6(*a*) of the Canadian Act. In computing net income no deduction is permissible in respect of "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate," or in respect of "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made"; so far as I can observe those are the principal provisions referable to capital disbursements.

The Income War Tax Act, as has been said of the corresponding English Act, does not provide a code of the law

1940

DOMINION NATURAL GAS CO. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

on the subject of income. It is silent as to many matters of the first importance. For example, the Act contains no explicit directions that in computing the profits of a trade any expense (as to which there is no express prohibition) is to be deducted, if on the facts of the case it is a proper debit item to be charged against incomings. The generally recognized rule as regards trade expenses is that a deduction is permissible which is justifiable on business and accountancy principles, but this principle is subject to certain specific statutory provisions, which prohibit the allowance of certain expenses as deductions in computing the net profit or gain to be assessed. To the extent that ordinary business and accountancy principles are not invaded by the statute they prevail. In computing the amount of the profits and gains to be assessed the Act does not sanction specific deductions, but by prohibiting certain deductions it impliedly allows other deductions. In order that a trade expense may be allowable as a deduction, the amount expended must be, "wholly, exclusively and necessarily" laid out for the purpose of "earning the income," which means the "annual net profit or gain," but this must not be construed so as to preclude the deduction of those expenses as a result of which receipts of profits may accrue in the future. The principle is well established that expenses to earn future profits are allowable deductions, for example, the cost of a reasonable amount of advertising is usually admitted as a business expense, although the result of a particular advertisement might not be reflected in the year in which the cost was incurred. Nor does it follow that all the deductions a trader might make in ascertaining his profit are necessarily allowed by the Act as an expense or deduction. Therefore, in considering what is an allowable expense or deduction, we must first enquire whether it is one prohibited by the Act; if it is not prohibited, then we must consider next whether it is of such a nature that according to sound business and accountancy principles it is a proper item to be charged against the receipts in a computation of the annual net profit or gain, and was expended for earning the same, and therefore allowable, or, whether it is an expense that should be charged as a capital expenditure, and therefore one not deductible in computing the amount of the profit or gain to be assessed. In the case under

consideration, the legal expenses incurred by the Dominion Company do not fall within the prohibited deductions and the question to be determined is whether it was one that should be charged against revenue or against capital. If it were properly a charge against revenue then the appeal herein must be allowed, if against capital then the appeal must be refused.

A number of English authorities were cited before me on behalf of the respondent in support of the contention that the expenditure here was a non-recurring expense, an expenditure made once and for all, and therefore a charge against capital and not deductible in ascertaining the net profit or gain for the purposes of the income tax. That contention was the subject of discussion in the case of *Anglo-Persian Oil Co. Ltd.* v. *Dale* (1). In that case there will be found, in the judgment of Lord Hanworth, M.R., a reference to several cases of the nature cited before me, and possibly others. The question there was whether a sum paid by the Anglo-Persian Oil Company to terminate an agency was an admissible deduction. The Commissioners held it was not an admissible deduction in computing the profits and gains of the company. On appeal, Rowlatt J. held it was a revenue payment and was deductible in ascertaining the net profits of the company, and in this he was sustained by the Court of Appeal. I would refer particularly to a passage from the judgment of Romer L.J., wherein, after a reference to some of the difficulties encountered in determining what are permissible deductions, he proceeded to say:

> At the end of the year 1925, however, all these authorities were considered by the House of Lords in *British Insulated and Helsby Cables* v *Atherton,* and the law applicable to such cases as the present was, as it seems to me, placed beyond the realms of controversy. The boundary line between deductions that were permissible and those that were not had previously been uncertain and difficult to follow As regards the large majority of deductions, there was and could be no conceivable doubt They were clearly on one side of the line or the other But as regard a comparatively small number, it was difficult to say on which side of the line they fell This was particularly the case where, as in the present case, an expenditure is not a recurring one, but is made once and for all It was pointed out by Lord Cave in *Atherton's* case that an expenditure, though made once and for all, may nevertheless be treated as a revenue expenditure, and he then added this· "But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a

(1) (1932) 1 K.B. 124.

1940

DOMINION NATURAL GAS CO. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

It should be remembered, in connection with this passage, that the expenditure is to be attributed to capital if it be made "with a view" to bringing an asset or advantage into existence. It is not necessary that it should have that result. It is also to be observed that the asset or advantage is to be for the "enduring" benefit of the trade. I agree with Rowlatt J. that by "enduring" is meant "enduring in the way that fixed capital endures." An expenditure on acquiring floating capital is not made with a view to acquiring an enduring asset. It is made with a view to acquiring an asset that may be turned over in the course of trade at a comparatively early date. Nor, of course, need the advantage be of a positive character. The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in *Mallett* v. *Staveley Cord & Iron Co.*

Now this being the test to be applied in such cases as the present, it is obvious that the question whether an expenditure made once and for all is or is not to be treated as chargeable to capital and not revenue is one of fact only. Being a question that the Commissioners are eminently qualified to answer, it is to be hoped that in future they will answer it by reference to the language of the test laid down by Lord Cave, and not as though they are deciding a question of law. Too often in the past the Commissioners have found that a particular sum is or is not a permissible deduction. That is a question of law, or at any rate mixed law and fact. If they will find that the expenditure in question was or was not made, as the case may be, with a view to bringing into existence some asset or advantage for the enduring benefit of the trade, their finding will be one of fact, and if there be some evidence upon which the finding can reasonably be made, it will not be subject to review in the Courts.

I am of the opinion that the expenditure in question here cannot be said to be a capital outlay or loss, that is to say, it was not, in the language of the Act, an "outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence." There would seem to be no warrant for holding that the fixed capital of the Dominion Company was benefited by the expenditure, or that its trade from a capital point of view gained any advantage by the expenditure. No advantage accrued to the capital of the Dominion Company by the success attending its defence of the action brought against it. The situation as to capital remained as it was.

We may then consider if the expenditure in question was one necessarily incurred for the purpose of earning the income, within the meaning of s. 6 (*a*) of the Act. As has been frequently said, no degree of ingenuity can frame a formula so precise and comprehensive as to solve all the questions that may arise in computing the annual net profit or gain of a trader, and reasoning by analogy from

the facts of one case to the facts of another case is not entirely satisfactory and is liable to lead to erroneous conclusions. I understood Mr. Lynch-Staunton to say on the hearing of this appeal that the revenue authorities had actually allowed, tentatively at least, as a deduction, the legal expenses of both the Dominion Company and the United Company, but this decision or ruling was apparently not adhered to. I mention this only as an indication of the difficulties frequently encountered in deciding whether or not an expenditure incurred was one necessary for earning the annual net profit or gain.

Considerable reliance was placed by counsel for the respondent on the case of *Ward & Company Ld.* v. *Commissioner of Taxes* (1), and therefore I feel compelled to make a brief reference to it. There the taxpayer, a brewery company, made certain expenditures with a view of influencing public opinion in a poll of the voters of New Zealand about to be held on the question of prohibition of intoxicants, by printing and distributing anti-prohibition literature. The taxpayer sought to deduct the expenditure in the assessment of the income derived from its business on the ground that it was made for the purpose of preventing the extinction or depreciation of the business from which the income was derived. It was held by the New Zealand Court of Appeal that no deduction was allowable in respect of such an expenditure because it was "not exclusively incurred in the production of the assessable income . . .", which decision was, on appeal to the Judicial Committee of the Privy Council, sustained, their Lordships holding that the expenditure was a voluntary expense incurred with a view to influencing public opinion, and not one necessary for the production of profit, and that it was not in fact incurred for that purpose. I should not have thought myself that any other conclusion was possible, but at any rate it is not, in my opinion, an authority applicable to the state of facts here.

No distinction is to be drawn between legal expenses and other business expenses. The question always is whether the expense was a necessary one for the purpose of earning the annual net profit or gain of the taxpayer. In the well known case of *Usher's Wiltshire Brewery Ltd.* v. *Bruce* (2), legal expenses were allowed as a deduction.

(1) (1923) A.C. 145 (2) 1915) A.C. 433 at 437.

1940

DOMINION NATURAL GAS CO LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

In that case these expenses consisted of "solicitors costs and disbursements in respect of the renewal of publicans' licences or tenancy agreements, the assessments of tied houses, obtaining a full licence, complaints against tenants, and advising as to thefts of beer." There is little discussion in the speeches of their Lordships concerning the particular deduction claimed for legal expenses, and, in fact, it would appear that no objection was taken by the Attorney-General against their allowance. The legal expenses were held to be a proper debit in ascertaining the balance of profit and loss in the taxpayer's trade. In Gordon's Digest of Income Tax Cases, under the caption of "Legal, Auditing and Technical Expenses," will be found reference to several cases in which legal expenses were allowed as deductions, and other cases in which they were disallowed.

I might now refer to some United States cases which involved the question of the allowance of legal expenses as deductions in computing the net taxable income of the taxpayer. As earlier mentioned, the United States statute provides that "in computing net income there shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In *Kornhauser* v. *United States* (1), it was held by the Supreme Court of the United States that, where a taxpayer successfully defended an accounting suit brought by his former law partner respecting shares of stock which the taxpayer had received for professional services performed by him, during the existence of the partnership as the partner alleged, but after its termination as claimed by the taxpayer, the legal expenses paid by the taxpayer in defending the suit were deductible from gross income as "an ordinary and necessary business expense" incurred in carrying on a business. In *Commissioner* v. *Peoples-Pittsburgh Trust Co.* (2), it was held that expenses incurred by the taxpayer in successfully defending himself against a criminal charge involving fraud in making up the income tax return of a corporation of which he was chairman were deductible in his personal income tax return as an "ordinary and necessary business expense." In *Commissioner* v. *Continental Screen Co.* (3), attorneys were employed to represent the taxpayer before

(1) 276 U.S. 145. (2) 60 Fed (2nd) 187.
(3) 58 Fed. (2nd) 625.

the Federal Trade Commission on a charge of operating in violation of the Sherman Anti-Trust Act, with the result that an order was eventually made dismissing the complaint. The legal fees paid to the attorneys were held deductible in computing net income. The Circuit Court of Appeals, Sixth District, in this case said: "The proceeding before the Trade Commission was undoubtedly an "action" against the respondent which was "directly connected with" or which "proximately resulted" from its business. To respondent's board of directors the situation was ominous. The life of the business was endangered. Under such circumstances respondent followed the very natural and ordinary procedure suggested by the vital necessity of the situation. It employed counsel to protect its interest and agreed to pay for their services. Any other course upon the part of its board of directors would have been unusual and would, no doubt, have subjected them to well founded criticism by its stockholders." This case was cited with approval by the Circuit Court of Appeals, Second Circuit, in the case of *National Outdoor Advertising Bureau* v. *Helvering* (1), on the ground that "the taxpayer's resistance was there justified and was necessary to the protection of his business." In *Citron-Byer Co.* v. *Commissioner* (2), a corporation and two of its officers were indicted for an alleged offence which arose directly out of its business, and it being determined by the court that no such offence had been committed it was held that the legal fees paid by the corporation to counsel, in defending the prosecution, were deductible and constituted an ordinary and necessary business expense.

It seems to me that if legal expenses are incurred in successfully defending an action in which one's title to existing assets, rights or facilities are put in serious question, such expenses should normally be admissible as deductions, and particularly would this be so in the case where the earning of profits are directly dependent upon and require the utilization of such assets, rights or facilities, as was the case here. If the action is unsuccessfully defended the revenue authorities might contend that there was no asset, right or facility to defend, and that therefore

(1) 89 Fed. (2nd) 878. (2) 21 B.T.A. 308.

1940

DOMINION NATURAL GAS CO. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

such expenses should not be allowed as a deduction in computing net taxable income, but that is not this case. If such expenses arose out of the promotion or acquisition of additional assets, rights or facilities, it is probable no deduction would be permissible. It was imperative here that the Dominion Company defend the action and the failure of its directors to do so would probably have rendered themselves liable in damages to the shareholders of that company. The action threatened the earnings of the Dominion Company, wholly or partially, and had the action succeeded it would have been unable to sell gas, at least in some sections of the City of Hamilton; the company's capacity to earn revenue was put in jeopardy and, I think, it is immaterial that its capital assets, or some of them, were incidentally threatened with extinction or depreciation. It was because the Dominion Company was producing and selling gas that it had to defend the action and thus protect and preserve its credit and its revenue. The United Company sought an injunction restraining the Dominion Company from continuing to supply gas to the inhabitants of the City of Hamilton, which, had the United Company been successful, would have prevented the Dominion Company from earning its usual revenue. The advantages and benefits accruing from the successful defence of the action were of a revenue character, and the cost of the same was, I think, a necessary expense in carrying on the trade, and in earning the annual net profit and gain. It seems to me that the legal expenses here incurred cannot be regarded as anything else than a charge against revenue. In my opinion the legal expenses incurred by the Dominion Company were incident to its trade, and were incurred for the purposes of its trade and the earning of its annual net profit or gain. I therefore think that the deduction claimed by the Dominion Company should be allowed. The appeal is therefore allowed and with costs.

Appeal allowed.