THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

1968
*Mar. 15, 18
Oct. 1

AND

HENRY J. FREUD ..... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Deductions—Capital outlay or deductible expense—Expenses incurred by individual in trying to develop and sell prototype of sports car—Adventure in the nature of trade or investment—Corporation formed to promote venture—Whether existence of corporation affects deductibility of loss from other income—Business losses to be deducted from other income in year in which they were incurred—Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(a), (b), 27(1)(e), 139(1)(e), (x).

In 1958 the taxpayer, practising law in Detroit and residing in Windsor, conceived, with an associate, the idea of designing and developing a prototype of a sports car with the intention of selling their concept, embodied in the prototype, to a manufacturer of cars who could be interested in putting it into production. A corporation was formed to carry out the project and shares were issued to the two associates and others who put money in the undertaking. In 1960, the taxpayer advanced to the corporation a sum of $13,840.47 in a final attempt to sell the idea to a manufacturer. Part of this money was paid to the corporation and part consisted of direct payments for labour, materials and expenses. When the venture became a total loss in 1960, the taxpayer sought to deduct the $13,840.47 from his other income for that year. The Tax Appeal Board upheld the Minister's assessment and ruled that the money was not deductible as it was to be regarded as a capital outlay. This judgment was reversed by the Exchequer Court which held that the moneys were spent by the taxpayer for the purpose of obtaining an income. The Minister appealed to this Court.

*PRESENT: Cartwright C.J. and Fauteux, Hall, Spence and Pigeon JJ.

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Held: The appeal should be dismissed.

The amount in question must be considered as an outlay for gaining income from an adventure in the nature of trade and not as an outlay or loss on account of capital. It could not be considered as an investment. From its inception, the venture was not for the purpose of deriving income from an investment but for the purpose of making a profit on the sale of the prototype. The payments made by the taxpayer were purely speculative. If a profit had been obtained it would have been taxable irrespective of the method adopted for realizing it. The fact that a corporation was formed to carry out the venture did not affect the matter. If the taxpayer and his friends had been successful in selling the prototype, they might well have done it by selling their shares in the company instead of having the corporation sell the prototype. There can be no doubt that if they had thus made a profit it would have been taxable. The same rule must be followed when a loss is suffered. The payments made by the taxpayer could not be considered as a separate operation isolated from the initial venture and had none of the characteristics of a regular loan. In the circumstances, the loss should be deducted from the other income of the taxpayer in the year in which it was sustained, namely 1960.

Revenu—Impôt sur le revenu—Déductions—Déboursé de capital ou dépense déductible—Sommes dépensées par un individu dans le but de construire et de vendre un prototype d'une automobile de sport —Affaire d'un caractère commercial ou placement—Compagnie constituée pour l'affaire—L'existence de la corporation n'empêche pas de déduire la perte des autres revenus du contribuable—Perte commerciale déductible des autres revenus dans l'année dans laquelle elle est subie—Loi de l'impôt sur le revenu, S.R.C. 1952, c. 148, art. 12(1)(a), (b), 27(1)(e), 139(1)(e), (x).

En 1958 le contribuable, un avocat de Détroit résidant à Windsor, et une autre personne ont conçu l'idée de construire un prototype d'une automobile de sport avec l'intention de vendre leur idée, réalisée dans le prototype, à un fabricant d'automobiles qui pourrait être intéressé à en faire la fabrication. Une compagnie a été constituée pour mettre ce projet à exécution et des actions ont été émises aux deux associés et à d'autres personnes ayant mis de l'argent dans l'entreprise. En 1960, dans une dernière tentative de vendre l'idée à un fabricant, le contribuable a avancé une somme de $13,840.47 à la compagnie. Une partie de cette somme a été versée à la compagnie et une partie a été payée directement pour main-d'œuvre, matériaux et dépenses. Lorsque l'opération est devenue une perte totale en 1960, le contribuable a cherché à déduire le montant de $13,840.47 de ses autres revenus pour l'année en question. La Commission d'appel de l'impôt a maintenu la cotisation et a jugé que la somme n'était pas déductible parce qu'elle devait être considérée comme une perte de capital. Ce jugement a été infirmé par la Cour de l'Échiquier qui a statué que la somme avait été dépensée par le contribuable en vue d'obtenir un revenu. Le Ministre en appela à cette Cour.

Arrêt: L'appel doit être rejeté.

Le montant en question doit être considéré comme une somme déboursée en vue de gagner un revenu provenant d'une affaire d'un caractère commercial et non pas comme un déboursé ou une perte de capital. Le montant ne peut pas être considéré comme un placement. Dès ses débuts, l'opération n'avait pas pour but de tirer un revenu d'un placement mais de faire un profit sur la vente du prototype. Les paiements faits par le contribuable étaient purement spéculatifs. Si un profit avait été obtenu il aurait été imposable quelle qu'ait été la méthode employée pour le réaliser. Le fait qu'une compagnie a été constituée pour mettre l'affaire à exécution ne change rien. Si le contribuable et ses amis avaient réalisé un profit en vendant le prototype, ils auraient pu le réaliser aussi bien en vendant leurs actions dans la compagnie au lieu que ce soit la compagnie qui vende le prototype. Il n'y a aucun doute que si un profit avait été ainsi réalisé il aurait été imposable. On doit suivre la même règle lorsqu'une perte a été subie. Les paiements faits par le contribuable ne peuvent pas être considérés comme une opération distincte et isolée de l'entreprise initiale et n'avaient aucune des caractéristiques d'un prêt régulier. Dans les circonstances, la perte doit être déduite des autres revenus du contribuable dans l'année dans laquelle elle a été subie, c'est-à-dire 1960.

APPEL d'un jugement du Juge Gibson de la Cour de l'Échiquier du Canada[1], infirmant une décision de la Commission d'appel de l'impôt. Appel rejeté.

APPEAL from a judgment of Gibson J. of the Exchequer Court of Canada[1], reversing a judgment of the Tax Appeal Board. Appeal dismissed.

Alban Garon and *Pierre H. Guilbault,* for the appellant.

P. N. Thorsteinsson and *M. J. O'Keefe,* for the respondent.

The judgment of the Court was delivered by

PIGEON J.:—The facts of this case are somewhat unusual. The respondent who resided in Windsor, Ontario but practised law in Detroit, Michigan had, in conjunction with one Kettlewell, a tool and die maker, conceived the idea of designing a small personal sports car. Their intention was not to start a manufacturing operation but to interest a manufacturer to produce such a car. Together with one Porritt, a retired mechanical engineer, they embarked upon the project in 1958 and a first prototype was made in that year.

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[1] [1967] 1 Ex. C.R. 293, [1966] C.T.C. 641, 66 D.T.C. 5414.

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The monies put up in carrying on this project were advanced by respondent and Kettlewell to a company incorporated in Michigan. Shares were issued to them and also to some of their friends who were persuaded to put money in the undertaking. Further prototypes were made and contacts were had with various corporations in an unsuccessful attempt to sell the idea to one of them. In 1960, the other shareholders declined to put up any further monies. The respondent, however, spent a sum of $13,-840.47 in a final attempt to sell to the Seagrave Corporation the concept of the small personal sports car embodied in the last prototype which was driveable. Part of this money was disbursed by cheques to the company and another part by direct payments for labour, materials and expenses. For some months the Seagrave Corporation expressed interest but, in the end, it made no offer and the venture became a total loss.

The issue on this appeal is whether the sum of $13,-840.47 expended by respondent in the circumstances above described, is deductible from his other income in the year 1960 for the purpose of computing his taxable income. The assistant chairman of the Tax Appeal Board held that it was not deductible saying that it must be regarded as a capital outlay that, it was hoped, would bring about a marketable asset. On appeal to the Exchequer Court[1] this was reversed, Gibson J. holding that the monies paid out in 1960 by the respondent were monies spent by him for the purpose of obtaining an income. In this Court it was contended on behalf of the appellant that:

(1) the corporate existence of the company cannot be ignored;

(2) the company alone was engaged in the development of a sports car;

(3) the sum spent was not an outlay for gaining income from a business, property or other source; and

(4) this amount was an outlay or loss on account of capital.

Before dealing specifically with these contentions, some general observations appear desirable.

[1] [1967] 1 Ex. C.R. 293, [1966] C.T.C. 641, 66 D.T.C. 5414.

In 1952, Parliament eliminated from the *Income Tax Act* the rule in s. 13 (s. 10 of the *Income War Tax Act*) whereby the deduction of losses incurred in accessory business ventures was prohibited by providing that a taxpayer's income "shall be deemed to be not less than his income for the year from his chief source of income", and in 1958 s. 27(1)(*e*) was amended to provide for business losses being carried back or forward against income from any business instead of income from the same business only. Thus our law no longer looks askance at taxpayers who do not believe in "the adage that the cobbler should stick to his last". They are not subjected to discriminatory fiscal treatment by being taxed if successful but denied a deduction if unsuccessful.

It must also be noted that the *Income Tax Act* defines business so as to include "an adventure or concern in the nature of trade" (s. 139 (1)(*e*)). By virtue of this definition, a single operation is to be considered as a business although it is an isolated venture entirely unconnected with the taxpayer's profession or occupation. This consequence of the definition has been recognized and given effect to in many cases but I will refer only to one of them namely *McIntosh v. Minister of National Revenue*[2] in which it was held that a single venture of speculation in land gave rise to taxable income when profit was obtained as a result of an acquisition made with a view to a profit on the resale. Kerwin C.J. said (at pp. 120-121):

> It is quite true that an individual is in a position differing from that of a company and that, as stated by Jessel M.R. in *Smith v. Anderson* (approved by this Court in *Argue v. Minister of National Revenue*),
>
> > So in the ordinary case of investments, a man who has money to invest, invests his money and he may occasionally sell the investments and buy others, but he is not carrying on a business.
>
> However, it is also true, as well in the case of an individual as of a company, that the profits of an isolated venture may be taxed: *Edwards (Inspector of Taxes) v. Bairstow et al.* It is impossible to lay down a test that will meet the multifarious circumstances that may arise in all fields of human endeavour. As is pointed out in *Noak v. Minister of National Revenue,* it is a question of fact in each case, referring to the *Argue* case, *supra,* and *Campbell v. Minister of National Revenue,* to which might be added the Jugment of this Court in *Kennedy v. Minister of National Revenue,* which affirmed the decision of the Exchequer Court.

[2] [1958] S.C.R. 119, [1958] C.T.C. 18, 58 D.T.C. 1021, 12 D.L.R. (2d) 219.

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In the present case I agree with Mr. Justice Hyndman's findings with reference to the appellant that:

> Having acquired the said property there was no intention in his mind to retain it as an investment, but to dispose of the lots, if and when suitable prices could be obtained.

Such being the principles to be applied in cases when a profit is obtained, the same rules must be followed when a loss is suffered. Fairness to the taxpayers requires us to be very careful to avoid allowing profits to be taxed as income but losses treated as on account of capital and therefore not deductible from income when the situation is essentially the same.

In the present case, appellant does not deny that the venture in itself was an adventure in the nature of trade so that if respondent and his friends had embarked upon it in their own names, the loss would be deductible. It is in this light that the four contentions advanced on behalf of appellant must now be examined.

On the first question, the decision of this Court in *Fraser v. Minister of National Revenue*[3] appears to be in point. It was there held that where real estate operators had incorporated companies to hold real estate, the sale of shares in those companies rather than the sale of the land was merely an alternative method of putting through the real estate transactions and the profit was therefore taxable. This decision does not in my view necessarily imply that the existence of the companies as separate legal entities was disregarded for income tax assessment purposes. On the contrary, it must be presumed that the companies remained liable for taxes on their operations and their title to the land, unchallenged. I must therefore consider that the decision rests on the view that was taken of the nature of the outlay involved in the acquisition of the companies' shares by the promoters.

It is clear that while the acquisition of shares may be an investment (*Minister of National Revenue v. Foreign Power Securities Corp. Ltd.*[4]), it may also be a trading operation depending upon circumstances (*Osler Hammond*

[3] [1964] S.C.R. 657, [1964] C.T.C. 372, 64 D.T.C. 5224, 47 D.L.R. (2d) 98.

[4] [1967] S.C.R. 295, [1967] C.T.C. 116, 67 D.T.C. 5084.

and Nanton Ltd. v. Minister of National Revenue[5]; *Hill-Clarke-Francis Ltd. v. Minister of National Revenue*[6]). Due to the definition of business as including an adventure in the nature of trade, it is unnecessary for an acquisition of shares to be a trading operation rather than an investment that there should be a pattern of regular trading operations. In the *Fraser* case, the basic operation was the acquisition of land with a view to a profit upon resale so that it became a trading asset. The conclusion reached implies that the acquisition of shares in companies incorporated for the purpose of holding such land was of the same nature seeing that upon selling the shares instead of the land itself, the profit was a trading profit not a capital profit on the realization of an investment. This principle appears equally applicable in the circumstances of this case. If the respondent and his friends had been successful in selling the prototype sports car, they might well have done it by selling their shares in the company instead of having the company sell the prototype, and there can be no doubt that if they had thus made a profit it would have been taxable. Because no sale could be made, respondent and his friends obviously never reached the point at which consideration would be given to the method to be adopted for realizing the profit. This should not alter the situation because the decision in the *Fraser* case implies that, irrespective of the method adopted, any profit would have been income, not capital gain. Also in that case it must be noted that the companies alone held the land just as in the present case the company owned the prototype sports car. This appears to dispose of the first two questions raised by appellant.

Appellant further contends that the disbursements made by respondent should be considered as a loan to the company. This is somewhat doubtful because while reimbursement of the sums advanced to the company could probably have been claimed as money had and received, the sums paid direct to third parties might well have been considered as voluntary payments and not recoverable (Halsbury's Laws of England, 3rd ed., vol. 8, p. 231).

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[5] [1963] S.C.R. 432, [1963] C.T.C. 164, 63 D.T.C. 1119, 38 D.L.R. (2d) 178.

[6] [1963] S.C.R. 452, [1963] C.T.C. 337, 63 D.T.C. 1211.

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Assuming that the whole amount should properly be considered as a debt due by the company, this does not necessarily imply that the outlay was an investment. Obligations to pay money can be trading assets just like other things (*Scott v. Minister of National Revenue*[7]; *Minister of National Revenue v. MacInnes*[8]; *Minister of National Revenue v. Curlett*[9]). It is true that in those cases the conclusion that the acquisition of mortgages at a discount was a speculation, not an investment, rests upon a consideration of the large number of operations of a similar nature that were effected. But, on account of the definition of "business", this is not the only basis on which this conclusion can be reached. As previously pointed out, a single venture in the nature of trade is a business for the purposes of the *Income Tax Act* "as well in the case of an individual as of a company".

It is, of course, obvious that a loan made by a person who is not in the business of lending money is ordinarily to be considered as an investment. It is only under quite exceptional or unusual circumstances that such an operation should be considered as a speculation. However, the circumstances of the present case are quite unusual and exceptional. It is an undeniable fact that, at the outset, the operation embarked upon was an adventure in the nature of trade. It is equally clear that the character of the venture itself remained the same until it ended up in a total loss. Under those circumstances, the outlay made by respondent in the last year, when the speculative nature of the undertaking was even more marked than at the outset due to financial difficulties, cannot be considered as an investment. Whether it is considered as a payment in anticipation of shares to be issued or as an advance to be refunded if the venture was successful, it is clear that the monies were not invested to derive an income therefrom but in the hope of making a profit on the whole transaction.

At this point, the decision of this Court in *Minister of National Revenue v. Steer*[10] must be considered. In that

[7] [1963] S.C.R. 223, [1963] C.T.C. 176, 63 D.T.C. 1121, 38 D.L.R. (2d) 346.

[8] [1963] S.C.R. 299, [1963] C.T.C. 311, 63 D.T.C. 1170.

[9] [1967] S.C.R. 280, [1967] C.T.C. 62, 67 D.T.C. 5058, 60 D.L.R. (2d) 752.

[10] [1967] S.C.R. 34, [1966] C.T.C. 731, 66 D.T.C. 5481.

case, it was held that a guarantee given to a bank for a company's indebtness was a deferred loan to the company and that a large sum paid to the bank to discharge this indebtedness was a capital loss. The decision cannot imply that loans are always investments but only that such was the character of the loan in the circumstances of that case because, as we have seen, there are at least three recent cases in this Court where loans were held to be trading operations with the consequence that profits and losses were on income not capital account. It must also be added that the decision cannot imply that an outlay for the acquisition of an interest in an oil well drilling venture such as the company involved in the *Steer* case, can never be a trading venture because in *Dobieco Ltd. v. Minister of National Revenue*[11] such an interest was treated as a trading asset of an underwriting and trading firm. As we have seen while there is a presumption against an isolated operation having such a character in the hands of an individual, this presumption can be rebutted and it may be shown that even a single operation is in fact a venture in the nature of trade and therefore a "business" for income tax purposes.

In the present case as we have seen, the basic venture was not the development of a sports car with a view to the making of a profit by going into the business of selling cars but with a view to a profit on selling the prototype. Therefore, the venture, from its inception, was not for the purpose of deriving income from an investment but for the purpose of making a profit on the resale which is characteristic of a venture in the nature of trade. Nothing indicates that the character of the operation had changed when the outlays under consideration were made. On the contrary, the venture had become even more speculative, it was abundantly clear that respondent could have no hope of recovering anything unless a sale of the prototype could be accomplished. The outlays cannot be considered as a separate operation isolated from the initial venture, they have none of the characteristics of a regular loan.

In my view, the payments made by respondent could not properly be considered as an investment in the circumstances in which they were made. It was purely specula-

[11] [1966] S.C.R. 95, [1965] C.T.C. 506, 65 D.T.C. 5300.

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tion. If a profit had been obtained it would have been taxable irrespective of the method adopted for realizing it. Such being the situation, these sums must be considered as outlays for gaining income from an adventure in the nature of trade, that is a business within the meaning of the *Income Tax Act*, and not as outlays or losses on account of capital.

I now find it necessary to point out that while s. 27(1)(*e*) of the *Income Tax Act* as amended in 1958 clearly provides for the deductibility of business losses in the taxation year immediately preceding and in the five taxation years immediately following the year in which they are sustained, there is no explicit provision for such deductibility in that last mentioned year. Due to s. 2(3), this is a matter of no small difficulty although the definition of loss in s. 139(1)(*x*) clearly contemplates such deductibility. Seeing that the loss in question if not deductible in the year in which it was sustained would undoubtedly be deductible in six other years from income of the kind from which it is sought to be deducted, namely professional fees which come within the definition of income from a business, and that appellant does not contend that if the loss is deductible it cannot be deducted in the year in which it was sustained but, on the contrary, that it must be applied against any other income in that year, this appears to be the proper conclusion for the purpose of this case.

I am therefore of the opinion that the appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitor for the appellant: D. S. Maxwell, Ottawa.

Solicitors for the respondent: Martin, Laird & Cowan, Windsor.