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

1955

*Mar. 28, 29
*Oct. 4

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Assessment—Taxation—Income Tax—Whether sum reserved to pay Foreign exchange but not drawn on, "income"—The Income War Tax Act, R.S.C. 1927, c. 97, s. 3.

The appellant, the Canadian subsidiary of an American corporation, for the years 1940-1945 inclusive, purchased goods from the parent company totalling $640,978.29 in American currency. During that time the United States dollar was at a premium and the appellant, though it made no payments on account, set up in its books the amount of its indebtedness in Canadian dollars (as if the two currencies were at parity) plus the amount required each year to cover the premium on exchange for the purchases made in that year. At the end of 1945 the amount of Canadian dollars required to cover the premium totalled $67,302.77. In filing its income tax returns in each of these years the appellant included the premium so computed as an expense and it was allowed by the taxing authorities. In July 1946, the Canadian dollar attained a position of parity with the United States dollar and the appellant in its 1946 profit and loss account included the said sum of $67,302.77 as income under the heading of "Foreign Exchange Premium Reduction" and, in filing its income tax return for that year, treated the amount as a capital rather than an operating profit and deducted it in determining its net income subject to tax. The deduction was disallowed by the Minister. Appeals by the taxpayer to the Income Tax Appeal Board and to the Exchequer Court were each dismissed. In its appeal to this Court the appellant contended that as all the goods were purchased prior to 1946 it, in making settlement of the indebtedness in that year (which it effected with $640,978.29 in Canadian dollars by the issue of additional shares to the parent company without payment of any exchange) realized neither a profit, gain nor gratuity within the meaning of s. 3 of the *Income War Tax Act* and therefore the amount in question was not properly included in the word "income" as defined in that section.

Held (Locke and Cartwright JJ. dissenting): That the amount set up by way of reserve to meet payments of foreign exchange when unnecessary for that purpose was properly included as an item of profit in computing income tax. In 1946, owing to the change in the rate of exchange, the $67,302.77 held by the appellant as a reserve to provide for the contingency of having to pay for the U.S. dollars required to discharge its indebtedness ceased to be required for that purpose. It thereupon became available for the general purposes of the appellant and was properly treated as income in the year in which it became so available. *Davies* v. *The Shell Co. of China Ltd.*, 32 T.C. 133 at

*PRESENT: Kerwin C.J. and Estey, Locke, Cartwright and Fauteux JJ.

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

151, and *H. Ford & Co. Ltd.* v. *Commssr. of Inland Revenue,* 12 T.C., 997 at 1004, applied. *The Texas Co. (Australasia) Ltd.* v. *Federal Commssr. of Taxation,* 63 C.L.R. 382, referred to. *British Mexican Petroleum Co.* v. *Jackson,* 16 T.C., distinguished.

Per Locke J. (dissenting): It was income and income only, which was taxed by the *Income War Tax Act* as amended, which applied to the taxation year 1946. As applied to corporations, taxable income was determinable by calculating the amount received from the operation of the company's business less operating expenses and other deductions permitted by the Act in calculating such income. The appellant was benefited by the restoration of the value of the Canadian dollar in terms of U.S. currency, an event over which it had no control, but the advantage to it, as distinguished from the extent to which its profits were increased by its occurence, was no more a trading receipt than the advantage accruing to an export company by a recovery in world trade, or the benefit accruing to all trading corporations by a reduction in income or other taxation. *British Mexican Petroleum Co.* v. *Jackson* 16 T.C. 570, applied.

Per Cartwright J. (dissenting): The indebtedness of the appellant to its parent company which accrued from 1940-1945 inclusive was rightly calculated and allowed in those years at $708,281.06 in Canadian funds. The fact that in 1946 owing to a change in the rate of exchange, the appellant was able to discharge its indebtedness by payment of $640,978.29 in Canadian funds did not render the difference between these amounts, income of the appellant. In the year 1946 the appellant neither received the sum of $67,302.77 nor acquired any right to receive payment of it. The principle of the decision in *British Mexican Petroleum Co.* v. *Jackson,* supra, applied.

Judgment of the Exchequer Court of Canada [1953] Ex. C.R. 269, affirmed.

APPEAL from a judgment of the Exchequer Court, Thorson P. (1) dismissing an appeal from the Income Tax Appeal Board.

R. B. Law, Q.C. and *S. H. S. Hughes, Q.C.* for the appellant.

Joseph Singer, Q.C. and *J. D. C. Boland* for the respondent.

The judgment of Kerwin C.J. and of Estey and Fauteux JJ. was delivered by:—

ESTEY J.:—The appellant, a Canadian subsidiary of Eli Lilly and Company of Indianapolis, Indiana, purchased goods from the latter during the period September 15, 1939, to December 31, 1945, at invoice prices which totalled $640,978.29 to be paid in United States dollars. While no part of this sum was paid prior to October, 1946, the appellant, as the United States dollar throughout that period

(1) [1953] Ex. C.R. 269.

was at a premium over the Canadian dollar, set up in its books an item equal to the amount required in each year to pay the premium on the purchases in that year. In filing its income tax returns in each of these years it included the premium so computed as an expense which was allowed by the taxing authorities.

In July, 1946, the Canadian dollar attained a position of par in relation to the United States dollar. On October 22 of that year the appellant's directors allotted 7,450 shares of its common stock to the parent company in settlement of appellant's indebtedness for goods purchased as already stated, computed at the sum of $717,532.72, and a cash payment of $27,467.28. These two items total $745,000, or an equavalent of 7,450 shares of common stock at a par value of $100.

The sum of $717,532.72 was made up of two items: (1) the sum of $640,978.29 and (2) the total of the premiums for the respective years in the sum of $67,302.77, and other items not material hereto. The appellant, in its factum, set the transaction up as follows:

> The said 7,450 shares, having in the aggregate a par value of $745,000, were paid for as follows:
>
> | | |
> |---|---|
> | The above mentioned liability | $640,978.29 |
> | Cash paid by the parent company to the appellant | 27,467.28 |
> | In satisfaction of other amounts owing by appellant to parent company | 76,554.43 |
> | | $745,000.00 |

In its 1946 profit and loss account the appellant included the said sum of $67,302.77 as income under the heading "Foreign Exchange Premium Reduction" and, in filing its income tax return for that year, treated the amount as a capital rather than an operating profit and deducted it in determining its net income subject to tax. This deduction was disallowed by the Minister and by the Income Tax Appeal Board, as well as in the Exchequer Court. In this appeal the appellant asks that the judgment in the Exchequer Court (1) be reversed and the deduction allowed.

It is contended that as all of the goods were purchased prior to 1946 the appellant, in making the settlement of that year, realized neither a profit, gain nor gratuity within the

(1) [1953] Ex. C.R. 269.

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

Estey J.

meaning of s. 3 of *The Income War Tax Act* (R.S.C. 1927, c. 97) and, therefore, the amount here in question was not properly included within the word "income" as defined in that section.

The agreement that the invoice price in the total sum of $640,978.29 was payable in United States dollars introduced a contingency, or a factor of uncertainty, in the purchase price that could only be settled or determined by payment and, therefore, upon the date of payment. In reality the amounts set up in each year totalling $67,302.77 were a reserve to provide for this contingency. If, at the date of payment, no premium was required, the reserve set up would be unnecessary. If the premium was lower than the rate at which it was computed, only a part of the reserve would be necessary, but if, on the other hand, a higher premium was required, an additional item of expense would be incurred. That such was the position would seem to follow from the following evidence on behalf of the appellant:

> Q. And you were not under any liability to them to pay the additional accumulated items for foreign exchange which you show in this statement totalling $67,302.77—that is correct, is it not? A. Yes.
>
> * * *
>
> Q. So we have our position then in 1946, that you paid all your indebtedness to the American Company by the issue of shares in the Canadian Company, and you did not have to resort or pay to anyone the sum of $67,302.77, or any part of it—you did not have to resort to or pay any part of the sum of $67,302.77, which is the accumulation of the various amounts set up by you in this record, Exhibit 1, for exchange? A. Yes, that is right.

Payment was never made because the appellant was never in a position to do so and it would appear that the parent company, in 1946, deemed it desirable that a settlement should be made.

This case is, therefore, distinguishable from *The British Mexican Petroleum Co., Ltd.* v. *Jackson* (*H.M. Inspector of Taxes*), (1). There, because of a slump in business conditions, the taxpayer was unable to pay its indebtedness. Three of its larger creditors, apparently to assist the taxpayer, entered into an agreement under date of November 25, 1921, whereby they reduced their respective claims.

(1) (1932) 16 T.C. 570.

One of the creditors, H. & Co., reduced its claim by the sum of 945,232 pounds. The issue, as stated by Lord Thankerton at p. 590:

> The question in this appeal is whether this sum of £945,232 fails to be brought into account for the purpose of computing the profits and gains of the Respondents under Schedule D of the Income Tax Act, 1918, either by reducing by that amount the debit item in the trading account to 30th June, 1921, or by crediting it as a trading receipt in the trading account to 31st December, 1922.

The total outstanding indebtedness of H. & Co. was the sum of £1,073,281 and the Crown contended that, as that amount had been treated as an expense in the accounts of June 30, 1921, part thereof, namely, £945,232, was never expended and, therefore, the account of June 30, 1921, should be reopened and this item of expense reduced by £945,232 in order to bring it into conformity with the amount actually paid. In the House of Lords this contention of the Crown was not accepted. Lord Thankerton, at p. 592, stated:

> . . . the account to 30th June, 1921, cannot be reopened, as the amount of the liability there stated was correctly stated as the finally agreed amount of the liability and the subsequent release of the Respondents' proceeds on the footing of the correctness of that statement.

In the case at bar there was no gift, nor had the item here in question ever been settled. The parent company continued to claim the invoice price of the goods in terms of United States dollars. The record indicates that throughout the relevant period the appellant was never in a position to pay cash and in 1946 it was apparently deemed, if not by the appellant by the parent company, desirable that a settlement be effected. There was, upon the day of the settlement, no premium and, therefore, the reserve which had been provided for that contingency was unnecessary. The position would appear, therefore, to be similar to that expressed by Rowlatt J. in *H. Ford & Co., Ltd.* v. *Commissioner of Inland Revenue* (1), where, in referring to the *woolcombers* (2) and *Newcastle Brewery* (3), cases at p. 1004, he stated that these cases

> went quite far enough to justify looking at the accounts and saying: "Nobody dreamt this was not a loss at the time, but it turns out it was not. Re-open the accounts and find out what really were the losses and the earnings in 1919."

(1) (1926) 12 T.C. 997. (2) 12 T.C. 768.
(3) 12 T.C. 927.

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

Estey J.

In the *Ford* case the taxpayers engaged in the grain business were under a contractual obligation to pay certain demurrage to the Royal Commission upon Wheat Supplies in England. The Commission claimed the sum of £33,847 for the period April to July, 1920. The taxpayer protested, but placed in its balance sheet an item of expense of £33,847. Two years later the Commission abandoned their claim and it was held by Rowlatt J., affirming the Commissioner, that this amount ought not to be allowed as an expense.

The appellant states its alternative position in the following language:

> In the alternative if there was a gain in 1946 it was due to the extinction by the action of the Government of Canada of a liability or reserve. This was entirely fortuitous in its nature—not resulting from any action by the debtor or the creditor in the way of trade or in any other way. It was a lucky windfall. And when the learned President and incidentally Mr. Fisher, have classified it in the field of trading they forget that it was not paid. The gain, if any, was not derived from capital or the use of capital but was of the nature of a fortuitous gain accruing to capital.

The cost of exchange arising out of fluctuations in foreign currency is an ordinary expense in relation to foreign trade and has been so recognized and treated in the computation of income tax. While the government, in times of emergency, may have particular reasons for fixing the exchange rate, it must be assumed that the market rate remains a dominating factor in the fixing of that rate. Moreover, while the rate of exchange, as fixed by government action, eliminates the fluctuations arising out of the operation of the market, it may itself be changed, as, indeed, it was in this case, from time to time and, therefore, it does not entirely remove the possibility of fluctuations. In other words, the fixing of the rate of exchange by government action does not alter its nature or character in respect to foreign trade. The language of Jenkins J. is appropriate:

> . . . where a British company in the course of its trade engages in a trading transaction such as the purchase of goods abroad, which involves, as a necessary incident of the transaction itself, the purchase of currency of the foreign country concerned, then any profit resulting from an appreciation or loss resulting from a depreciation of the foreign currency embarked in the transaction as compared with sterling will *prima facie* be a trading profit or a trading loss for Income Tax purposes as an integral part of the trading transaction. *Davies (H. M. Inspector of Taxes)* v. *The Shell Company of China, Ltd.* (1).

(1) (1951) 32 T.C. 133 at 155.

In *Texas Co. (Australia) Ltd.* v. *Federal Commissioner of Taxation* (1), goods purchased were paid for in subsequent years when the exchange rate for the purchase of United States dollars had increased. It was contended that the delay in payment was permitted by the American company in order that the Australian company might have additional capital and that consequently the increase in exchange should be a capital rather than a revenue charge. It was held that it was a revenue rather than a capital charge. Latham C. J. stated at p. 428:

> Such expenditure of Australian pounds is an ordinary business expenditure, and the taxpayer is entitled to claim as a deduction the actual outgoing which he makes in order to discharge his normal business debts for stock-in-trade and the like.

Dixon J. stated at p. 465:

> For where liabilities are not fixed in their monetary expression, whether because of contingencies or because they are payable in foreign currency, a difference between the estimate and the actual payment must be borne as a business expense, and where the continuous course of a business is divided for accounting purposes into closed periods it is a reduction of the net profit, which otherwise would be calculated for the period.

The appellant apparently followed the usual practice of taking goods into account at the invoice price and where an uncertain factor such as foreign exchange must be provided for that was done by way of setting up a reserve. The position at bar is just the opposite of that in *Texas Co. (Australia) Ltd.* v. *Federal Commissioner of Taxation, supra,* where Dixon J. stated at p. 468:

> . . . the true nature of the deduction claimed is for the increase in the cost of discharging a past liability for which provision in the accounts was made at a lower figure.

The appellant was in the more fortunate position that the exchange discount had been eliminated. This, however, does not alter the principle that should be applied and, in my view, the established practice must here be followed that whether there be a loss or a gain in respect to the item of foreign exchange it should be taken into account as a trading loss or profit in the computation of income tax.

In my opinion the appeal should be dismissed with costs.

LOCKE J. (dissenting):—This is an appeal from a judgment delivered in the Exchequer Court by which the appeal of the present appellant from a decision of the Tax Appeal Board was dismissed with costs.

(1) (1939) 63 C.L.R. 382.

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

Locke J.

The appellant is an incorporated company having its head office in Toronto, its business being that of a manufacturer of drugs, and it is a wholly owned subsidiary of Eli Lilly International Company, an American corporation carrying on business in the United States.

During the years 1940 to 1945, both inclusive, the appellant purchased, from the American corporation, materials the agreed purchase price of which was $640,978.29 payable in American currency. In each of these years, in preparing the balance sheet of the appellant for income tax purposes, the amount payable to the American company for material supplied during the year was shown in Canadian funds, which were at a discount in relation to American currency during the entire period. It was upon this basis that the appellant was assessed for taxation purposes under the *Income War Tax Act* during this six year period. On December 31, 1945, the debt of the appellant to the American Company for goods supplied during the period, expressed in Canadian funds, totalled $708,281.06.

During the period referred to, American funds were at a premium of from 10 to 10½%. On July 1, 1946, this differential disappeared and the Canadian dollar established at parity with that of the United States and, as of that date, the appellant's debt to the parent company might have been discharged by the outlay of $640,978.29 in Canadian funds. While the manner in which it was accomplished does not, in my opinion, affect the question of liability, this debt and a further indebtedness of the appellant to the American company was extinguished by issuing to the creditor shares of the common stock of the appellant company at their par value.

The question to be determined is whether the benefit that accrued to the appellant company, by reason of the recovery in the value of Canadian funds in relation to American funds, became taxable as income for the taxation year 1946. No question arises in regard to the earlier years where in preparing the profit and loss account the indebtedness was, as stated, reckoned at the amount of the debt in American currency plus the current rate of exchange and, since no impropriety is suggested in regard to the tax returns made during those years, no question can now be raised by the Crown in relation to any of them. It is to be noted, though the fact does not affect the matter to be determined,

that since the liability to the American company was shown at the above mentioned amount in the company's books at the commencement of the taxation year 1946, the fact that the liability had been extinguished for the equivalent of $67,302.77 less in Canadian funds necessitated a compensating entry for a like amount in the company's books. The difference while shown in the profit and loss account as "other income" was treated as a capital gain and shown as "foreign exchange premium reduction."

The learned President who delivered the judgment in the Exchequer Court rejected the contention of the present appellant that the difference between the amount of the debt as shown in the books and the amount of the consideration necessary to extinguish it was a fortuitous or capital gain, saying that since the gain, if it must be so called, was the result of the rise in value of the Canadian dollar and came to the appellant in the course of its business and, since this had increased the amount of its distributable profit for the year 1946, it had realized a profit within the meaning of s. 3 of the *Income War Tax Act*.

It is income, and income only, which was taxed by the *Income War Tax Act* (c. 97, R.S.C. 1927) as amended, which applied to the taxation year 1946. By s. 3 of that Act, income was defined as follows:—

> 3. For the purposes of this Act, "income" means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be whether derived from sources within Canada or elsewhere; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source including . . .

The enumeration which follows does not affect the matter to be decided here.

As applied to corporations, taxable income is determined by calculating the amount received from the operation of the company's business, less operating expenses and other deductions permitted by the Act in calculating such income. The argument addressed to us on behalf of the Minister in the present matter amounts to this, that the benefit

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

Locke J.

which enured to the present appellant, together, it may be said, with all other Canadian nationals who were obligated to pay debts in American currency, was in itself a receipt.

While the circumstances were different, the decision of the House of Lords in *British Mexican Petroleum Co.* v. *Jackson* (1), affords an example of a somewhat similar attempt to impose income tax on a benefit accruing to a company which, it was contended, must be taken into account in computing its taxable income. The facts were that the company incorporated in England for the purpose of dealing in oil imported large quantities of oil purchased from Huasteca Petroleum Co., an American company operating in Mexico, and incurred a large liability to Weir & Co., a shipping company operating in England. In the year 1921 the company was in insolvent circumstances and, in order to enable it to continue in operation, the two creditor companies who owned all of its issued capital, and another creditor, released the Mexican company of the greater part of the debt owing. To the extent that these debts were released they were, for the purpose of the company's balance sheet, carried to a reserve and the question in the appeal was as to whether the amount so released was to be brought into account for the purpose of computing the income of the company under Schedule D of the *Income Tax Act 1918,* either by reducing the amount of the debit item in the trading account which showed the debt at its full amount or by crediting the amount rebated as a trading receipt for the year in which the debt was partially remitted. This contention on behalf of the Crown was upheld by the Special Commissioners. The matter came in the first instance by way of appeal before Rowlatt J. who reversed this decision. An appeal from that judgment was dismissed by the Court of Appeal, and a further appeal by the House of Lords.

In the *British Mexican* case the company benefited to the extent that the debts were remitted by its creditors. In the present case, the appellant was benefited by the restoration of the value of the Canadian dollar in terms of American currency, an event over which it had no control and which it had no part in bringing about. There is, in my opinion, no difference in the principle to be applied in

(1) (1930) 16 T.C. 570.

the present case from that applied by the courts in England. The advantage to the company which accrued from an event such as this, as distinguished from the extent to which the profits of the company are increased by its occurrence, is no more a trading receipt than the advantage accruing to an export company engaged in international trade by a recovery in world trade or the benefit accruing to all trading corporations by a reduction in income or other taxation.

I would allow this appeal, with costs throughout, and set aside the assessment.

CARTWRIGHT J. (dissenting):—The relevant facts are set out in the reasons of my brother Locke. I agree with his reasons and conclusion and have little to add.

The only matter now in dispute is whether the sum of $67,302.77 was properly included by the Minister as an item of taxable profit in assessing the appellant for income and excess profits tax for 1946. This sum is the difference between $708,281.06, the total of the amounts charged in the appellant's annual tax returns for the years 1940 to 1945 as representing in Canadian dollars its indebtedness for raw materials purchased during such years from its parent company in the United States and for which it owed $640,978.29 in United States dollars, and the sum of $640,978.29 in Canadian dollars with which it was able to discharge such indebtedness in 1946, by reason of the Canadian dollar having reached parity with the United States dollar.

There is no question but that the Minister was right in allowing the appellant to charge the sums totalling $708,281.06 in the years mentioned as the cost in Canadian dollars of materials purchased. We are not concerned to inquire whether upon such indebtedness being paid off in 1946 with $640,978.29 in Canadian funds the Minister might have re-assessed the appellant for any or all of the years 1940 to 1945, as, no such re-assessment having been made and more than six years having elapsed since the latest assessment for the years in question and there being no suggestion that the appellant made any misrepresentation or committed any fraud in making its returns, it is conceded that the accounts for those years can not now be re-opened.

1955

ELI LILLY AND COMPANY (CANADA) LIMITED v. MINISTER OF NATIONAL REVENUE

Cartwright J.

In these circumstances this case seems to me to fall within the principles enunciated by the House of Lords in *British Mexican Petroleum Co. Ltd.* v. *Jackson* (1). One of the questions calling for decision in that case was whether the amount by which a debt, actually owing and treated as an expense of the trade deductible from gross receipts in the trading account of the taxpayer for the year ending June 30, 1921, was subsequently reduced by the voluntary act of the creditor should be treated as a trading receipt in the account for the year in which such reduction was granted. I can find no significant difference between the statutory provisions considered in that case and those of the *Income War Tax Act* which applied to the taxation year 1946. The fact that in the case at bar the reduction in the amount payable in satisfaction of the debt contracted and allowed in earlier years resulted from a change in the rate of exchange and not from the voluntary act of the creditor does not appear to me to render the principle of the *British Mexican* case inapplicable. In each case a debt, actually owing and properly deductible in one taxation period, was, in a later taxation period, discharged for a lesser sum by reason of a circumstance beyond the control of the taxpayer; and in each case it was sought to tax the reduction in the amount required to discharge such debt as a profit received in the taxation period in which the reduction occurred.

In the *British Mexican* case Lord Thankerton said at page 592:—

> I am unable to see how the release from a liability, which liability has been finally dealt with in the preceding account, can form a trading receipt in the account for the year in which it is granted.

and Lord MacMillan said at page 593:—

> If, then, the accounts for the year to the 30th June, 1921, cannot now be gone back upon, still less in my opinion can the Appellant Company be required to enter as a credit item in its accounts for the eighteen months to 31st December, 1922, the sum of £945,232 being the extent to which the Huasteca company agreed to release the Appellant Company's debt to it. I say so for the short and simple reason that the Appellant Company did not, in those eighteen months, either receive payment of that sum or acquire any right to receive payment of it. I cannot see how the extent to which a debt is forgiven can become a credit item in the trading account for the period within which the concession is made.

(1) (1932) 16 T.C. 570.

In the case at bar it seems equally clear that in the year 1946 the appellant neither received the sum of $67,302.77 nor acquired any right to receive payment of it.

I would allow the appeal with costs throughout, declare that the said sum of $67,302.77 should not have been included in assessing the income of the appellant in the year 1946, and remit the assessment to the Minister for amendment accordingly.

Appeal dismissed with costs.

Solicitors for the appellant: *Raymond, Spencer, Law & MacInnes.*

Solicitor for the respondent: *A. A. McGrory.*