BETWEEN:

1959 Oct. 29 — 1960 Nov. 4

CRANE LIMITED ....APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Revenue—Income—Income tax—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 12(1)(e), 14(1), 85B(1) and 139(1)(a)—Contingency reserves—Concurrence of Minister necessary to change in accounting methods—Time of recognition.

Appellant, incorporated in and carrying on business in Canada, allowed a discount to certain classes of customers for prompt payment on the invoice price of sales to them if payment were made before the 15th day of the month following the date of sale. It is the practice of appellant to make monthly payments on account of income tax for the current year as soon as the amount of discounts taken by its customers on the sales of the previous month can be ascertained, calculating the amount of this income tax instalment accordingly. Appellant's fiscal year corresponded with the calendar year and prior to 1954 it entered as taxable income unpaid December sales at their invoice price, paid its tax instalment and closed its books as of December 31, and sometime after the 15th of the following January when it ascertained the exact amount of discount taken on December sales, it claimed and was allowed to deduct such amount from the current years accounts receivable.

[1] [1958] S.C.R. 119.

1960

CRANE LTD.
v.
MINISTER OF NATIONAL REVENUE

In 1954 appellant changed its method of treating discounts by making a 1954 adjustment entry reducing its accounts receivable by the amount of the estimate the discount would be in respect of December billing and would be given at January, 1955, and closed its books without waiting until the exact amount of discount could be ascertained.

The Minister of National Revenue reassessed the appellant on its 1954 income by adding thereto, *inter alia,* the amount of estimated discounts for 1954.

An appeal to the Income Tax Appeal Board was dismissed and appellant appealed to this Court.

Held: That the appeal must be dismissed since the change in accounting methods was made by the appellant without receiving the concurrence of the Minister in accordance with s. 14(1) of the *Income Tax Act* R.S.C. 1952, c. 148.

APPEAL under the *Income Tax Act.*

The appeal was heard before the Honourable Mr. Justice Kearney at Montreal.

D. R. McMaster, Q.C. for appellant.

John Gotlieb, Q.C. and *Paul Boivin, Q.C.* for respondent.

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

KEARNEY J. now (November 4, 1960) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated July 14, 1958[1], which affirmed a reassessment made by the Minister of National Revenue, whereby the amount of the appellant's declared taxable income for the year 1954 was increased by $49,633.64.

The appellant offered to certain classes of customers a discount for prompt payment, and the above-mentioned sum represents its estimate of the discounts on December sales of which such customers would take advantage. It sought to eliminate it from its accounts receivable for 1954 on the grounds that it was not income, but this was disallowed by the respondent.

The appellant, a company duly incorporated under the laws of Canada, with its head office in Montreal, Que., is a wholly-owned subsidiary of a United States parent corporation with head office in Chicago, Ill. It is engaged in the manufacture, sale and wholesale distribution of valves, fittings, and of plumbing and heating products, sold mainly

[1] 20 Tax A.B.C. 12.

through its numerous wholesale branch offices across Canada. By the terms of the invoice which accompanies shipments made by the appellant to contractors and trade customers, the purchaser is allowed a discount of 2% on the invoice price provided the account is fully paid before the fifteenth day of the month following the date of the sale.

The branch offices always record only the invoice price of sales, and the head office, which follows the practice of making monthly payments on account of income tax for the current year as soon as the amount of discounts taken by its customers on the sales of the previous month can be ascertained, calculated the amount of this income tax instalment accordingly. In following such practice no difficulty presented itself until the last month of the year when it became impossible to determine until the following year the amount of the discounts taken in the previous December. The appellant's fiscal year corresponded with the calendar year and it was important that its audited annual financial statement should be in the hands of the head office of the parent company as soon as possible after the close of the year. In order to comply with this requirement, in 1953 as in previous years instead of keeping its books open until ascertainment sometime later in 1954, of discounts taken, the appellant entered as taxable income unpaid December sales at their invoice price, paid its tax instalment and closed its books as of December 31. Sometime after the 15th of the following January when the appellant ascertained the exact amount of discount taken on December sales, it claimed and was allowed to deduct such amount from its 1954 accounts receivable.

In its income tax return for the year ended December 31, 1954, the appellant for the first time altered its manner of dealing with December discounts and, basing its calculations on previous experience, estimated that its customers would take advantage of the 2% discount in respect of December billing to the extent of $49,633.64. It made an adjustment entry reducing its accounts receivable by the amount of the estimate (Ex. A-5), spread over the last three months of the year (Ex. A-3) and as before closed its books and procured its audited statement without waiting

1960
CRANE LTD.
v.
MINISTER OF NATIONAL REVENUE
Kearney J.

until the exact amount of discount taken could be ascertained. It turned out later that its estimate was on the conservative side by about $3,000.

On July 7, 1955, the Montreal office of the Taxation Division of the Department of National Revenue issued a notice of assessment in accordance with the appellant's return, but on February 23, 1956, the Minister issued a notice of reassessment which increased the amount of its taxable income by $86,610.95. This amount was made up of an item of $36,977.31 which, according to the respondent, represented taxable additions to fixed assets less capital cost allowance thereon, with which we are not here concerned; and the item of estimated discounts totalling $49,633.64 which is now before me for adjudication.

On April 18, 1956, the appellant filed a notice of objection to the reassessment and the respondent by notice of January 9, 1957, confirmed it. The appellant on April 3, 1957, gave notice of its appeal to the Income Tax Appeal Board, which resulted in the decision herein first mentioned.

Although it is usual to set out first the grounds on which an appellant bases his appeal, I will begin for convenience by stating the reasons put forward by counsel for the respondent in justification of the Minister's disallowance of the deduction claimed.

It is submitted for the respondent that the amount of $49,633.64 which was claimed by the appellant allegedly as a deduction from income constitutes a reserve for cash discounts and was properly disallowed because it was contrary to the provisions of s. 12(1)(*e*) of the *Income Tax Act*, R.S.C. 1952, c. 148, which reads as follows:

> In computing income, no deduction shall be made in respect of an amount transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by this Part.

Furthermore, counsel for the respondent in oral argument contended that the method adopted by the appellant prior to 1954 for the computation of income in respect of cash discounts had been accepted by the respondent, and that in 1954 it changed such method without prior concurrence of the Minister, in contravention of s. 14(1) of the Act which states:

> When a taxpayer has adopted a method for computing income from a business or property for a taxation year and that method has been accepted for the purposes of this Part, income from the business or property for a

subsequent year shall, subject to the other provisions of this Part, be computed according to that method unless the taxpayer has, with the concurrence of the Minister, adopted a different method.

The appellant submitted that s. 12(1)(*e*) is inapplicable because the amount in question did not at any time, and more particularly in the taxation year 1954, constitute income; that it was not a reserve and was never transferred or credited to a reserve or contingent account. Furthermore it alleged that at no time prior to the hearing did the respondent invoke s. 14(1); that he had restricted himself to s. 12(1)(*e*), and that the case must be judged on that section alone; alternatively, that any change in the appellant's manner of computing income in respect of the cash discounts in the taxation year 1954 did not constitute a change of method such as contemplated by s. 14(1); and if it did, such a change of method was justified because the previous one was incorrect.

As there is no dispute regarding the facts, I need only deal with the expert evidence produced by the respective parties. The appellant called George P. Keeping, an experienced accountant, former president of the Institute of Chartered Accountants of Quebec, of the Institutes of Chartered Accountants of England, Wales and Ontario, and a member of similar institutes of New Brunswick and Nova Scotia. Mr. Keeping became a member of the firm of Arthur Young, Clarkson and Gordon Co. in 1953, the then official auditors of the appellant company, and in 1954 he was placed in charge of the auditing of its accounts.

This witness testified that the practice formerly followed by the company showing accounts receivable at their invoice price was wrong and not in accordance with good accounting practice; that the correcting entry made in 1954 in the accounts receivable with his approval, showing them at their estimated realizable value, was not a deduction from income but one made in order to reflect properly the company's gross income from sales; that the amount of the estimate was never set up in the books of Crane Limited as a reserve or contingent account and cannot be so considered. He cited in support of his opinion Montgomery, *Auditing,* 8th ed., pp. 163 and 165; Smails, *Accounting Principles and Practice,* 5th ed. (1954) p. 156; Geo. O. May, *Financial Accounting,* p. 188. The last mentioned authority,

1960

CRANE LTD.
v.
MINISTER OF NATIONAL REVENUE

Kearney J.

to whom Mr. Keeping refers as the dean of the accounting profession in the United States, recommended that in regard to discounts, and the witness agreed with him, the taxpayer should record only the net amount of all receivables instead of estimating the amount of the discounts. The author states at p. 188:

> It follows that in measuring the gain, what is received should be stated at its equivalent in cash, which is not necessarily the face value of the Account Receivable. . . . In relation to discount, the point is obvious. Certainly an Account Receivable cannot be regarded as the equivalent of cash . . . , which would discharge the debt, if it were tendered immediately. Any further sum that may be collected eventually is a penalty paid by the debtor for delay in discharging the debt and is income to the recipient for the period covered by the delay.

If the appellant had wished to follow the method above described, then to be consistent its books should have been kept on that basis that only $98 in respect of any $100 December sale should have been entered as an account receivable at the end of that month in respect of each one of such sales; and not merely in respect of a percentage of its sales estimated on the basis of past experience, which was the method actually followed by the appellant when reporting its income for its 1954 taxation period.

The respondent called Mr. Samuel Horn who, having graduated from McGill University in 1935 with the degree of Bachelor of Commerce, became a chartered accountant of the Province of Quebec in 1942, served with the Department of National Revenue for fourteen years and is presently on the teaching staff of McGill University. Mr. Horn prefaced his evidence by saying: "First of all I would like to state that I do not wish to differ with Mr. Keeping on his general conclusions. However, I feel that the emphasis might be shifted a little on one or two points." He stated that, as a consequence of changing to the estimation method, the appellant company was creating a non-deductible reserve and at the same time studiously avoiding calling it by that name. He added that it seems very close to a contingent reserve. Mr. Horn was able to point to several authorities listed hereunder wherein provision made in respect of cash discounts was referred to as a

reserve: Finney & Miller, *Principles of Accounting Intermediate,* 5th ed., p. 211; Smails and Walker, *Accounting Principles and Practice* (1947), p. 135; Spicer & Pegler, *Bookkeeping and Accounts,* 11th ed., c. 4, p. 74.

Mr. Keeping stated that he and the appellant had studiously avoided making use of the word "reserve" in respect of cash discounts, not for fear of any implications contained in s. 12(1)(*e*), but because its use in such connection was obsolete and erroneous. I think the meaning of words in the accounting world as elsewhere does not remain static and the truth of this observation, in respect to the meaning of the word "reserve," is made abundantly clear by Professor Smails in his 1954 edition of *Accounting Principles and Practice* wherein he states at p. 153:

Historically, accountants have for centuries used the word "reserve" to denote three quite different things—to the considerable confusion of themselves and the utter confusion of the student and the layman. These three different things are:

(1) an estimate of the amount required to compensate for some overvaluation of assets which is known to exist but whose precise incidence or amount cannot be determined at the moment, e.g., estimated bad and doubtful accounts receivable and estimated depreciation of fixed assets,

or (2) an estimate of the amount required to meet some liability which is known to exist but whose precise amount cannot be determined at the moment, e.g., income taxes not yet assessed,

or (3) a voluntary appropriation of earnings designed to reduce the amount of earned surplus immediately available for distribution in the form of dividends but itself constituting a part of the proprietorship or net worth of the business, e.g., general reserve or reserve for contingencies.

* * *

The professional accounting bodies (The Canadian Institute of Chartered Accountants, the Institute of Chartered Accounts in England and Wales and the American Institute of Accounts) are now formally recommending that the word "reserve" should be used only in reference to appropriations of earned surplus, that is to say in the third of the three senses distinguished above. (See Bulletin No. 9 January 1953 of The Committee on Accounting and Auditing Research of The Canadian Institute of Chartered Accountants.) This recommendation has already been implemented (so far as published statements of corporations are concerned) by *The Companies Act, 1947* of the United Kingdom, and *The Corporations Act, 1953* of Ontario. So-called "reserves" of the first two types distinguished above must therefore be called by some other name. For purposes of this text the "valuation reserve" will be designated an "allowance", the "liability reserve" a "provision". The use of these new terms is urged on all unincorporated businesses and on incorporated companies in those jurisdictions which have not yet regulated the matter by statute.

At p. 159 under the title of "True Reserves" the same author states:

> The creation of an asset valuation allowance or a provision for a liability represents an expense of earning revenue; it effects a reduction of proprietorship (in the form of net profit) and is reflected in a reduction of assets or increase in liabilities. A true reserve, by contrast, is created by transfer from earned surplus account to the credit of some other surplus account; it does not change the total of proprietorship but merely changes the name under which some part of this total is carried.

In ordinary parlance the word "reserve" signifies something set aside that can be relied upon for future use; and in good accounting practice, since 1954 it has been recognized that it is a misnomer to apply the word to an amount which the taxpayer never anticipated receiving and never received.

Mr. Horn subscribed to the statement that before the prohibition against a reserve can be applied there must be an amount received or receivable from which the reserve is set up. The only amount which the appellant could legally receive in 1954 with regard to December sales was, to use the example of a $100 sale, the net figure of $98 and not $100 as shown on the invoice. I do not think the appellant could demand payment of the $98 until the following January 15, but it was entitled to receive that amount and nothing more during the interval so that, if the purchaser inadvertently sent a cheque for $100 to the appellant at any time during December, the latter would be required in law to refund the $2 discount.

Sections 3 and 4 of the Act state:

> 3. The income of a taxpayer for a taxation year for the purposes of this Part is his income *for the year* from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all (emphasis mine)
>
> (*a*) businesses,
>
> (*b*) property, and
>
> (*c*) offices and employments.
>
> 4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom *for the year* (Italics are mine.)

Unless some other section of the Act declares the contrary, I do not think it can be said that the item of some $49,000 can be said to constitute income for 1954. In this connection

I think that s. 12(1)(*e*) must be read in conjunction with s. 139(1)(*a*) of the Act which defines the word "amount" as follows:

"Amount" means money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing.

The word "right" is undefined and if, as I am led to believe, it means an unconditional right, then the only amount which may be so regarded in the example is the sum of $98, and nobody suggests that the appellant placed an estimated value on this sum, and much less did it transfer it to a reserve. It must be said, however, that in 1954 the appellant had also acquired a conditional or contingent right to receive a further $2 in the event that the account would not be paid by January 15 of the next year.

In the case of *Canadian General Electric Co. Ltd. v. Minister of National Revenue*[1], the appellant, a Canadian company, stood to make a foreign exchange profit on promissory notes payable to its parent company, a United States corporation. Some of them were long-term notes, payable in American dollars; and when given the Canadian dollar was at a discount, but when they fell due Canadian funds were at a premium. Cameron J., after a lengthy review of authorities, held that foreign exchange profits or losses are considered to be contingent until payment is actually received or made, and that no taxable profit in respect of foreign exchange was made in that case by the appellant until the time when the several notes payable in United States currency were actually paid, and I think the same can be said in this case.

The *Canadian General Electric* case was concerned only with the taxation years 1950-51 and 1952; and s. 85B(1)(*b*), since it was enacted by S.C. 1952-53, c. 40, s. 73(1), was not then in force and, though it was not invoked in the present case, it is wide in scope and warrants comment. It reads:

85B (1) In computing the income of a taxpayer for a taxation year,

(*b*) every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable until a subsequent year unless the method adopted by the taxpayer for computing income from the business and accepted for the purpose of

[1] [1960] Ex. C.R. 24, 46.

1960
CRANE LTD.
v.
MINISTER OF NATIONAL REVENUE
Kearney J.

> this Part does not require him to include any amount receivable in computing his income for a taxation year unless it has been received in the year.

Once again we encounter the word "amount" and I think that the words "notwithstanding that the amount is not receivable until a subsequent year" refer only to the unconditional right to receive $98 if paid on or before December 31, as in the example cited, and not the future contingent right to an additional $2 which the appellant was not entitled to receive and could only be established in the subsequent year. After some hesitation I do not think the intent of the section was meant to cover overlapping discounts from one year into another. To hold the contrary would lead to incongruities. Thus, taking the same example, if at the close of business on December 31 the account is not paid, then it will be taken into 1954 accounts receivable at $100 and the $2 discount will constitute a profit; if the account is paid the next day the same $2 will constitute a loss in 1955. If the case for the respondent rested solely on the applicability of s. 12(1)(*e*), I would be disposed to maintain the appeal.

As I observed during the hearing, I think a more formidable obstacle presents itself by reason of the respondent's invocation of s. 14(1) of the Act. I do not believe that the respondent can be precluded from raising during the argument any provision contained in the Act notwithstanding that it was not mentioned in the pleadings or previously relied upon by the Minister. Neither do I think that the words "change of method" refer only to a change from a cash to an accrual method, or vice versa. Cameron J., in *Canadian General Electric Co. Ltd. v. Minister of National Revenue* (*supra*), stated:

> I do not think, however, that the word "method", used in s. 14(1), is in any way limited to those frequently referred to as the "cash" and "accrual" methods.

I believe that a change in the system of treating discounts may constitute a change of method. In the case of *Industrial Mortgage and Trust Co. v. Minister of National Revenue*[1], Thurlow J. made similar observations.

[1] [1958] Ex. C.R. 205, 213.

I think it can be said that three properly so-called methods are described in the evidence: (a) the one which had been followed by the appellant for many, many years, whereby December sales, except those actually paid before the end of the month, were shown on the company's books at the invoice price in the same way as if the invoice contained no reference to a 2% discount; secondly, method (b), in a sense a compromise between (a) and (c), which, as we have seen, treated discounts by an estimation system calculated by past experience and based not on individual accounts but on global averages; and (c) which would take into the current year as income only that amount which the appellant was entitled to receive, i.e., 98% of the invoice price, thus eliminating all discounts from 1954.

A weakness in method (a) is that it included as income in 1954 amounts which were not receivable in that year and the appellant's right to them could not arise before January 15, 1955, and as a result the appellant was required to show in 1954 as taxable income an amount which it never at any time received and which was established sometime in February 1955 at some $52,000.

As regards method (b), had the respondent concurred in its adoption, the appellant would not have paid income tax in 1954 on some $49,000 which it never received; but nevertheless it would have paid in that year income tax on some $3,000 of discounts which it did not receive, and this latter amount would have required adjustment in 1955 when the exact amount of discount had been determined. (A similar adjustment in reverse would have arisen if the appellant had estimated the amount at $55,000.) Another consequence of such a system is that in the same taxation year 1954 the appellant would have been also claiming a deduction in respect of 1953 discounts. At p. 42 of the *Canadian General Electric* case (*supra*), Cameron J., speaking of computations based on estimates, states:

> The computations made by the taxpayer at the end of each year and based entirely on the then current rates of exchange were estimates only and however useful such computations may have been for the domestic purposes of the company, they could be of no assistance in computing the actual costs of the company for the purposes of ascertaining its taxable profit.

1960

CRANE LTD.
v.
MINISTER OF NATIONAL REVENUE

Kearney J.

Method (c), like method (a), eliminates all question of a reserve and the necessity of readjusting entries such as would result in (b) due to errors in estimation; and the appellant obtains complete relief from the inclusion of discounts in the taxable income for 1954 compared to partial relief under method (b) and none under (a).

I think it is important to bear in mind that what is being sought is the establishment of particular profits for a particular year. Cameron J., in the course of discussing the prerequisites which would justify a change of method under s. 14(1) said in the *General Electric* case (*supra*) at p. 46:

In my opinion, a taxpayer can invoke the provisions of s. 14(1) only when the method which he has adopted in an earlier year to compute his income (and which he proposes to follow in the taxation year in question) is one which is computed in accordance with the provisions of the Act and which truly reflects his real profit or loss for the year. If the method that has been used in previous years does not result in the ascertainment of the true gains as nearly as can be done, it is not a method sanctioned by the law. ... It is not, therefore, a method which it is entitled to adopt in a subsequent year even if the respondent's assessors had knowledge of it or if it had been accepted by the respondent in an earlier year.

The Court of Appeal held in *Duple Motor Bodies Ltd. v. Inland Revenue Commissioners*[1] that, if there were two alternative accounting practices which might be applied, that practice should be applied which on the facts of the particular case would produce the fairest result. In that case the question arose whether the direct cost or on-cost method should be applied to valuation of work in progress and there had been a divergence of views in the accountancy profession on the respective merits of the two methods. Pearce, L.J., after referring to the foregoing divergence of opinion, said at p. 118, and I think his observation is particularly applicable in the present case:

. . . It is a question of fact in each case to ascertain the true profit. The result has been that the ascertainment of the *particular profits for the particular year*—which, after all, was the real object of the enquiry—has been a little submerged by this ideological dispute. . . . It would be unfortunate if dogmas of method obscured the real purpose—the finding of a fair, true and reasonable assessment of the real profit of the business for the year. (Italics mine)

In the above-mentioned cases the better of two alternative methods was being discussed, while here we are concerned with choosing the best of three. I am of the opinion that

[1] [1960] 2 All E.R. 110.

method (c) is the one which most accurately establishes the appellant's taxable income for the year. Mr. Keeping stated that where it was followed it certainly constituted good accounting practice, but in respect of bookkeeping mechanics he considered it inconvenient.

Mr. Horn conceded that method (b), from the point of view of good accounting, had considerable merit. I think it should be borne in mind, however, that the function of a public accountant is to establish in the annual financial statement, for the benefit of the shareholders and the public, the company's net year end worth. In the preparation of this statement the auditor sometimes takes into account items on both sides of the ledger which are not countenanced for income tax purposes. Although advocating method (b) as representative of good accounting, when asked by his counsel: "Would you say it is generally accepted accounting practice?" Mr. Keeping answered: "No."

I think that method (a) conforms much less to the requirements of the Act than the other two and, unless I misunderstood the argument of counsel for the respondent, he does not seek to perpetuate this method. His submission, and I agree with him, is that the appellant has contravened the provisions of s. 14(1) by changing from a method which it has followed for over twenty years and which admittedly was adopted in agreement with the taxing authorities, to another method to which the respondent takes exception.

It is regrettable that the appellant without seeking the respondent's concurrence precipitately adopted method (b) because, as counsel for the respondent observed, the appellant had the choice of adopting method (c) and could have obtained the respondent's concurrence had it been sought.

In conclusion I think it can be said that this case is largely of academic interest because, since the cause of action arose, s. 14(1) has been repealed; and as far as the amount of taxable income is concerned, it matters little into which year the incidence of discounts falls.

For the above reasons I dismiss the appeal with costs.

Judgment accordingly.