BETWEEN:

ALGER B. FERRISS .....APPELLANT;

1964
Mar. 16-19
Nov. 4

AND

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

Revenue—Income tax—Method of income computation—Change from cash to accrual method—Whether cash of earlier year received after change to accrual method reportable in later year—Income Tax Act, R.S.C. 1952, c. 148, ss. 14(1), 141(6)—Reserve for doubtful debts, calculation of—Income Tax Act, R.S.C. 1952, c. 148, s. 11(1)(e).

Appellant carried on a retail hardware business in Harrow, Ontario, in partnership with his brother and his nephew, from 1945 to 1959. Prior to 1957 the firm's annual income from the business was ascertained by including only cash actually received each year and deducting expenditures incurred in that year. In December 1956 the Department of National Revenue indicated dissatisfaction with this basis of income computation and in 1957 and 1958 the firm calculated its annual income by including the gross amount of the year's sales, deducting expenditures incurred in that year and a reserve for doubtful debts. In 1957 the firm received $15,506 and in 1958 $2,662 in respect of accounts payable to it for 1956 and earlier years; but did not report these sums in its income tax returns for 1957 and 1958. The Minister, invoking s. 141(6) of the *Income Tax Act*, assessed the partners to income tax for 1957 and 1958 on these two sums.

The firm's accounts receivable for which a reserve for doubtful debts could be claimed under s. 11(1)(e) of the *Income Tax Act* amounted to $16,992 at the end of 1957. Of this sum $8,331 remained unpaid on the date appellant prepared his 1957 income tax return, *viz.*, on April 16, 1958; and $3,493 remained unpaid on October 31, 1958. For the year 1958 $8,200 remained unpaid on accounts receivable at the time appellant prepared his 1958 income tax return and $3,558 was unpaid at the end of October 1959. In the income tax assessments for 1957 and 1958 the firm was allowed a reserve for doubtful debts of $2,171 for 1957 and $1,401 for 1958.

Appellant appealed against the assessments, contending (1) that the cash received by the firm in 1957 and 1958 on accounts payable for years prior to 1957 was not to be taken into account in computing the firm's income for 1957 and 1958; and (2) that the Minister should have allowed a larger reserve for doubtful debts for the years 1957 and 1958.

Held: 1. That s. 141(6) of the *Income Tax Act* applied and accordingly the sums received in 1957 and 1958 on the accounts receivable for 1956 and earlier years were properly included in the partners' income for 1957 and 1958. Section 141(6) is not excluded from application where the only taxation years involved are years to which the 1948 *Income Tax Act* applies. Section 141(6) applies even though appellant's income computation for 1956 and earlier years may not have complied with the *Income Tax Act*. (*Ken Steeves Sales Ltd. v. Minister of National Revenue* [1955] Ex. C.R. 118 referred to.) If, as

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argued by appellant, the firm's pre-1957 computation was not an acceptable method of computing income under the *Income Tax Act*, s. 14(1)* of the Act could not be applied to require computation of the firm's 1957 income in the same manner. If, on the other hand, it was an acceptable method the evidence established that a different method had been adopted in 1957 by the appellant and the Minister. Section 14(1) of the *Income Tax Act* did not require any formal application for leave to change a method of accounting. The evidence did not support appellant's contention that he had not voluntarily adopted the accrual method for 1957 and 1958.

2. That on the evidence with respect to the 1957 receivables, viewing the position as nearly as possible as of the time when the 1957 return was made, a reasonable reserve for doubtful debts under s. 11(1)(*e*) of the *Income Tax Act* would have amounted to at least $2,700. On the same basis the reserve for 1958 should have been maintained at $2,700.

3. That the appeal is allowed in part.

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Thurlow in Windsor.

Arthur B. Weingarden for appellant.

G. W. Ainslie and *M. Barkin* for respondent.

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

THURLOW J. now (November 4, 1964) delivered the following judgment:

This is an appeal from a judgment of the Tax Appeal Board which dismissed the appellant's appeal from re-assessments of income tax for the years 1957 and 1958. During both of these years the appellant was a partner in a business carried on under the name of L. T. Ferriss Hardware and the first issue in the appeal is whether the appellant's share in amounts of $15,506.05 and $2,662.52 representing payments of accounts owing to the partnership at the end of the year 1956 but received in the years 1957 and 1958 respectively, was properly included in computing his income for the years in question. The other issue in the appeal is whether the appellant's portions of the amounts of $2,171 for the year 1957 and $1,401 for the year 1958 were in the circumstances reasonable amounts as a reserve for his share of the doubtful debts owing to the partnership in respect of which the

* Section 14(1) of the *Income Tax Act* was repealed by S. of C. 1958, c. 32, s. 6.

partners were entitled to such a reserve in computing income for the years in question.

The business was that of a retail dealer in hardware and builders' supplies and was carried on at Harrow, a rural community in southern Ontario. It had been established by the appellant's father, L. T. Ferriss, in 1905, and was carried on later by the appellant and his brother, David E. Ferriss, and from 1945 to the end of 1958 by a partnership consisting of the appellant, his brother, David E. Ferriss, and the latter's son, Edwin Meredith Ferriss. In computing income from the business for the year 1956 and for the years prior thereto the partners had followed a practice of including in the receipts only amounts received in cash during the year but amounts so received were included regardless of whether they represented payments for goods sold during the year or for goods sold in earlier years. Accounts owing to the partnership at the end of the year for goods sold in the year or in previous years were shown in the balance sheet but they were not included as receipts in the profit and loss statement nor was any deduction made therein in respect of any of them which might have become bad or doubtful. Expenditures on the other hand were deducted in the year in which they were incurred whether or not they had been paid at the end of the year. This was called a "cash receipts and expenditures system" of computing profit.

However, in the statements with respect to the partnership business which accompanied the appellant's 1957 income tax return a different method of computation was followed. This was an accrual system and in it the amount shown as receipts included the gross amount of merchandise sales for the year regardless of whether the price of the merchandise sold had been received by the end of the year. The profit and loss statement did not include any amounts received in the year in payment for goods sold in any earlier year nor did it include any item in respect of a reserve for doubtful debts provided for in any earlier year. Expenditures were deducted on the same basis as had been followed in previous years but in this computation for the first time a deduction entitled "Bad Debt Expense" was made in respect of the debts owing to the partnership, the amount deducted being $2,171. Though called bad debt expense the item was in substance and in fact a deduction of a reserve in

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respect of doubtful debts. For the year 1958 the statements were again prepared on the same basis but the reserve for doubtful debts was not included on the revenue side of the profit and loss statement. Instead the list of expenditures included a credit amount of $770 entitled "Bad Debt Expense" the net effect of which was to reduce the $2,171 reserve in that year to $1,401.

In adding to the appellant's declared income for the 1957 and 1958 taxation years his share of the $15,506.05 and $2,662.52 received in those years respectively in payment of debts owing to the partnership at the end of 1956 the Minister purported to do so on the ground that "Due to a change in the method of accounting in the 1957 calendar year, the opening accounts receivable in that year have never been taxed" and in confirming the reassessment following notice of objection he ruled that these amounts were properly included "in accordance with the provisions of subsection (6) of section 141 of the Act".

The subsection referred to is one of a group of provisions appearing in Part VIII of the *Income Tax Act* R.S.C. 1952, c. 148 entitled "Transitional Provisions" and it reads as follows:

> 141. (6) Where, upon the application of a method adopted by a taxpayer for computing his income from a business or property for a taxation year to which this Act is applicable, an amount received in the year would not be included in computing his income for the year because on the application of that method it would have been included in computing his income for the purposes of this Act, *The 1948 Income Tax Act* or the *Income War Tax Act* for a previous year in respect of which it was receivable, if the amount was not included in computing the income for the previous year, it shall be included in computing the income for the year in which it was received.

It will be observed that while this subsection has application as a transitional provision it is not limited to situations in which on the application of the method the amounts referred to would have been included in computing income for years in which either of the two earlier statutes applied but by its terms applies as well to amounts which on the application of the method would have been included in computing income for an earlier year to which the *Income Tax Act* itself applies. I mention this because of a submission made by counsel for the appellant that the subsection was not intended to apply where the only taxation years involved were years to which the *Income Tax Act* applied.

On the wording of the subsection the submission in my opinion cannot succeed.

A further observation to be made is that, while in the circumstances described or, perhaps more accurately, on the occasion referred to in it, the subsection requires that there be brought into the computation of income for a particular taxation year an amount which would not ordinarily enter into the computation of the taxpayer's income for that year, and while to that extent the subsection alters the measure of income prescribed by ss. 3 and 4 of the Act, the subsection applies only "if the amount was not included in computing the income" for "a previous year in respect of which it was receivable". In my opinion this wording does not refer exclusively to the taxpayer or to what he has done but to whether the amount was in fact included in the computation of income upon which the taxpayer was assessed for the earlier year. What the taxpayer included may be material if the Minister has adopted the computation. But the Minister is not bound by the taxpayer's return. He may or may not have used the same method of computing the taxpayer's income and regardless of what the taxpayer included in his return the Minister may have included the amount in his computation. If he did, in my opinion there could be no room for application of the subsection.

However, no issue was raised on this point in the notice of appeal. Instead what the notice of appeal set forth was that prior to 1957 the appellant had calculated his receipts for the year by adding together his cash sales and the amounts received from persons to whom he had extended credit and that "for the taxation year 1957 and years following the appellant calculated his receipts for the fiscal year by adding together the amount of cash sales and the amount of sales made in which credit was extended during the fiscal year 1957". This appears to me to state that for the year 1957 the appellant changed from what is commonly referred to as the "cash" method which he had used prior to 1957 to what is known as the "accrual" method. Notwithstanding this statement, however, the appellant went on to plead that he had made no change in his method of computing income and had made no application to the Minister to concur in a change of method of computing income.The explanation for the apparent inconsistency in the appellant's pleas appears to lie

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in the contention to which reference is made later in these reasons that the practice followed prior to 1957 was not a method of computing income. In his reply the Minister did not admit these allegations but he stated that in re-assessing the appellant he assumed a number of facts with respect to what was included in the appellant's computation which appear to me to be substantially to the same effect as the appellant's allegations. He did not, however, state that the amounts in question had not been included in his computation of the appellant's income for a previous year or years in respect of which they were receivable or that he had assumed that the amounts had not been so included. The critical fact upon which the application of the subsection depended was thus neither put in issue by the appellant nor expressly alleged by the Minister in his reply. It had, however, been suggested by the wording of the notice of re-assessment and it appears from the Minister's notification that it was the basis for the re-assessment. It sufficiently appears, therefore, that the Minister did re-assess on the basis that the sums in question had not been "included in computing the income" of the appellant for "a previous year in respect of which (they were) receivable" and accordingly it must I think be taken that so far as this particular part of the subsection is concerned the fact required for its application exists. I should add, however, because of the argument advanced on the question, that in my view nothing in the evidence establishes that the sums in question were included by the Minister in computing the income of the taxpayer for any previous year.

The appellant's main point with respect to the application of the subsection was that the taxpayer had not "adopted" a method of computing his income from the business for the years 1957 and 1958 within the meaning of the subsection. It was argued first that since the appellant's computation for 1956 and earlier years was not in accordance with the Act (*vide Ken Steeves Sales Ltd. v. M.N.R.*[1]) it could not be regarded as a method of computing income and that the Minister was not entitled to treat it as an acceptable method for the purposes of the Act in assessing the appellant for 1956 and earlier years and then to treat the use by the taxpayer of the accrual method for 1957 as a

[1] [1955] Ex. C.R. 108.

change of method, but should have attributed the 1956 accounts receivable to the year in which they arose. Secondly, it was said that in any case the Minister was not entitled to treat the computation in the appellant's return as a change of method until the taxpayer had applied for and the Minister had granted his approval pursuant to s. 14(1) of a change of method of computing income. Finally, it was submitted that the adoption of a method involved an act by the taxpayer of a voluntary character and that, since no mehod of computing income from the business other than the accrual method used in 1957 and 1958 was in accordance with the requirements of the statute and the taxpayer therefore had no choice but to follow it, this voluntary character was lacking.

While there is something to be said for the argument that the accounts owing at the end of 1956 should have been brought into the computation and taxed as income for the years in which they arose, it is to be observed that the reason they were not brought in at the time probably was the failure of the appellant to report them in the appropriate year and moreover that the evidence does not disclose the year or years in which they did in fact arise. All that does appear is that they arose prior to 1957. To bring the accounts into the computation for the years in which they arose would at this stage involve an inquiry probably going all the way back to the time of the formation of the partnership, that is to say to 1945, when the *Income War Tax Act* applied, and a revision of the computations for all the intervening years in accordance with the accrual method. If this had been done there might have been a year, presumably the first year of the partnership, in which the revenues were understated to the extent of the receivables at the end of that year and in that case the amount of them would have to be brought into the computation for that year with consequent effect on the tax assessed and possibly would result as well in an assessment of upwards of ten years interest thereon. Adjustments in respect of other years might be expected to produce little if any change in net result. Alternatively, the computations might have been made on the accrual basis starting with the year 1949, the first year to which the 1948 *Income Tax Act* applied, and if

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the revision were being made at the instance of the taxpayer, who does not want s. 141(6) to apply for 1957, s. 141(6) would apply to require the inclusion in income of the 1948 receivables in the years when they were ultimately paid. On the other hand if the revision was not being made at the instance of the taxpayer the consequence would be that the 1948 receivables would not enter into the computation for any year and to that extent profits from the business might escape taxation.

It appears to me that s. 141(6) was designed to meet this kind of situation by providing as an alternative to reviewing and revising assessments for a number of years, as to some of which a limitation period may have come into operation, that the adoption by the taxpayer of a method of computing income should be the occasion for requiring that the receivables accumulated in earlier years should be added, when paid, to what would otherwise be the income for the year. On this basis the taxpayer is taxed on income which has in fact been earned in an earlier year but which was not brought into the computation and taxed as income for that year. The result is a rough and ready form of tax adjustment which, though it could turn out to be harsh in some cases, appears to me to be authorized and required by the subsection. The appellant's objection accordingly fails.

Turning to the second contention, which is based on s. 14(1), it appears to me that if it be assumed that the manner in which the appellant's income from the business was computed prior to 1957 was not a method of computing income capable of being accepted for the purposes of Part I of the Act there is no room for applying s. 14(1) to require computation for 1957 in the same manner. On the other hand if it be assumed that this manner of computing income was capable of being accepted and had in fact been accepted it appears to me that nothing in s. 14(1) requires any formal application for leave to change a method of computing income and that the evidence of the change actually made by the taxpayer in his return for 1957 coupled with the re-assessment and the confirmation of it by the Minister conclusively establishes the adoption of a different method by the appellant and the Minister's concurrence therein. This contention as well accordingly fails.

With respect to the final contention, that is to say, that s. 141(6) refers to a voluntary adoption of a method by a taxpayer, the short answer appears to me to be that nothing in the evidence establishes that the use by the appellant of the accrual method of computing his profit for the year 1957 was anything but voluntary. He had, according to the evidence, been computing profit by the cash receipts and expenditures system for many years when in December 1956 a letter from the department to his agent suggested that the Minister was not satisfied with this manner of reporting income. His agent replied with a suggestion that the method had been accepted as a method adopted by the taxpayer but that since in his opinion the accrual method would be a better method of computing income for the taxpayer and since the Minister presumably approved of it he would recommend that the taxpayer adopt it for 1956. In fact, however, it was not adopted by the taxpayer for 1956 but, with no explanation as to what considerations led to it other than that the agent considered that the *Ken Steeves* case required it, the appellant's computation for 1957 was prepared on the accrual basis. To my mind this is quite insufficient to establish that the use of the accrual method was not voluntary or that it was not "adopted" by the appellant within the meaning of that expression in s. 141(6). I am accordingly of the opinion that the additions to the appellant's income made by the Minister under s. 141(6) for the years 1957 and 1958 must stand.

This brings me to the question of the adequacy of the reserves claimed by the appellant and allowed by the Minister in making the re-assessment. The provisions with respect to reserves for doubtful debts are contained in ss. 6 (*e*) and 11 (1)(*e*) of the Act the relevant portions of which read as follows:

6. Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year

(*e*) the amount deducted as a reserve for doubtful debts in computing the taxpayer's income for the immediately preceding year;

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

(*e*) a reasonable amount as a reserve for

(i) doubtful debts that have been included in computing the income of the taxpayer for that year or a previous year,

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As already stated deductions of $2,171 and $1,401 for the years 1957 and 1958 respectively were allowed by the Minister these being the amounts claimed by the appellant in his returns. In his notice of objection the appellant contended that these amounts were grossly inadequate and that they should be increased to 33⅓ per cent of the total accounts. The Minister, however, declined to increase them. At the trial evidence was given by Mr. David Lazonsky, a chartered accountant, who in November 1960 and again in November 1963 made a study of the accounts for the purpose of forming an opinion of what amounts would be reasonable. He stated that he took into account a number of considerations including payments actually received in January and February of the following year and he reached the conclusion that a proper reserve would consist of the whole amount of certain old accounts for which notes had been obtained plus two-thirds of the amount of the rest of the accounts outstanding at the end of the year which contained unpaid items more than 60 days old at the end of the year. The effect of this is of course to include in the reserve considerably more than two-thirds of the amount outstanding at the end of February in each year. This opinion is not borne out by what actually occurred later in payment of the accounts and I regard it as unsound. Evidence was also given by Mr. David Ferriss, who impressed me as a credible witness whose long experience in the business afforded a substantial basis of knowledge on which to form an opinion. He stated that while as a rule of thumb 10 per cent had been a useful guide in the business in the years before the depression in estimating probable losses on book accounts, it was not satisfactory for the years in question and he expressed the opinion that 10% was "not one-third enough".

The evidence and admissions indicate that at the end of 1956 the accounts receivable totalled $20,220 of which $15,506 was paid in 1957 leaving $4,714 representing unpaid accounts of 1956 and earlier years which had not been taken into income. As total accounts receivable at the end of 1957 amounted to $21,706 the receivables in respect of which a reserve for doubtful debts might be deducted under s. 11(1)(*e*) in computing 1957 income thus amounted to $16,992. In the course of his study Mr. Lazonsky prepared

Exhibit 10 which is a list of accounts owing at the end of 1957 totalling $16,425 all of which contained unpaid items which were then more than 60 days old. After allowing for the $4,714 representing 1956 receivables, which must have been included, this list would thus include $11,531 in 1957 receivables. As the statements accompanying the appellant's income tax return for 1957 are dated April 16, 1958 it appears to me to be reasonable to assume that the appellant when preparing his return for 1958 should have known how much of this $11,531 had been paid at least up to the end of March 1958 and the particulars furnished by the appellant in this appeal indicate that roughly $3,200 of the amount had in fact been paid by that date leaving a balance of about $8,331 still outstanding. With respect to the portion of the 1957 receivables not included in Mr. Lazonsky's study as there is no evidence that any of them ever became overdue I think I must assume that they were paid when due and leave them out of my calculation. At the time of making the return therefore there was a total of about $8,331 in unpaid receivables in respect of which a reasonable reserve might be deducted, all of which receivables were already more than three months old and portions of which were more than five months old. The particulars and Exhibit 10 indicate as well that by the end of October 1958, when some portion of the $11,531 would have been a year old, and all of it would have been at least ten months old, some $8,042 had been paid, the balance remaining unpaid being in the vicinity of $3,493. Thus ten months after the end of the year in which the receivables were treated as income and taxed as profits of the year $3,493 remained unpaid and against this the appellant had a reserve of but $2,171.

Turning to 1958, Exhibit 11, Mr. Lazonsky's list of accounts owing at the end of the year containing items more than 60 days old, totals $11,960. As $2,662 of the $4,714 remnant of 1956 receivables had been paid during the year the $11,960 would therefore include $2,052 in 1956 receivables and $9,908 in 1957 and 1958 receivables. Of the latter amount about $1,700 appears from the exhibit and from the particulars to have been paid by the end of March 1959 leaving some $8,200 uncollected at the time of preparation of the 1958 income tax return. By the end of October 1959, when some portion of each of these accounts would have

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been more than a year old and all of them would have been at least ten months old, there was still, according to Exhibit 11, at least $3,558 of the total unpaid. This experience with respect to both the 1957 and 1958 receivables appears to me to bear out Mr. Ferriss' opinion that a reserve of 10 per cent was not sufficient, and I think this is so whether the percentage is applied to the balance owing at the time of preparation of the return or to the amount of accounts owing at the end of the taxation year. I am moreover not impressed by the fact that by November 1963 most of the amounts had been paid. Had the appellant known in April 1957 and 1958 that he would have to wait for a matter of years for payment of these accounts he would I think have had good reason to regard them as doubtful and probably good reason to regard some of them as bad. On the whole viewing the position as nearly as possible as of the time when the 1957 return was made and having regard both to Mr. Ferriss' opinion and to the extent to which support for it may be found in the facts which I have mentioned with respect to the accounts I do not think a sound estimate made in April 1958 of the present value of the $8,331 still remaining unpaid would have been in excess of two-thirds of the total that is to say $5,554 and I am satisfied that a reasonable reserve for doubtful debts under s. 11(1)(*e*) for 1957 would have amounted to at least $2,700. On the same basis I am also satisfied that for 1958 instead of being reduced to $1,401 the reserve should have been maintained at $2,700. To the extent indicated the appellant is accordingly entitled to relief in respect of both the 1957 and 1958 re-assessments.

In the course of the trial it also appeared that the merchandise sales for the year 1957 had by mistake been overstated at $104,792 and the correct figure having subsequently been agreed upon at $102,770 leave to amend the notice of appeal to allege this was granted and counsel for the Minister, very properly, in my opinion, consented to an order that the 1957 re-assessment be referred back to the Minister for reconsideration and re-assessment accordingly. The appellant is therefore entitled to relief in this respect as well.

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In the result the appeal will be allowed and the re-assessments for both years will be referred back to the Minister for reconsideration and re-assessment in accordance with these reasons. As there is only one proceeding and the appellant has achieved success in respect of a portion of the matters raised against the re-assessments for both of the years involved in the appeal, he is entitled to his costs.

Judgment accordingly.