1954

Mar. 29, 30, 31, April 1, 2

Sept. 10

BETWEEN:

SELLERS-GOUGH FUR COMPANY LIMITED .... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Revenue—Income Tax—The Income Tax Act, R.S.C. 1952, c. 148, s. 14 (2) —Establishment of "market value" of inventory—Losses must be actually suffered and not merely anticipated.

Held: That in putting the market value upon the inventory of appellant's stock-in-trade for purpose of write-down in arriving at the amount of deduction to be allowed for income tax purposes the respondent should have taken into account certain additional factors to the goods being shopworn and soiled and thus lessened in value, namely, a reduction in excise tax on furs which on the evidence would be passed on to purchasers from appellant and the effect of changes in styles due to the relaxation of wartime controls and regulations.

2. That when establishing the market value of an inventory on the basis of estimated realizable value it is not permissible to take into account losses in inventory value which for the subsequent year are merely anticipated and have not in fact been suffered or sustained in the taxation year under consideration.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Cameron at Toronto.

H. G. Steen, Q.C. for appellant.

J. Singer, Q.C. for respondent.

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

CAMERON J. now (September 10, 1954) delivered the following judgment:

This is an appeal and a cross-appeal from a decision of the Income Tax Appeal Board dated August 19, 1952, which allowed in part an appeal by the appellant company in respect of its 1946 taxation year. On January 31, 1946, the close of its 1946 fiscal period, the appellant valued its inventory of merchandise at $108,631.81. In assessing the appellant, the Minister increased the inventory value by $27,039.00. The Board referred the assessment back to the Minister for reassessment by reducing the amount added back to the inventory evaluation from $27,039.00 to $22,647.76.

In *Minister of National Revenue* v. *Simpson's Ltd.* (1), the learned President held that the hearing of an appeal from a decision of the Income Tax Appeal Board to this Court is a trial de novo of the issues of facts and law that are involved and that such a hearing must proceed without regard to the case made before the Board or the Board's decision. He also held that whether the appellant be the Minister or the taxpayer the assessment under consideration carries with it a presumption of its validity until the taxpayer establishes that it is incorrect either in fact or in law, and the onus of proving that it is incorrect is on the taxpayer, notwithstanding the fact that the Board may

(1) [1953] Ex. C.R. 93.

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have allowed an appeal from it. In this case, therefore, the onus is on the appellant company to establish the invalidity of the assessment.

For many years the appellant has carried on business as a retail furrier, selling mainly ladies' fur coats, but also fur accessories such as capes, stoles, scarves, gloves and mitts. It purchases its merchandise from fur manufacturers but operates a small workroom in which fur garments are repaired or remodelled for its customers.

The assessment in question was made under the provisions of the Income War Tax Act, R.S.C. 1927, c. 97 as amended. There is nothing in that Act which specifically requires a commercial concern, in ascertaining its annual profits or gains, to take an inventory of its stock-in-trade at the end of its taxation year. It has long been recognized, however, that the right method of ascertaining and assessing profits and gains is to take into account the value of the stock-in-trade at the beginning and at the end as two of the items in the computation. In revenue matters, profits are normally the profits realized in the course of the year. The ordinary principles of commercial accounting have for many years provided what seems to be an exception where traders have purchased and still hold goods or stocks which have fallen in value. No loss has, in fact, been made, and may not occur. Nevertheless, the trader is permitted at the end of the year, in making his inventory, to enter these goods at cost or market value, whichever is the lower. That accounting practice has now found a place in the Income Tax Act, Statutes of Canada, 1948, c. 52, s. 14(2) (now R.S.C. 1952, c. 148, s. 14 (2)), which is as follows:

14. (2) For the purpose of computing income, the property described in an inventory shall be valued at its cost to the taxpayer or its fair market value, whichever is lower, or in such other manner as may be permitted by regulation.

In this case it is not denied that the appellant's stock-in-trade on January 31, 1946, had a market value less than its cost. In assessing the appellant, the respondent fixed the market value of the stock-in-trade at $8,500.45 less than cost, thereby placing a market value thereon of $135,770.81. Its actual cost was shown to be $144,271.26, and the appellant had written it down by $35,539.45 to a market value of $108,731.81.

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The question for determination, therefore, is whether the market value put upon the inventory by the respondent is correct. In my opinion the value to be placed upon stock-in-trade at a particular time is entirely a question of fact.

There is no direct evidence as to the basis on which the Minister allowed the write-down of $8,500.45. No particulars are given in the assessment, the notification by the Minister, or in the pleadings. The assessor was not called as a witness and it is common ground that no one on behalf of the respondent examined the stock-in-trade as a preliminary to arriving at its fair market value. Indeed, such an examination would have been physically impossible as the tax return was not made until June 30, 1946, by which date a substantial percentage of the goods had been sold. From statements made by counsel for the respondent, however, I am satisfied that the allowance was solely on the basis that the merchandise included in the inventory had to some degree lessened in value because it had been in stock for some months and had become shop-worn due to handling and soiling of the lining and may have faded to some extent. In my view, however, there were other factors which on the evidence should have been taken into consideration in arriving at the market value and which, having been considered, would have led to an increased write-down.

One important factor was that in the previous December the excise tax applicable to furs had been reduced from 25 per cent to 10 per cent and the evidence of Mr. Gough, the president of the appellant company, was that that reduction would definitely have to be passed on to the customer and that the reduction occasioned thereby would have been a substantial one. Another important factor was that the fur coats carried in the inventory had all been manufactured at a time when styles were drastically limited by wartime controls which were lifted in the autumn of 1945. The result of the lifting of the controls was that the new fur coats coming on to the market were to some degree longer and fuller, and again, to some extent, the stock carried over would be in competition with the newer and more attractive styles, and therefore of less value. These matters were not taken into consideration by the

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assessor and for that reason I am satisfied that the write-down made by the Minister was somewhat less than it should have been.

I turn now to the inventory values placed upon the stock-in-trade by the appellant. The inventory was taken by Mr. R. P. Gough, the president of the appellant company. There is no question as to his ability to properly evaluate his merchandise. He has had a lengthy experience in the family business and not only buys all his goods but takes an active part in the selling. He therefore acquired an intimate knowledge of the stock-in-trade and for many years has valued the inventory. In establishing his values, he took into consideration a great many factors but made no attempt, in reducing the values of the stock below cost, to evaluate these factors in percentages and to apply such percentages to the stock as a whole. What he did was to make a personal inspection of each article on January 31, and having in mind the various factors, to some of which I shall refer, he then immediately placed an inventory value on each article, the entire matter taking up something less than one minute for each individual article. In the result, the write-down averaged 25 per cent for the whole of the inventory.

Now Mr. Gough's evidence was that he valued the inventory at its replacement value. Had he established that as a fact there would be no difficulty in upholding his valuation. It is common ground that a closing inventory is properly valued at "cost or market value" and Mr. Pettit, an accountant called on behalf of the appellant, stated that one of the accepted meanings of "market value" in accountancy is that of "replacement value", namely, the cost at which similar goods in customary quantities can then be purchased, but less, I assume, a further deduction for depreciation due to shop wear and the like. For reasons presently to be stated, the appellant failed to establish that the inventory values were taken at figures which represented "market values".

Mr. Gough, however, took into consideration two factors to which he attributed great importance. He says that he had in mind that there had been a serious break in the market for raw furs in the preceding months and that as

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a result buyers in January, 1946, were paying a great deal less for furs then than they had done in the preceding year. In the Notice of Appeal he stated the reduction to be 25 to 50 per cent. The evidence does not indicate that such was the fact. I accept the evidence of Mr. Prentice, a witness for the respondent that there was no "break" in the fur market in the preceding months, but merely the normal seasonal fluctuations experienced annually. Mr. Prentice since 1947 has been general manager of the Canadian Fur Auction Sales Ltd., and while he was not in Canada in 1945 and 1946, he was at that time general manager of a subsidiary of the New York Fur Auction Co. Inc., the parent company of the Canadian firm, had full knowledge of conditions in Canada and has the records for those years. Mr. Rose, a witness for the appellant who has been a manufacturer of fur garments for many years and is now president of the Fur Manufacturers' Wholesale Association for Canada, also stated that there was no "break" in the fur skin market in 1945 but that there was a very serious one in the summer of 1946 which continued through 1947.

Another factor to which Mr. Gough attributed special importance was the advent of the "New Look" in fur coats. He said that as a buyer he knew on January 31 that the "New Look" involved styling of a radically new nature and which would render most of his stock relatively obsolete. He frankly admitted that the buying public in January or February, 1946, would have no knowledge of the "New Look" style. On the evidence as a whole, however, I am satisfied that he is mistaken as to the date on which it came into effect. As I have stated above, fur manufacturers, following the lifting of wartime controls in 1945, were free to change the style as they saw fit and minor changes did follow at once. But on the evidence as a whole I am of the opinion that the "New Look" style was introduced not earlier than 1947 and was unknown to Mr. Gough and the fur trade generally on the inventory date.

I do not know what weight was given to these factors by Mr. Gough, but undoubtedly he considered them of the greatest importance. If their existence had been established as a fact, they would have been of some importance in

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fixing inventory values, but finding as I do that there was no break in the raw fur market in the preceding months and that the "New Look" was introduced many months thereafter, these facts had no place in the computation. To that extent Mr. Gough's inventory was incorrect. Other factors of a minor nature entered into Mr. Gough's computation but I do not think it necessary to discuss them.

But there was one additional factor which Mr. Gough did take into consideration which I think on the evidence had no place in a computation based on "replacement value". As an experienced retailer in fur garments, he knew that his market was a seasonal one; that while February was a good month for sales, the demand would lessen sharply thereafter and that there would be no substantial pick-up until the following September or October, by which time the goods carried over from the preceding year would be in competition with the new merchandise which he customarily ordered in the spring and which he received throughout the summer. He knew that to then get rid of the old stock he would probably have to reduce his sales price of the inventory from time to time and that in all probability it would take many months and possibly as much as a year or more to entirely dispose of the carry-over.

He therefore considered it advisable, in establishing his inventory value, to take into consideration the length of time which it would probably take to dispose of the carry-over and the final realizable value of the stock which I have mentioned above. His purpose was to so value the inventory which he could expect to receive after later making the reductions in prices that after taking into account the anticipated realizable value of the stock and deducting therefrom the cost of sales (which in this case would be the inventory value), he would still realize his normal profit. He stated that his normal sales price was 50 to 60 per cent over cost (or inventory) and that in the result a ratio of gross profit to sales of approximately 33·3 would follow. It is clear that this was one of the substantial elements which he took into consideration, along with

many others, in arriving at an inventory based on "replacement value"; and it is interesting to note that his "forecast" turned out to be a fairly accurate one; notwithstanding the very serious break in the fur market in the fall of 1946 and in 1947, the appellant did realize a gross profit rate to sales of 31·4 on all inventory notwithstanding the fact that by January 31, 1947, only about one-half had been sold and that the remaining items were disposed of in 1947, 1948 and 1949.

On the evidence of Mr. Pettit, it appears that in accepted accounting practice it is permissible under certain conditions to take into consideration the length of time it would take to dispose of the goods, the conditions existing at such times, and their probable realization value as a method of determining inventory value. It is accepted in accounting circles, he states, that "market value" may mean not only the cost of replacement, but also the estimated realization, less costs of sale and the usual gross profit, and it is customary to take the lower of these two alternatives as "market value". In support of that statement he cited Principles of Accounting by Finney (1951 Edition), an American authority on taxation which he said was generally accepted in Canada and in which at p. 375 it states:

Realization Basis:

For some items in the inventory, such as obsolete or repossessed merchandise, a purchase or reproduction market value may not be determinable. For such items it may be necessary to accept, as an estimate of market value, the prospective selling price minus all prospective costs to be incurred in conditioning and selling the goods, and minus a reasonable profit.

It is clear that this method is referable to those items in the inventory which are obsolete or repossessed merchandise, and where a reproduction market value cannot be determined; and that it is an alternative method to the reproduction "market value" method and not an additional factor to be taken into consideration when reproduction "market value" is the objective as it was with Mr. Gough. On the evidence, either method is acceptable in accounting practice, but not a combination of both.

Now it seems to me that in taking into account the reductions in sale prices which he would possibly or even probably have to make during the next year (or perhaps over a longer period) and thus forecasting the future, he

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was in fact taking into account losses in inventory which had not been sustained in the taxation year 1946, but which might be suffered in a subsequent year or years, thereby setting up what amounted to an inventory reserve. It is of paramount importance to keep in mind that the object of the computation in which the closing inventory values constitute one element is to determine as precisely as possible the actual balance of the profits and gains in each year of the company's operations; and that only those elements of loss or expense enter into the computation which are suffered or incurred during the taxation year in question. These principles were stressed by the Lord President (Clyde) in *Collins & Sons Ltd.* v. *Commissioners of Inland Revenue* (1), the headnote of which reads:

> Held, that, as the loss was only an apprehended future one and had not been suffered in the accounting period in question, the deduction claimed was inadmissible.

At p. 780 the Lord President said:

> It is a general principle, in the computation of the annual profits of a trade or business under the Income Tax Acts, that those elements of profit or gain, and those only, enter into the computation which are earned or ascertained in the year to which the enquiry refers; and in like manner, only those elements of loss or expense enter into the computation which are suffered or incurred during that year. There are, it is true, some elements in the computation of the profits of a business —such as repairs (under Rule 3(*d*) of Cases I and II of Schedule D)— which are matters of estimate. But that does not detract from the importance of keeping in mind that the object of the computation is to ascertain, or . . . to "determine", as nearly as may be, the actual balance of the profits and gains of the business in each year of its operations. If authority be needed for these (as I think) elementary propositions, as applying to the case of Excess Profits Duty, such authority will be found in the case of *Hall & Co.* v. *The Commissioners of Inland Revenue,* 12 T.C. 382; (1921) 3 K.B. 152.
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> It is, however, quite consistent with this that a prudent commercial man may put part of the profits made in one year to reserve, and carry forward that reserve to the next year, in order to provide against an expected, or (it may be) an inevitable, loss which he foresees will fall upon his business during the next year. The process is a familiar one. But its adoption has no effect on the true amount of the profits actually made, and does not prevent the whole of the profits, whereof a part is put to reserve, from being taken into computation in the year in question for purposes of assessment. On the contrary, the balance of profits and gains is determined independently altogether of the way in which the trader uses that balance when he has got it; and, if he puts part of it to reserve and carries it forward into the next year, that has no effect whatever upon his taxable income for the year in which he makes the profit.

(1) 12 T.C. 773.

While it is true that the particular facts in that case differ from those in the present case (in that the prospective loss for which an allowance was there claimed was in respect of goods which had been contracted for in the taxation year but had not been executed by way of payment or receipt of the goods or otherwise during the year), I think the opinion of the Lord President above quoted was of general application. His further observations at p. 783 are also of interest:

> The Appellants put forward their claim on the footing of an estimate of the loss to be incurred. But, as it appears to me, this only serves to make it plain that what they are seeking to do is to put against the actual ascertained receipts from their business in one period a loss which is neither suffered nor incurred in that period. I know of no justification for this, either under the rules or principles of the Income Tax Acts, or in ordinary commercial accounting. We are told that the circumstances of the years in question—those of 1920 and 1921—were exceptional. I can readily believe that they were unusually difficult years for commercial undertakings. But it is not an exceptional experience to find that a commercial contract unexpectedly turns out to be unsuccessful, or that a commercial engagement undertaken in a sanguine spirit is seen to be fraught with unfavourable results long before the hour for its fulfilment arrives. After all, the problem is to determine the profits actually earned by the Appellants in their last accounting period (Finance Act, 1921, Section 35). I realize that it is hard for them that the relief which they might have got under Section 38 (3) of the Finance (No. 2) Act, 1915,—if the Excess Profits Duty had been continued—will no longer be available to them. But this does not entitle us to make bad law in order to meet what is (in this view) a hard case.

Reference may also be made to *Whimster & Co.* v. *Commissioners of Inland Revenue* (1).

Notwithstanding the evidence of Mr. Pettit that it was accepted as a sound principle in accounting circles to take into account in valuing inventory the losses which inventory might sustain in a subsequent year, I do not think that principle can be used when applying the provisions of the Income War Tax Act to the ascertainment of the profits or gains of a taxation year. It may be of interest to note that at the time the inventory was taken there was a provision in s. 6 (1) (*b*) of the Excess Profits Tax Act, 1940, as amended, which to a limited degree permitted a deduction from profits of a reserve against future depreciation in inventory values. That provision, however, was limited to the computation of the tax imposed under the Excess Profits Tax Act and was not applicable

(1) 12 T.C. 813 at 823.

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to the ascertainment of taxable income under the Income War Tax Act. The fact that its application was limited to the former would seem to indicate clearly that it had no place in the latter. It is clear, also, that an inventory reserve was not one of the reserves permitted under the Income War Tax Act.

My conclusion on this point is, therefore, that when establishing the "market value" of an inventory on the basis of estimated realizable value, it is not permissible to take into account losses in inventory value which for the subsequent year are merely anticipated and have not, in fact, been suffered or sustained in the taxation year under consideration. In other words, the estimated realizable value of the inventory must be taken as it appears to be on the date of taking the inventory and not as it might be by forecasting the future with all its uncertainties. To the extent, therefore, that these factors entered into Mr. Gough's fixation of inventory values, the inventory was undervalued.

It is urged by counsel for the appellant that the various elements which were in the mind of Mr. Gough at the time he made the inventory are of very little importance; that what is of importance is the amount of the write-down. He says, however, that when tested by the results, it is established that only the normal gross profit was in fact realized and that thus the inventory values are shown to be accurate. Mr. Pettit stated that "all things being equal", that would constitute a fair test. In this case, however, it is shown that "all things were not equal" due to the very severe break in prices in mid-summer of 1946, a break which continued in 1947 and for some time thereafter. The evidence is that for the taxation year ending January 31, 1947, the appellant's sales increased by one-third, but its ratio of gross profit to all sales (including those from the carry-over) was 17·9, or just slightly over one-half of the normal or expected ratio. That being the case, the test suggested by Mr. Pettit is not here of any validity.

It is apparent, therefore, that not only is the inventory value established by the respondent too low, but that that

of the appellant is too high. It becomes necessary, therefore, to endeavour to determine from the evidence what should have been established as the fair market value.

I have reached the conclusion that it is not possible to ascertain the replacement market value. Mr. Gough stated that his recollection was that in January he had been offered new goods similar to those in his inventory at 20 to 25 per cent less than his original cost. I have no doubt whatever that he was doing his best to recall what actually occurred, but as he was speaking of matters which had occurred some eight years previously, and could produce no documentary evidence in support of his statements, and as his recollection had been found to be faulty on other matters—I refer to the advent of the "New Look" style—I cannot accept his recollection as proof of the fact. His witness Mr. Rose also stated that it was customary for him in January of each year to clear out the few remaining goods then on hand at a discount of 25 to 30 per cent; that he was willing to "sacrifice" them in order to have no carry-over to the new season. He was unable to support that statement by the production of any documentary evidence and he made no offers to the appellant at that time.

There is another method, however, by which the accuracy of the inventory values may be tested (even if not precisely ascertained), namely, to ascertain what they should have been had the appellant used the last method suggested by Mr. Pettit, namely, to take the estimated realizable value of the stock and deduct the usual and reasonable profit, the balance representing the fair "market value" of the inventory.

Now, it is a most significant fact that notwithstanding the 25 per cent reduction in inventory values made by the appellant, the sale prices on the goods comprised in the inventory were not reduced on January 31 but remained as they had been, namely, 50 to 60 per cent above original cost. In retaining these prices Mr. Gough was, in fact, fixing his estimated realizable value as of that date. They were offered to the public in February at the same price. Those were the prices which he hoped to realize and had the demand been more active in February, he would have realized them on the whole of the inventory.

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Exhibit 3 is an analysis of the inventory and while it refers only to about 70 per cent thereof, it is agreed that it is typical of the whole of the store inventory. It contains a description of each article sold, its inventory value as at January 31, the date of sale, the selling price (and in some cases the final selling price), and final gross profit. Exhibit B is a further analysis of Exhibit 3 providing much the same information, but arranged in chronological order showing the sales in each month. Attached thereto is a further summary showing by months the selling price, the inventory value, losses due to re-sales, final selling prices, final gross profits or loss, actual profit or loss and the percentage of profit or loss to inventory value. Now while there were reductions on the sale prices after February, I think I may assume from the evidence that the sale prices throughout February (with possibly a very few exceptions) remained as they were when established by Mr. Gough at January 31.

In that month, goods carried over and having an inventory value of $19,976.00 were sold, the first selling price totalling $37,848.00; after allowing for lesser sales prices on goods which had to be resold, the final selling prices totaled $36,967.00, representing a final gross profit of $16,991.00, such profit being 85·05 per cent over inventory values, or very substantially in excess of the stated normal write-up over inventory of 50 to 60 per cent. For that month the gross profit ratio to the first selling prices was approximately 45 per cent, again a figure very substantially in excess of the normal ratio of approximately 33·3. The stated profit ratio would have been even higher had not the summary taken into consideration some losses on resales. The sales in the summary of that inventory for that month were of ninety-one articles, eighty-seven being fur coats and the balance fur scarves.

Mr. Gough stated that his customary mark-up was from 50 to 60 per cent, "but closer to 60 per cent". I shall assume that the average was 58 per cent. I think it proper, also, to apply the test to all of the first selling prices in February and as they were established on January 31. (It seems to me that it would be improper to exclude from the computation the seven coats which after being sold in February had to be re-sold in later months at lower prices.)

Since 158-100ths of the inventory equals $37,848.00 (the total of the first selling prices), the inventory valuation thereof should have been $23,954.00.

I was given to understand that the parties were not concerned with the inventory valuation placed by the appellant on its skin room and factory supplies which were respectively $5,627.90 and $2,347.21, but only with the values placed on the merchandise on hand in the store, namely, $100,656.70. Applying the formula which I have adopted for the computation of the proper inventory value of the stock sold in February to the whole of the merchandise in the store, I place upon the latter a "market value" of such inventory as of January 31, 1946, of $120,199.00. Accordingly, there should have been added back to the inventory the difference between $120,199.00 and $100,656.70, or $19,542.30. I realize the great difficulty in establishing precise inventory values in matters of this sort, and that, at best, the decision can be but little more than an approximation arrived at by applying what seems to me to be a reasonable test.

It is of some interest to note that in Federal income tax matters in the United States there is a special regulation in regard to the method of valuing an inventory of subnormal or obsolete goods. In Mertens Law of Federal Income Tax, Vol. II, p. 540-1, reference is made to Reg. 103, a portion of which is quoted as follows:

> . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (*a*) or (*b*) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

The basis (*a*) there referred to is cost, and basis (*b*) is cost or market, whichever is lower. It is of special interest to note the definition of *bona fide* selling price. Thereunder

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it would seem to be improper to take the selling prices as something that might come into existence months after the date when the inventory is taken.

For these reasons, there will be judgment allowing the appellant's appeal to the extent I have mentioned and referring the matter back to the Minister for reassessment by reducing the amount added back to income in respect of inventory values from the sum of $27,039.00 to $19,542.30. The cross-appeal will be dismissed. The appellant is also entitled to the costs of the appeal, and of the cross-appeal, after taxation.

Judgment accordingly.