1964

June 2-4

June 19

BETWEEN:

TED DAVY FINANCE CO. LIMITED ...APPELLANT;

AND

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

Revenue—Income Tax—Income Tax Act, R.S.C. 1952, c. 148, ss. 85D, 85F (4) and 139(1)(w)—Income or capital gain—Realization sale—Sale of chattel mortgages and conditional sales contracts to another finance company—Inventory—Receivables—Whether sale of receivables or right to receivables.

[1] 33 Tax A.B.C. 149 [2] 27 Tax A.B.C. 373

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In 1958 the appellant, which had been carrying on the business of purchasing conditional sales contracts from motor vehicle and appliance dealers and of lending money to individuals on the security of chattel mortgages, sold the majority of its conditional sales contracts and chattel mortgages to Industrial Acceptance Corporation Ltd. under a contract by the terms of which the sale was with recourse to the appellant in case of default.

The evidence established that there was a *bona fide* intention on the part of the appellant to go out of the conditional sales and chattel mortgage business because of the conditions then obtaining which made it no longer a financially satisfactory business for the appellant. The issue on appeal was whether the net gain obtained by the appellant on the sale was capital profit or income.

Held: That the sale in question was a realization sale and not a sale in the ordinary course of the appellant's business.

2. That the net excess proceeds of the sale were capital receipts, it being a sale of a right to receivables and not a sale of receivables.

3. That s. 85F(4) of the *Income Tax Act* refers only to cash basis taxpayers and not accrual basis taxpayers and is accordingly inapplicable insofar as the conditional sales contracts are concerned.

4. That s. 85D of the *Income Tax Act* deals with the sales of receivables by accrual basis taxpayers.

5. That s. 85F(4) deals only with income receivables and not with receivables representing capital loans repayable.

6. That what was sold in this case was not inventory within the meaning of s. 139(1)(*w*) of the *Income Tax Act,* and the definition of inventory in that section should not be given the broadest meaning that could be attached to it but the whole Act should be looked at to give it a reasonable and practical meaning, especially when there are other sections of the Act which in themselves constitute a complete code and which override the definition contained in s. 139(1)(*w*) insofar as it is repugnant to them.

7. That the appeal allowed.

APPEAL under the *Income Tax Act.*

The appeal was heard by the Honourable Mr. Justice Gibson at Toronto.

R. M. Sedgewick, Q.C. for appellant.

G. W. Ainslie and *D. H. Aylen* for respondent.

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

GIBSON J. now (June 19, 1964) delivered the following judgment:

Ted Davy Finance Co. Ltd. was, at the material times, a corporation incorporated under the *Ontario Corporations Act* and carried on, in the city of Toronto, Ontario, in the years 1953 to 1958, the business of purchasing conditional sale contracts from the used car sales company known as

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Ted Davy Ltd., and from other motor vehicle and appliance dealers. It also loaned money to individuals on the security of chattel mortgages.

On August 23, 1958, it sold to Industrial Acceptance Corporation Ltd. the majority of its conditional sale contracts and chattel mortgages but retained apparently one mortgage loan and twelve conditional sale contracts because Industrial Acceptance Corporation Ltd. did not wish to purchase them.

It was a term of the contract with Industrial Acceptance Corporation Ltd. that these chattel mortgages and conditional sale contracts were sold with recourse in case of default to Ted Davy Finance Co. Ltd.

The chattel mortgages sold were accounted for in the accounts of Ted Davy Finance Co. Ltd. on what is known as a cash basis; the conditional sales contracts were accounted for on what is sometimes known as an accrual basis.

The only contract document evidencing this sale and purchase from Ted Davy Finance Co. Ltd. to Industrial Acceptance Corporation Ltd. is a letter dated August 23, 1958 from Industrial Acceptance Corporation Ltd. to Ted Davy Finance Co. Ltd., which was filed as Exhibit A-12 in this appeal.

Ted Davy Finance Co. Ltd. credited the net excess of monies received from Industrial Acceptance Corporation Ltd. over and above the sum equivalent to the amount owing by all the debtors of Ted Davy Finance Co. Ltd., as of August 23, 1958, to its surplus account and not to its profit and loss account on the basis that this was a transaction out of the ordinary course of business and should not be accounted for in the accounts of the Company in a method which would result in the financial statements not reflecting a true criterion of the earning capacity of the Company.

The appellant submits that this sum represented a gain at the time of the sale, subject to future adjustments by way of premiums from or rebates paid to Industrial Acceptance Corporation Ltd., pursuant to the letter contract dated August 23, 1958. All such adjustments, the appellant submits, should be made through its surplus account and should not be reflected in the profit and loss account of the company at the time.

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The evidence dealt with the method employed by the Ted Davy Finance Co. Ltd. in accounting for its earnings on its chattel mortgages which was described as the "cash method"; and also on its conditional sale contracts which was described as the "average interest method". Exhibit 10 was filed which is a copy of an article from the Canadian Chartered Accountant of July, 1962, entitled "Accounting for Finance Charges by Sales Finance Companies", wherein, among other things, the author of the article describes these two methods, whose opinion was concurred in by the witness, Mr. Richard McDonald Parkinson, C.A.

After this sale to Industrial Acceptance Corporation Ltd., the Ted Davy Finance Co. Ltd. did enter into one chattel mortgage contract and certain other transactions in respect to land mortgages but none of these transactions, in my opinion, have any relevance to the issue to be decided here.

The sole issue to be decided is whether the net gain obtained by Ted Davy Finance Co. Ltd. by reason of this transaction made with Industrial Acceptance Corporation Ltd., pursuant to the contract dated August 23, 1958, is capital profit or income which should be included in computing the appellant's income for the taxation year 1958.

I am of opinion as was given in evidence, that there was a *bona fide* intention on the part of Ted Davy Finance Co. Ltd. to go out of the conditional sale and chattel mortgage business in 1958 because of the conditions then obtaining in this business which no longer made it a financially satisfactory business for the shareholders, of whom the principal one was Mr. Ted Davy. The reasons given by him for going out of this business were entirely credible, namely that competition of other companies who entered the Toronto market and discounted conditional sale contracts and chattel mortgages in financing the sale of cars without requiring that there be recourse to the dealer, and who financed a most substantial part of the total sale price of cars, not demanding that a substantial down payment on the purchase price of motor cars be made by purchasers of same, resulted in this finance company becoming increasingly a less attractive business financially.

I am of opinion, therefore, that this was intended to be and was in fact a realization sale by Ted Davy Finance Co. Ltd. and not a sale in the ordinary course of its business.

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The net excess proceeds as hereinafter mentioned, I find were capital receipts within the principles of *Frankel v. Minister of National Revenue*[1].

I am further of opinion that s. 85 F (4) is not applicable to the facts of this case so as to require the inclusion of the amount referred to at the end of this judgment in computing the appellant's income for the year 1958, for a number of reasons.

Firstly, in my opinion, this was a sale of a "right" to receivables and not a sale of receivables, and is therefore a capital receipt. The principle of law enunciated in *C.I.R. v. Paget*[2] per Lord Romer at p. 699, is in my opinion applicable.

Secondly, s. 85 F (4) refers only to "cash" basis taxpayers and not "accrual basis" taxpayers, and therefore, in so far as the conditional sales contracts are concerned which were sold, is inapplicable.

Thirdly, s. 85 D deals with the sale of receivables by "accrual basis" taxpayers.

Fourthly, s. 85 F (4), in my view, deals only with "income" receivables and not receivables representing "capital" loans repayable.

I am also of opinion that what was sold in this case was not "inventory" within the meaning of s. 139(1)(*w*) of the *Income Tax Act*.

That definition of inventory, in my view, should not be given the broadest meaning that could be attached to it, but instead the whole Act should be looked at to give it a reasonable and practical meaning, especially when, for example, there are other sections of the Act which in themselves constitute a complete code. These particular statutory provisions override this general provision or definition (s. 139(1)(*w*)) in so far as it is repugnant.

With respect, therefore, I do not agree with the decisions of *Kendon Finance Co. Ltd. v. Minister of National Revenue*[3] and *Cosmopolitan v. Minister of National Revenue*[4].

Some examples of such particular statutory provisions referred to above, are as follows. Depreciable assets fit the description of "inventory" in the Act, but cannot be such because if classified as inventory, then Regulation

[1] [1959] C.T.C. 244.
[2] (1937) 21 T.C. 677.
[3] 33 Tax A.B.C. 149.
[4] 27 Tax A.B.C. 373.

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1102(1)(*b*) precludes a capital cost allowance deduction; if receivables are "inventory" then a deduction for "bad" and "doubtful" accounts could be obtained by a valuation under s. 14(2) and ss. 11(1)(*e*) and 11(1)(*f*) would be unnecessary; and if receivables are "inventory" then on their sale s. 85 E sets out consequence of sale and both section 85 D and 85 F (4) of the Act are unnecessary.

In the result therefore the appeal is allowed with costs.

Because of the adjustments that have been made between the appellant and Industrial Acceptance Corporation Limited, by reason of the wording of the contract between them of August 23, 1958, I am of opinion that the net gain in 1958, which is capital profit, is $68,259 and the appellant does not have to include it in computing its income; but the appellant will not henceforth be able to set up any future reserves under the provisions of s. 12(1)(*e*) of the Act.

Judgment accordingly.