1957 Jan. 29,30,31, Feb. 1

1958 Sept. 5

BETWEEN:

THE MINISTER OF NATIONAL REVENUE .... APPELLANT,

AND

FRANKEL CORPORATION LIMITED RESPONDENT.

Revenue—Income tax—Profits—Sale of business—Specific sum for inventory included in the purchase price—Whether profit on inventory taxable—The Income Tax Act, 1948, S. of C. 1948, c. 52, ss. 2(1)(3), 3, 4, 127(1)(e).

The respondent's business comprised the smelting of non-ferrous metals and dealing in non-ferrous scrap; the smelting of copper from scrap; the wrecking of buildings and the salvage and sale of the material therefrom; the fabrication and erection of structural steel. On January 2, 1952 it sold the non-ferrous metals part of its business comprising machinery and equipment, metals inventory, supplies, accounts receivable, prepaid items, good-will, patents, trade marks, etc. under an agreement that provided that out of the aggregate price paid for all the assets the purchase price of the metals inventory

should be the market price at the time of closing. Pursuant to the agreement the aggregate amount paid by the purchaser included some $822,611 for the inventory carried on respondent's books at the end of 1951 at a cost of some $744,515. In assessing the respondent for 1952 the Minister added to the income reported the difference between the two amounts, some $78,095, as "profit on inventory".

Held: That the Minister was right in adding this difference and in assessing accordingly.

2. That although the *Income Tax Act* taxes actual, and not potential profits, a realization of potential profit occurs when a taxpayer so deals with goods as to appropriate to himself whatever enhancement has resulted from a partially completed operation.
3. That the metals inventory was acquired for the purpose of gaining a profit in the non-ferrous metals business but when, to effect a sale of that business, it was diverted from its original purpose such diversion must be treated as a disposition of trading stock, the result of which for income tax purposes must be recorded as a receipt in the trading account for the period in which it occurred, namely 1952, and the amount to be so recorded must be the realizable value of the inventory at the time it was diverted and not its cost.

Sharkey v. Werner [1955] 3 All E.R. 493 applied, *Doughty v. Commissioner of Taxes* [1927] A.C. 327, distinguished.

APPEAL from a decision of the Income Tax Appeal Board.

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

W. R. Jackett, Q.C. and *J. D. C. Boland* for appellant.

H. C. Walker, Q.C. and *P. N. Thorsteinsson* for respondent.

THURLOW J. now (September 5, 1958) delivered the following judgment:

This is an appeal by the Minister of National Revenue from a judgment of the Income Tax Appeal Board,[1] allowing an appeal by the respondent, Frankel Corporation Ltd., against an income tax assessment for the year 1952. In assessing the respondent's income for the year, the Minister, among other changes, added to the income reported by the respondent an amount of $78,095.68 described in the notice of assessment as "profit on sale of inventory," and it is the liability of the respondent for income tax on this amount which is in issue in the present appeal.

[1] 13 Tax A. B. C. 399; 55 D. T. C. 509.

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The amount in question arose in the following circumstances. The respondent was incorporated on October 30, 1950, and on the following day it took over the business assets and operations of Frankel Brothers Ltd. Thereafter the respondent carried on such operations in the same way as its predecessor had done until the events in question occurred. Frankel Brothers Ltd. had been operating since 1924 as a dealer in ferrous and non-ferrous scrap, and in the smelting and alloying of non-ferrous metals. The latter operation consisted of the recovering of certain non-ferrous metals from scrap material, alloying them with other non-ferrous metals to specifications required by the purchasers, and selling the products. The selling part of the non-ferrous metals operations was carried on under the name "National Metal Company" by Frankel Brothers Ltd. in its time and by the appellant in its turn, and both made use of a registered trade mark consisting of the letters "N. M. C." and also of the word "National" in connection with the products. These operations had been expanded in 1942 to include the smelting and alloying of copper recovered from scrap material. During the time this operation was carried on by the respondent, its activities as a dealer in non-ferrous scrap metal were incidental to the smelting operation, purchases of non-ferrous scrap metal being made only for the purposes of the smelting operation and sales of such scrap materials being made only when the respondent was oversupplied.

The ferrous scrap operation consisted of acquiring the scrap, sorting and preparing it by breaking the iron and shearing the steel for use in iron foundries and steel mills and selling it.

In 1926 Frankel Brothers Ltd. had begun carrying on wrecking and salvage operations which consisted of the wrecking and demolition of buildings and structures and the salvaging and sale of materials therefrom. The chief product of this operation was salvaged timber, but considerable quantities of ferrous scrap metal and minor quantities of non-ferrous scrap metal were recovered as well. When recovered, such ferrous scrap metal was transferred to the ferrous scrap metal operation and the non-ferrous scrap metal to the smelting operation.

In 1929 Frankel Brothers Ltd. had further expanded its activities to include a steel fabrication and erection operation consisting of the fabrication of steel for buildings in its plant and the erection of the steel on the site.

The respondent, on assuming these operations in October, 1950, also acquired the rights of Frankel Brothers Ltd. in the premises where the operations were carried on. These consisted of an area of land between Broadview and Lewis Avenues in Toronto devoted exclusively to the wrecking and salvage operation, and another area nearby at the corner of East Don Roadway and Eastern Avenue where the other three operations were carried on. The latter area was the larger of the two and was equipped with four crane runways and a number of buildings. It was also served by a railway line. Each of the remaining three operations had separate portions of this area where the machinery and equipment used in connection with them were located and the processing of the materials was carried out. In general, the portion used for the purposes of the non-ferrous smelting operation adjoined Eastern Avenue and was completely separated from that of the ferrous scrap metal operation by the area occupied by the steel fabrication operation which lay between the areas occupied by the other two operations and, by itself, held more than half of the whole area.

Not only were the areas and equipment of these operations separate, but the equipment of one was neither used nor usable in connection with any of the other operations. Goods or materials on the premises, for the purposes of these operations, were stored on the portion of the premises allotted to the particular operation and separate accounts of them were maintained, that of the non-ferrous metals being a complete list of each item with its weight and value. When scrap metal from the wrecking and salvaging operation was transferred to the ferrous or non-ferrous operation, the transfer was recorded by a voucher crediting the wrecking and salvaging operation and debiting the receiving operation with the market value of the scrap. Both the sources of material and the customers who bought the products of any of these operations were, in general, different from those of the other operations. The staffs who carried out the different operations were also separate

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and distinct from each other. Those employed in the non-ferrous smelting operation worked exclusively in that operation and consisted of some sixty-five persons, including a production supervisor, three salesmen, a purchasing agent, and laboratory and other workers.

The accounting practices followed by the respondent and its predecessor were not explained in detail, nor was detailed evidence given respecting the duties of clerical or accounting employees. In the annual statements, however, which accompanied the respondent's income tax returns, the profit and loss statement was broken down between what was headed "Metals Division", including both the ferrous and non-ferrous metal operations, and the "Structural Division", embracing the steel fabrication and the wrecking and salvage operations. A separate operating profit from each of these divisions was carried to the profit and loss statement, and overhead expenses, consisting of selling expenses, property expenses, and administrative expenses, were deducted generally to show the operating profit of the company for the year. To what extent these expenses were incurred separately for and charged to separate operations in the course of business does not appear, though there is evidence that the accounting for the structural steel operation and for the wrecking and salvage operation were separate from the others but that that for the ferrous scrap and non-ferrous metals operations was combined. Nor does it appear to what extent, if any, items such as directors' fees, municipal taxes on the property occupied, and other items of an apparently overall nature, were in fact incurred exclusively for or charged to any of the several operations. All four operations were, however, under the control of a single board of directors, each operation having one person in charge responsible to the board. There is also evidence that the respondent had a single union labour contract and insurance and pension plans covering employees of all the operations.

As a business field, the smelting and alloying of non-ferrous metals, such as copper, lead, zinc, tin and aluminum, is regarded by persons engaged in the trade as separate from that of iron and steel on the one hand and the precious metals such as gold, silver, and platinum on the other, the

type of plant and equipment, the sources of raw material, the processing and the uses of the product being quite different and distinct in each field.

In August, 1951, the respondent became aware that American Smelting and Refining Corporation, a large organization controlling some fourteen non-ferrous metals smelting and refining plants in the United States, as well as mining and other allied enterprises, was seeking a favourable opportunity to establish a non-ferrous metals smelting and refining business in Canada, and negotiations ensued which led to the sale in question in these proceedings. From the point of view of the respondent, two principal reasons prompted the course which it took. First, the respondent was controlled by members of the Frankel family, the younger members of which were more interested in the structural steel operation and in its expansion than in the other operations, and more space on the premises was required to accommodate such expansion. The second and more important reason was the prospect of another large competitor in the Canadian market. Ultimately, on December 19, 1951, an agreement was reached by which the respondent sold to Federated Metals Canada Ltd., a subsidiary of American Smelting and Refining Co., all the assets used in the non-ferrous metals operation other than the land and buildings, a number of overdue accounts, and a quantity of drosses representing about one per cent of the non-ferrous metals inventory. In the transaction the respondent leased the land and buildings to the purchaser for a four-year term and transferred to it, as well, the employees engaged in this operation. The assets transferred to the purchaser included laboratory equipment, inventories of raw, partly processed, and finished non-ferrous metals, supplies useful in the non-ferrous metals operation, accounts receivable, prepaid insurance and similar items, and

(f) Good-will, Patents, Trade Marks, etc. All the business, unfilled customers' orders, good-will, trade connections, patents, patent applications, inventions, licences, formulae, processes, trade names and trade marks of every nature and description owned or possessed by Frankel and pertaining to its non-ferrous metals business.

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On completion of the transaction on January 2, 1952, the respondent ceased operating in the smelting and refining of non-ferrous metals and as a dealer in non-ferrous scrap metal, and the purchaser assumed and carried on that operation on the same portion of the premises which had theretofore been used by the respondent for that purpose. The respondent continued as before with its other three operations, save that non-ferrous scrap metal recovered in the wrecking and salvage operation was thenceforth disposed of to the purchaser, pursuant to a term of the contract. No new or other operation in the smelting or refining of non-ferrous metals or the sale of non-ferrous scrap metal was set up or carried on by the respondent.

The contract, pursuant to which the sale was effected, was made between the respondent and American Smelting and Refining Co. and, after reciting the nature of the respondent's non-ferrous metals operations and the general nature of the agreement between the parties, proceeded as follows:

NOW THEREFORE THIS AGREEMENT WITNESSETH that in consideration of the premises and the mutual promises hereinafter exchanged, it is agreed as follows:

1. Frankel agrees to sell, transfer and convey to Federated the following assets of its non-ferrous metals business, namely:

(*a*) *Machinery and equipment*. . . .

(*b*) *Inventories of Raw Materials and Finished Metals*. All raw materials, such as scrap metals, drosses, skimmings and residues, and all new or finished metals on hand at the time of closing hereunder. The purchase price for scrap and other raw materials shall be the market price therefor at the time of closing, but should there be any dispute between the parties as to such market price, then Frankel shall offer such material for sale, privately or in any available market, and Asarco shall have the option of purchasing the same at a price equal to the best price bid therefor. Since Federated will take over Frankel's unfilled customers' orders at the time of closing and some of these may have been taken at prices below the current market at the time of closing, it is agreed that a sufficient allowance from said purchase price for raw materials will be made to Federated for the quantity of raw materials required to fill such customers' orders which are below market price so that said allowance will result in a market price for such raw materials that would normally prevail therefor when the finished product is sold at the price at which such orders were taken. The purchase price of ingot and other finished product shall be determined by adding the cost of manufacture to the current market price at the time of closing of the scrap or other raw materials that went into the manufacture thereof, provided such purchase price shall not exceed the current market price for the finished product less a fair allowance for the cost of storing,

selling and delivering the same. If any of such ingot or other finished product is required to fill customers' orders to be transferred to Federated and such orders are at prices below the current market prices at the time of closing, any necessary allowance will be made on the purchase price of the finished product to enable Federated to complete such customers' orders and make the normal profit which would accrue if such orders were at current market prices and made from currently priced raw material.

(c) *Supplies.* . . .

(d) *Accounts Receivable.* . . .

(e) *Prepaid Items.* . . .

(f) *Good-will, Patents, Trade Marks, etc.* . . .

* * *

2. The purchase price for all of the aforesaid property shall be:

(*i*) for the items specified in sub-paragraphs (*a*), (*b*), (*c*), (*d*) and (*e*) of paragraph 1 hereof, the aggregate of the sums specified therein which shall be payable in cash by Federated to Frankel at the time of closing, and

(*ii*) for the items set forth in sub-paragraph (*f*) of paragraph 1 hereof the amount of 150,000.00 which shall be payable in cash by Federated to Frankel at the time of closing, together with 49,000 shares without nominal or par value in the capital stock of Federated to be allotted and issued to Frankel or its nominee at the time of closing as fully paid and non-assessable and constituting 49% of the capital stock of Federated then authorized, issued and outstanding.

* * *

The contract also included a number of indemnity clauses, provisions for the sale of the 49,000 shares to Asarco within certain times, a provision that, in the meantime, certain members of the Frankel family should be members of the Board of Directors of Federated, a clause respecting the leasing of the premises to Federated, several clauses respecting the transfer of employees and the protection of the respondent in respect to their pension and insurance rights, and a clause respecting non-competition in the non-ferrous metals field by the officers and directors of the respondent.

As previously mentioned, the whole of the respondent's inventory of non-ferrous metals was purchased by Federated pursuant to the contract, with the exception of certain drosses which accounted for some one per cent of the whole. The aggregate amount paid by Federated pursuant to paragraph 2(i) above included $822,611.15 in respect of inventory calculated as set out in the above

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paragraph 1(b). The same inventory was being carried at the end of 1951 at a cost of $744,515.47, and it is the liability of the respondent to income tax on the difference between these figures which is in issue in this appeal.

In the profit and loss statement accompanying the respondent's income tax return for 1951, the closing inventory for the metals division was shown at $767,191.01, of which $744,515.47 represented inventory of non-ferrous metals which were thus treated as being on hand and as trading assets at the end of 1951. This statement formed part of the report of the respondent's auditors which was dated May 15, 1952. In the report it was stated that subsequent to the year end the respondent disposed of the non-ferrous metals division of the business to Federated Metals Canada Limited. In the profit and loss statement accompanying the respondent's 1952 income tax return, the opening inventory of the metals division was shown as follows:

Inventory December 31, 1951	$767,191.01
Less sold to Federated Metals Canada Limited	744,515.47
	$ 22,675.54

and only the difference was carried into the computation of gross profit for the year. The sum of $822,611.15 was not included as a receipt. The auditors' report stated that on January 2, 1952 the respondent disposed of the non-ferrous metals division of the business to Federated Metals Canada Limited. In each year the return was, of course, certified as correct on behalf of the respondent, and the sum reported as income was that appearing from the auditors' computation.

While I attach no importance to the use of the word "division" as characterizing the nature of the respondent's non-ferrous metal operations, these statements indicate that, despite the fact that the contract and notice to customers suggest that the transaction was to be closed in 1951, it was in fact closed, and the respondent treated it as having been closed in 1952, rather than in 1951.

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By s. 2(1) of *The Income Tax Act* income tax is imposed upon the taxable income for the taxation year of all persons resident in Canada at any time in the year; and by s. 2(3) taxable income is defined as the taxpayer's income for the year minus certain deductions which are not in issue in this appeal. The income of a taxpayer for a taxation year is declared by s. 3 to be his income for the year from all sources, including income for the year from all businesses, and by s. 4 income for a taxation year from a business is defined, subject to the other provisions of Part I of the Act, as *the profit therefrom for the year*. Business is defined by s. 127(1)(*e*) as including a trade, manufacture or undertaking of any kind whatsoever and also as including an adventure or concern in the nature of trade. Since what is taxed under these provisions as income from a business is *the profit therefrom for the year,* the fundamental question that arises in the present situation is, what was the profit from the respondent's business for the year 1952?

In *Whimster & Co. v. The Commissioners of Inland Revenue*[1], Lord Clyde, in a passage which was cited with approval by the Privy Council in *Minister of National Revenue v. Anaconda American Brass Ltd.*[2], said at p. 823:

> In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn *those receipts*. In the second place, the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be.

In the present case no problem as to expenditures arises, and so the question is narrowed down at once to what were the receipts from the respondent's business for the year 1952. Now if the transaction by which the respondent sold the inventory and other assets of its non-ferrous metals operation was a transaction of the respondent's business, there could, I think, be no answer to this question but that the amount of $822,611.15 included in respect of

[1] [1925] 12 T. C. 813; [1926] Sess. Cas. 20.
[2] [1955] C. T. C. 314; 55 D. T. C. 1220; [1955] C. T. C. 311.

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inventory in the aggregate sum paid by the purchaser was a receipt from the respondent's business. But the question is broader than that of whether or not the sale to Federated was a transaction of the respondent's business, for even if that sale was not a transaction of the respondent's business it is still necessary to determine whether or not a receipt of the amount in question was realized from the respondent's business by or as the result of an event which, for income tax purposes, must be treated as the equivalent in point of law of a transaction of that business for, if so, the receipt of such amount must be accounted for in computing the profit from the business for the year in which such event occurred.

I turn, therefore, to consider the sale to Federated to determine first whether or not it was a transaction of the respondent's business. In essence, this problem seems to me to be that of applying to the situation the test propounded in *Californian Copper Syndicate v. Harris*[1] by the Lord Justice Clerk when he said:

> It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, *where what is done is* not merely a realisation or change of investment, but *an act done in what is truly the carrying on, or carrying out, of a business.*
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> * * *
>
> What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realising a security, or *is it a gain made in an operation of business in carrying out a scheme for profit-making?*

In *Doughty v. Commissioner of Taxes*[2], the assets of a partnership, including stock in trade, were sold to a limited company formed to carry on the business, the consideration being a lump sum payable in shares of the company. This sum was greater than the value placed on the assets in the last balance sheet of the partnership, and adjustments had been made in the values shown on the

[1] (1904) 5 T. C. 159 at 165.
[2] [1927] A. C. 327; 96 L. J. P. C. 45; 136 L. T. 706.

balance sheet, including an increase in the value assigned to the stock in trade. This increase was assessed as profit of the partnership business and Doughty, one of the partners, appealed. The trial judge disallowed the assessment, but the Supreme Court restored it. Doughty then appealed to the Privy Council. In delivering the judgment of the Privy Council allowing the appeal, Lord Phillimore said at p. 331:

The appellant puts his case in two ways. He says: (1.) that if the transaction is to be treated as a sale, there was no separate sale of the stock, and *no valuation of the stock* as an item forming part of the aggregate which was sold, and (2.) that there was no sale at all, but merely a readjustment of the business position of the two partners, and an application for their benefit of the law of New Zealand allowing the formation of private companies with limited liability.

Income tax being a tax upon income, it is well established that the sale of a whole concern which can be shown to be a sale at a profit as compared with the price given for the business, or at which it stands in the books, does not give rise to a profit taxable to income tax.

It is easy enough to follow out this doctrine where the business is one wholly or largely of production. In a dairy farming business or a sheep rearing business, where the principal objects are the production of milk and calves or wool and lambs, though there are also sales from time to time of the parent stock, *a clearance or realization sale* of all the stock in connection with the sale and winding up of the business *gives no indication of the profit* (if any) *arising from income;* and the same might be said of a manufacturing business which was sold with the leaseholds and plant, even if there were added to the sale the piece goods in stock, and even if those piece goods formed a very substantial part of the aggregate sold.

Where, however, a business consists, as in the present case, entirely in buying and selling, it is more difficult to distinguish between an ordinary and a realization sale, the object in either case being to dispose of goods at a higher price than that given for them, and thus to make a profit out of the business. The fact that large blocks of stock are sold does not render the profit obtained anything different in kind from the profit obtained by a series of gradual and smaller sales. This might even be the case if the whole stock was sold out in one sale. Even in the case of a realization sale, if there were an item which could be traced as representing the stock sold, the profit obtained by that sale, though made in conjunction with a sale of the whole concern, might conceivably be treated as taxable income.

But upon the evidence in this case, it would appear that no such separate sale was effected.

In *Hickman v. Federal Commissioner of Taxation*[1], a case referred to by Lord Phillimore in the *Doughty* case (*supra*), a grazier had sold his ranch with the cattle but not the horses thereon for a total sum made up of an

[1] (1922) 31 C. L. R. 232.

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amount for the ranch and £10,876 for the cattle, and it was sought to tax a portion of this sum as a profit "arising from" the vendor's business. Knox C. J. said at p. 238:

In this case it is clear from the words of the contract of 1st January 1918 that it was an indivisible contract for the sale of the land and stock—substantially the whole of the assets of the business theretofore carried on by the appellant—and that the allocation of portion of the purchase-money to the live-stock and the balance to the land, presumably made for the convenience of the parties, does not convert the single contract into two—one for the sale of the land and the other for the sale of the live-stock for independent considerations. The single transaction must be treated as effecting a complete change of ownership of a continuing business and of the assets employed in carrying it on.

The substantial question is whether any part of the purchase money payable on such a transaction is to be brought into account as a receipt in the assessment of the vendor to war-time profits tax in respect of the profits of the business sold.

Mr. *Douglas* for the appellant admitted that he was liable to be assessed to this tax in respect of so much of the trading profits of the business made during the accounting period as was properly attributable to the six months during which he carried on the business; but contended that no portion of the sum of £10,876 could be treated as taxable profits, because the Act was directed to the taxation of trading profits and did not assume to tax the proceeds of realization of a business sold as a whole in one transaction. In my opinion this contention is correct.

Higgins J. said at p. 242:

The proceeds of the sale of a business are not, in any part profits "arising from any business," within the meaning of sec. 7.

Starke J. said at p. 243:

The taxpayer had carried on the business of a grazier on his property, buying, fattening, breeding and selling cattle. The sale from which the sum of £10,867 arose was not in the ordinary course of trade. It was not made for the purpose of realizing the profits of the business, but in order to end it so far as the taxpayer was concerned, and, in truth, to change the form in which his assets then existed into that of money. Such a transaction was not, as it appears to me, carrying on or carrying out his business. Consequently profits accruing from such a transaction do not arise from the business of the taxpayer within the meaning of the *War-time Profits Tax Assessment Act.*

Turning now to the facts in the present case, it may be noted that, while the respondent's non-ferrous metals operation was not separate in all respects from its other operations, it was, nevertheless, separate in many of its features, and as a whole it was readily separable from the others. The sources of the material and supplies used in the operation, the employee of the respondent who bought them, the machinery and equipment used in the operation,

and the employees who operated it, the portion of the premises where the operation was carried on, the customers who bought the products, and the employees of the defendant who sold them, the name under which the operation was carried on and the trade mark and trade name used on the products, as well as the supervision provided, were all almost entirely distinct from the other operations. Indeed, the whole process by which profit was earned seems to have been quite distinct from the others, save in respect of the acquisition of minor quantities of scrap material from the wrecking and salvage operation, the combination for some purposes of the accounting with that of the ferrous scrap operation and such general matters as control by the same board of directors, the arrangement of a single union contract for employees of the respondent, employees' pension and insurance plans, and the ultimate preparation of the profit and loss account for the operations of the company.

Next, the contract was, in my opinion, an indivisible one for the sale of the items mentioned in their entirety, rather than for the sale of the separate items by themselves. While the contract contained formulae for ascertaining the amount by which the aggregate sum to be paid by the purchaser would be increased according to the amount of inventory transferred to the purchaser in the transaction; and while the formula was, in the case of raw material, based on the prevailing price and, in the case of finished goods, on the lower of the cost of materials at prevailing rates plus the cost of manufacture, or market price, there was but one transaction in which, for the aggregate sums to be paid, the purchaser was to acquire not only the stock, equipment, good-will, business and other assets, but a right, as well, to a four-year term in the premises in addition to the benefit of the other covenants. Under this contract neither party could have held the other to any part of it while refusing on its part to carry out the whole and, despite the formulae above mentioned, I think it is impossible to say that the contract or the transaction shows that the sum calculated according to the formulae as forming part of the aggregate sum paid was paid or received for the inventory. The truth is that the whole consideration was paid and received for the

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assets and rights granted as a whole, and no part of the consideration was paid or received for inventory alone or for equipment alone or for any other single asset or right by itself. Now the assets sold included substantially the whole of the inventory of processed and unprocessed non-ferrous metals and partly processed metals as well. It also included the supplies provided for the processing of non-ferrous metals. Neither partly processed metals nor supplies had previously been sold in the course of the respondent's business. In the same transaction, substantially all of the tangible and intangible assets of the non-ferrous metals operation were also sold, including good-will, trade name and trade mark and—what is perhaps more significant—the unfilled customers' orders under terms which contemplated that they would be filled by the purchaser in the course of its own trading, and not on behalf of the respondent. The same contract provided for the transfer to the purchaser of the employees engaged in the operation and for the granting to the purchaser of a lease of the premises used in the operation. Finally, by or in conjunction with this transaction, the respondent put itself out of the non-ferrous metals trade. While none of these features would in itself be conclusive, in my opinion, taken together they distinguish this transaction from those of the respondent's business and classify this sale as one not in the business but outside and beyond the scope or course of that business. It follows, in my opinion, that no part of the receipts from this sale was a receipt from the respondent's business.

This, however, leaves undetermined the question whether or not the act of the respondent in diverting trading stock from the trade for the purpose of disposing of it in a transaction beyond the scope of the trade must itself be treated for income tax purposes as a disposition giving rise to a trading receipt equivalent to the realizable value of the stock so diverted.

In *Sharkey v. Wernher*[1] a horse forming part of the trading stock of a stud farm was taken by the owner for purposes not associated with the earning of income, and a question arose as to what amount, if any, should be

[1] [1955] 3 All E. R. 493; [1956] A. C. 58.

entered in the trading account of the farm to account for the horse so removed from the trade. It was held that, for income tax purposes, an amount must be entered as a receipt in the trading account of the stud farm to account for the horse and that the amount to be so entered was its realizable value at the time of such removal rather than the cost incurred in breeding it. At p. 504, Lord Radcliffe, with whom two other members of the House concurred, discussed the question as follows:

My Lords, with these considerations in mind, I must now say what I believe to be the right way to deal with the present case. When a horse is transferred from the stud farm to the owner's personal account, there is a disposition of trading stock. I do not say that the disposition is made by way of trade, for that is a play on words which may beg the question. At least three methods have been suggested for recording the result in the stud farm's trading accounts. There might be others. Your Lordships must choose between them.

First, there might be no entry of a receipt at all. This method has behind it the logic that nothing, in fact, is received in consideration of the transfer, and there is no general principle of taxation that assesses a person on the basis of business profits that he might have made, but has not chosen to make. Theoretically, a trader can destroy or let waste or give away his stock. I do not notice that he does so in practice, except in special situations that we need not consider. On the other hand, it was not argued before us by the respondent that this method would be the right one to apply; and a tax system which allows business losses to be set off against taxable income from other sources is, in my opinion, bound to reject such a method because of the absurd anomalies that it would produce as between one taxpayer and another. It would give the self-supplier a quite unfair tax advantage.

Secondly, the figure brought in as a receipt might be cost. That is what the respondent contends for. It is not altogether clear what is to be the basis of such an entry. No sale in the legal sense has taken place, nor has there been any actual receipt. The cost basis, therefore, treats the matter as though there had been some sort of deal between the taxpayer and himself but maintains that, in principle, he can only break even on such a deal. I do not understand why, if he can be supposed to deal at all, he must necessarily deal on such self-denying terms. But then the respondent argues that the cost figure entered as a receipt is to be understood as a mere cancellation of the cost incurred to date. The item of stock transferred to the owner's private account is shown by that very event to have been "withdrawn" from the trade, and the only practical course is to write out of the trader's accounts the whole of the cost bona fide, but mistakenly, entered in respect of it. I think this a very attractive argument, but its weakness is that it does not explain why such cancellation should take place. This is not put to us as a case in which, there being no market, cost is the best available estimate of value. The fact that an item of stock is disposed of not by way of sale does not means that it was any the less part of the trading stock at the moment of disposal. On the contrary, it was part of the stock of the venture at every moment up till then, and whatever was spent on it was

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rightly entered as a part of the costs and expenses of the trade. Its disposal does not alter that situation. The trade of which the receipts and expenses are in question is the whole activity of farming, and the disposal of the produce is only one, though a very important, incident of that activity. I think it a fallacy, therefore, to suppose that the method of disposal can give any warrant for treating costs hitherto properly charged to the trade as if, ex post facto, they never ought to have been charged at all. Yet, if a cancelling entry is not to be made, there must either be a figure entered as a receipt which, admittedly, does not represent any actual legal transaction or the costs incurred up to the date of disposal must remain on the books to create or contribute to a "loss" of income which common sense suggests to be a fiction.

In a situation where everything is to some extent fictitious, I think that we should prefer the third alternative of entering as a receipt a figure equivalent to the current realisable value of the stock item transferred. In other words, I think that *Watson Bros. v. Hornby,* [1942] 2 All E. R. 506, was rightly decided, and that its principle is applicable to all those cases in which the income tax system requires that part of a taxpayer's activities should be isolated and treated as a self-contained trade. The realisable value figure is neither more nor less "real" than the cost figure, and, in my opinion, it is to be preferred for two reasons. First, it gives a fairer measure of assessable trading profit as between one taxpayer and another, for it eliminates variations which are due to no other cause than any one taxpayer's decision as to what proportion of his total product he will supply to himself. A formula which achieves this makes for a more equitable distribution of the burden of tax, and is to be preferred on that account. Secondly, it seems to me better economics to credit the trading owner with the current realisable value of any stock which he has chosen to dispose of without commercial disposal than to credit him with an amount equivalent to the accumulated expenses in respect of that stock. In that sense, the trader's choice is itself the receipt, in that he appropriates value to himself or his donee direct instead of adopting the alternative method of a commercial sale and subsequent appropriation of the proceeds.

Viscount Simonds also said at p. 498:

But it appears to me that, when it has been admitted or determined that an article forms part of the stock-in-trade of the trader, and that, on his parting with it so that it no longer forms part of his stock-in-trade, some sum must appear in his trading account as having been received in respect of it, the only logical way to treat it is to regard it as having been disposed of by way of trade. If so, I see no reason for ascribing to it any other sum than that which he would normally have received for it in the due course of trade, that is to say, the market value. As I have already indicated, there seems to me to be no justification for the only alternative that has been suggested, namely, the cost of production. The unreality of this alternative would be plain to the taxpayer, if, as well might happen, a very large service fee had been paid so that the cost of production was high and the market value did not equal it.

In my opinion, the principle of this judgment is applicable under *The Income Tax Act* in the present situation. Counsel for the respondent sought to distinguish it on the

ground that *Sharkey v. Wernher* was a case where the trade was continuing, whereas the present situation is one in which the particular trading operation was brought to an end by the transaction in question. This, however, in my opinion, makes no difference, for in each case the problem seems to me to be the same, namely the manner in which trading stock which has been disposed of by the owner otherwise than in the ordinary course of trade is to be accounted for when, for income tax purposes, one is seeking an answer to the question: what were the receipts from the trade for the period in which the disposition occurred? The period in 1952 in which the respondent carried on its non-ferrous metals operation was short, consisting only of the period from the beginning of the year to the moment on January 2 when the sale was completed, and I think it is probable that in that period no ordinary transactions of the operation occurred and that the processing of metals was at a standstill. But the inventory of non-ferrous metals was still trading stock at the end of 1951. The metals comprised in it had been acquired in carrying on the business of buying, processing, and selling non-ferrous metals with the object of gaining profit thereby. Whatever the stage of their processing might be, the whole of these metals continued to be trading stock held for that original purpose until they lost that character at some time after the end of 1951. In my opinion, that time was January 2, 1952, when the sale to Federated was closed. Until then, the respondent's non-ferrous metals operation, as well as the scheme for making profit by it, were still in existence. There had been no discontinuance of the operation, nor had the respondent any intention of discontinuing it except upon the transfer becoming effective. Had the sale been cancelled at any time up to the moment when it was closed, I think the conclusion would have been inevitable that the respondent's operation had never been terminated. At that moment, in selling the non-ferrous metals inventory along with the other assets the respondent voluntarily diverted the inventory to a purpose other than that for which it had been acquired. In this situation, the judgment in *Sharkey v. Wernher,* in my opinion, is authority both that such diversion must be treated as a disposition of trading

stock, the result of which for income tax purposes must be recorded as a receipt in the trading account for the period in which it occurred, that is, 1952, and that the amount to be so recorded must be the realizable value of the inventory so diverted at the time when it was diverted, rather than what it had cost the taxpayer to acquire it.

In the present case, selling the product was but one incident of the process by which profits were gained in the respondent's non-ferrous metals operation. The purchasing of raw materials and the processing of them were also incidents of the profit-earning operation, and the profits themselves were the result of the whole operation. In such an operation, at any particular moment when there are on hand raw, partly processed, and finished materials the value of which exceeds what they have cost, what may for convenience be called a potential profit has been earned, though it has not been realized because the goods have not been sold. If the operation proceeds and the goods are sold, that potential profit may be realized along with whatever increment may accrue from the selling as well. As I understand the law, *The Income Tax Act* taxes actual, that is to say, realized profits, not potential profits. If a potential profit is never realized, it never becomes subject to tax. But sale in the ordinary course of trade is not the only means by which potential profits which have been earned in a trade may be realized. Realization of a potential profit which has been earned in the trade may occur whenever the goods are so dealt with by the owner that he appropriates to himself whatever enhancement of value has resulted from the partially completed operation. He realizes that enhancement when he turns the property to his own private, as distinguished from his trade purposes, and he also realizes it when, as in this case, he diverts the property from the trade for the purpose of disposing of it in a transaction beyond the scope of the trade. In this view, the realizable value of the inventory so diverted from the trade must be brought into the computation of the profit of the operation as a receipt for the period in which the diversion occurred.

There is, in my opinion, nothing in the judgment in the *Doughty* case which conflicts with the application of the principle of the *Wernher* case in the present situation, for in the *Doughty* case it is apparent from the judgment that neither the transaction nor the other established facts afforded any indication that the realizable value of the stock transferred was in fact greater than the amount at which it was being carried on the books of the partnership. In the *Hickman* case the principle later applied in the *Wernher* case does not appear to have been raised or considered, nor was the realizable value of the cattle necessarily equal to the amount received from the purchaser in respect of them.

There remains the question: what was the realizable value of the inventory of non-ferrous metals so diverted? Counsel for the Minister submitted that the amount calculated in accordance with the contract and included in the aggregate sum paid by the purchaser is evidence of the realizable value. With respect to raw material, the contract provided that the amount to be included should be the market price of such raw material at the time of the transfer. In case of disagreement as to that price, the contract further provided a procedure whereby the best realizable price might be ascertained. In the case of finished goods, the amount was to be market price of raw material plus cost of manufacture but not exceeding the market price of the finished product less a fair allowance for the cost of storing, selling, and delivering the goods. Here, I think, the result of the formula was that the amount would not exceed realizable value but might conceivably be less. There was no special provision in the contract covering partly processed material. Nor was there evidence as to how much of the sum added in respect of inventory represented material in this state, though there is evidence that partly processed material was but a small proportion of the whole.

Having regard to the presumption in favour of the assessment and to the terms of the contract, and in the absence of evidence that the sum of $822,611.15 at which the inventory was valued in the aggregate amount paid by the purchaser was more than the realizable value of it, I

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think that the realizable value was at least equal to that amount. In my opinion, this amount should have been entered as a receipt in the respondent's trading account for the year 1952 and, had this been done, the respondent's income for 1952 would have been shown to be greater by $78,095.68 than the amount reported. It follows that the Minister was right in adding this difference and in assessing it accordingly.

The appeal will be allowed and the assessment of the sum in question restored. The appellant is entitled to his costs.

Judgment accordingly.