1952
Mar. 27 & 28
Oct. 17

BETWEEN:

MINISTER OF NATIONAL REVENUE APPELLANT;

AND

SINNOTT NEWS COMPANY LIMITED RESPONDENT.

Revenue—Income—Deduction—Income War Tax Act R.S.C. 1927, c. 97, s. 6(1) (d)—Reserve set up against future unascertained events is not deductible from income—Appeal from Income Tax Appeal Board allowed.

Respondent distributed magazines to retail sellers of the same and claimed the right to deduct from income for a particular year "a reserve for loss of returns" being the estimated loss of profits on magazines not sold by the retailers and liable to be returned to it the following year. The Income Tax Appeal Board allowed such a deduction and the Minister of National Revenue appealed to this Court. The respondent also appealed directly to this Court from the disallowance by the Minister of National Revenue of such a claim for deduction for another tax year.

The Court found that the transaction between respondent and its customers were sales and that the whole of the accounts receivable in respect thereof at the end of the fiscal year constituted part of the income of the respondent to be taken into account in computing its profit or gain.

Held: That every reserve set up out of profits or gains which seeks to provide against the happening of unascertained future events and claimed as a deduction from income is barred by s. 6(1) (*d*) of the Income War Tax Act.

APPEAL from the Income Tax Appeal Board.

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

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

Mannie Brown for respondent.

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

CAMERON J. now (October 17, 1952) delivered the following judgment:

This is an appeal by the Minister of National Revenue from a decision of the Income Tax Appeal Board dated August 27, 1951 (4 T.A.B.C. 397) which allowed the appeal of the respondent from its assessment to income tax for its fiscal year ending January 31, 1946. The respondent company was incorporated on February 1, 1942, and has since carried on business as a wholesale distributor of

magazines, periodicals and books. For the fiscal year ending January 31, 1944, and in previous years, the company reported its income for tax purposes on an accrual basis, taking into account the accounts receivable in respect of magazines, periodicals and books which had been distributed to its customers. For the fiscal year ending January 31, 1945, the company for the first time set up a "reserve for loss on returns" of $11,574.69, that sum being the amount which the company estimated to be the profit on the periodicals, etc., which had been distributed to the retailer but which were unlikely to be sold and which, under their contracts, could be returned within certain specified periods. That reserve was disallowed by the Minister of National Revenue and from that disallowance the company has appealed direct to this Court.

For the fiscal year ending January 31, 1946, the company increased its "reserve for loss on returns" by $1,655.38, which was disallowed by the Minister; but an appeal to the Income Tax Appeal Board was allowed, the assessment vacated and the matter referred back to the Minister to deduct the said sum from its taxable income, and to re-assess the respondent accordingly. By consent, the appeal from that decision, and the appeal of the company direct to this Court in respect of its fiscal year ending January 31, 1945, were heard together, the point involved in the two cases being precisely the same.

For the Minister it is contended that the income of the company was properly determined under the provisions of s. 3 of the Income War Tax Act, and that the amount of $1,655.38 was an amount transferred or credited to a reserve or contingent account and was therefore barred by the provisions of s. 6(1) (*d*) of the Act, which is as follows:

> 6(1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
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> (*d*) amounts transferred or credited to a reserve, contingent account or sinking fund, except such amount for bad debts as the Minister may allow, and except as otherwise provided in this Act.

The respondent submits that the deduction was not an amount transferred or credited to a reserve or contingent account; that having taken into the current assets of its balance sheets as accounts receivable the value of all periodicals distributed to the trade, it was entitled to offset

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against that item the profit thereon which it would lose by reason of unsold periodicals which the retailers were likely to return within certain time limits under their contract with the company. It relies, also, on the finding of the Income Tax Appeal Board that there was no profit or gain to the company unless and until the goods were sold by the retailer.

The respondent publishes nothing itself but is a distributor to some 2,500 retailers in Toronto and throughout Ontario of about 450 different publications which it receives from either the publishers or distributing firms for the publishers. Its contracts with the publishers are in writing and the goods which it receives are on the basis of "fully on sale or return," or, as it is sometimes called, "fully returnable." That means that if the respondent returns unsold goods to the publisher within certain specified time limits, it receives full credit for such return. In the main, the contracts provide that the goods shipped to the respondent are "on consignment," the title to the goods remaining in the publishers until they are sold by the respondent; and in some cases it is provided also that the respondent shall hold the funds it receives on the sale of the goods as trustee for the publisher.

The respondent has no written contract with the retailers to whom it distributes the goods. It makes regular deliveries several times a week to each retailer, placing in the retailers' stores that number of each publication which it considers the retailer is likely to dispose of, and it is clearly understood that such goods are also delivered on the basis of "fully on sale or return." The retailer is notified by the respondent as to the date by which unsold goods are to be returned, and upon their return by that date full credit is given to the retailer for the amount he has paid or been charged. When regular deliveries are made, the retailer is supplied with a delivery slip such as Ex. 1. It contains a list of the publications so delivered, the number and price of each, and information as to when unsold previous issues are to be returned. At the top the words, "On Consignment," appear. For request and repeat orders, no such form is supplied.

The retailers' accounts are payable on a weekly basis, except in special cases such as that of the United Cigar Stores which pays the accounts on a monthly basis. On Wednesday of each week, the retailer is given a recap and payment of the amount shown as due is requested. It was agreed that Ex. B is a fair sample of such weekly recap. It is a statement debiting the retailer with the value of goods supplied him during the previous week and crediting him with any cash payments and all goods returned during that week. It states that "Accounts are payable weekly," and "Last amount in this column is now due."

Prior to its fiscal year 1945, the respondent had relatively few unsold publications returned to it by the retailers. In its income tax returns which were on an accrual basis, it carried into accounts receivable the full value of all goods delivered to the retailers and for which it had not received payment, apparently being content to claim as losses in the following fiscal year credits given to retailers for the few goods which were actually returned after the end of the fiscal year. However, in 1945, when the controls on paper were removed, it was supplied with a much larger number of each publication, with the result that the retailers' returns became very substantial and in some cases were as much as 30 to 40 per cent of the deliveries made.

In completing its income tax returns for the fiscal year ending January 31, 1945, the respondent realized that if it included in its accounts receivable the sale price of all goods previously delivered to the retailers for which payment had not been received, it would be assessed to income on that part thereof which it would later have to credit to the retailers in respect of goods returned after January 31. While continuing to file its returns on an accrual basis and to show in its accounts receivable the sale price of all goods delivered (and not yet paid for), it attempted to meet the difficulty I have referred to by introducing into its liabilities the item "reserve for loss on returns," and continued the same practice in subsequent years. For 1945 the "reserve" of $13,230.07 was arrived at by adding together the profit element which it had lost on all the goods which had been returned to it in the last three months of the 1945 fiscal period, it being considered that the same percentage of goods delivered in the fiscal year of 1945 would be returned

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after January 31, 1945, and that the precise number of such returns would not be accurately ascertained until three months of the new fiscal year had elapsed. It was purely an estimate based on actual experience, and while not precisely corresponding to the numbers actually returned, it was fairly accurate.

In view of the provisions of s. 6(1) (*d*) (*supra*), prohibiting the deduction of any such "reserve," the taxpayer took the position that the item claimed was not, in fact, a reserve at all, that the goods which it delivered to the retailers were "on consignment," that no profit arose until the retailer had actually sold the goods. Further, it alleges that it would have been a physical impossibility—or at least very expensive—to have taken an exact inventory on January 31 of their goods on hand in each of the 2,500 outlets, and that the estimate they made as to probable returns was the only reasonable way of ascertaining what sales had been made and what goods would be returned.

In my opinion, the sole question to be determined is whether or not there was a sale of the goods by the company to the retailers. If there was a sale, then, as the taxpayer was reporting on an accrual basis, all accounts receivable in respect thereof constituted income subject only to such allowances for bad debts as the Minister might allow.

Now the only suggestion that the goods were delivered "on consignment" is the use of those words on the delivery slips (ex. 1). The respondent's witnesses asserted that all goods were delivered "on consignment," but the evidence establishes that it did not treat them as such. It kept no running inventory account of goods in the hands of the dealers; at the end of the year in valuing its inventory it took into consideration only the goods on hand in its own warehouse. It carried no insurance on the goods in the hands of the retailers. Moreover, on proper accounting practices, goods on consignment in the hands of dealers would be shown as part of the inventory, and in respect thereof no element of profit would be shown in the owner's books unless and until the consignee had sold the goods. That was not done here, but on the contrary, when a bill such as Ex. B was rendered to the dealer, his account was

charged with the full amount of the price to him and whether or not the goods referred to in the bill had or had not then been sold by him.

On the other hand, the evidence of the respondent's own employees, and more particularly in regard to the use made of Ex. B would seem to establish that the whole transaction was intended to be and was, in fact, a sale. Ex. B is not a statement of specific goods held by the retailer for the respondent. It is a bill for goods sold and delivered during the previous week to the retailer for which payment is now due and is demanded. Ordinarily, it would be presented and paid on the Wednesday of the week following the delivery of the goods, but I observe from Ex. B that in that case goods actually delivered on March 14 were declared to be payable on the following day. Now, when it is kept in mind that many of the publications delivered to the dealers were weekly and monthly periodicals, and that as given in the evidence, returns in some cases were not made for a period of many weeks, it seems perfectly clear that when a retailer paid such an account as Ex. B, he was, in fact, paying for all goods received in the previous week, less such cash payments as he may have made and less, also, the sale price of any goods which he had received mainly, if not entirely, in prior weeks, but had returned as unsold in that week. For that reason, I am unable to concur in the finding of the Income Tax Appeal Board that the retailer pays only for the goods after he has returned the unsold portion of the goods delivered and pays only for the goods sold by him. Ex. 1, however was not in evidence before the Board and certain additional evidence on behalf of the appellant was given on the hearing of the appeal.

It is established, therefore, that in each case there was a delivery of the goods, that the account thereof was rendered for the whole of such goods on the Wednesday of the following week and was usually paid on that date, a date prior to the time by which in the main the unsold goods would be returned. If there was any doubt that there was a sale at the time of the delivery to the retailers, there can be no doubt that the sale was complete and that the property in the goods passed to the retailer when he adopted the transaction as a sale by paying for the goods.

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In addition, as I have stated, the respondent set up the accounts due from the retailers as accounts receivable and throughout has so treated them in its annual balance sheet. On these facts I find that the transactions in question were sales, and that the whole of the accounts receivable in respect thereof at the end of the fiscal year constituted part of the income of the respondent to be taken into account in computing its profit or gain. Moreover, it is clear that the respondent in seeking to deduct from its income the estimated amount of the profit which it might lose in the next fiscal year by reason of compensating the retailers for unsold goods then returned, was transferring or crediting to a reserve or contingent account a part of the income which it had earned, and that is forbidden by the terms of s. 6(1) (*d*) (*supra*).

In the Shorter Oxford English Dictionary, 2nd Ed., "contingent" is defined as "liable to happen or not . . . dependent on a probability; conditional, not absolute." In *Gardner* v. *Newton* (1), a contingent claim was stated to be one which may or may not ever ripen into a debt, according as some future event does or does not happen. In this case, there was no doubt a possibility, or perhaps even a very strong probability, that the respondent would be called upon to make some compensation to the retailers in the next fiscal year, but the event necessary to create that liability—the return of the unsold goods—did not occur in the taxation year in question.

In *Robertson Ltd.* v. *Minister of National Revenue* (2), the President of this Court held that every reserve set up out of profits or gains of whatever kind, which seeks to provide against the happening of unascertained future events is excluded as a deduction except insofar as the Act permits. In that case reference was made to *Edward Collins & Sons Ltd.* v. *Commissioners of Inland Revenue* (3), in which it was held that a deduction for an apprehended future loss was not permissible. There at p. 781 the Lord President (Clyde) stated the principle in these words:

> 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

(1) (1916) 2 D.L.R. 276. (2) [1944] Ex. C.R. 170.
(3) (1924) 12 T.C. 773

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.

In the *Robertson* case, reference was also made to the decison of the Supreme Court of the United States in *Brown* v. *Helvering* (1). In that case, the facts were as follows: "a general agent of fire insurance companies received 'over-riding commissions' on the business written each year, subject however to the contingent liability that when any of the policies was cancelled before its term had run, a part of the commission thereon, proportionate to the premium money repaid to the policy holder, must be charged against the agent in favour of the company. In his accounts and income tax returns involved in this case, he deducted from the accrued commissions of each year a sum entered in a reserve account to represent that part of them which, according to the experience of earlier years, would be returnable because of cancellation. It was held that he was not entitled to make any deduction for such purposes."

In rendering judgment, Mr. Justice Brandeis stated in part:

The overriding commissions were gross income of the year in which they were receivable. As to each such commission there arose the obligation—a contingent liability—to return a proportionate part in case of cancellation. But the mere fact that some portion of it might have to be refunded in some future year in the event of cancellation or reinsurance did not affect its quality as income . . . . When received, the general agent's right to it was absolute. It was under no restriction, contractual or otherwise, as to its disposition, use or enjoyment . . . . The refunds during the tax year of those portions of the overriding commissions which represented cancellations during the tax year had, prior to the tax return for 1923, always been claimed as deductions; and they were apparently allowed as necessary expenses paid or incurred during the taxable year. The right to such deductions is not now questioned. Those which the taxpayer claims now are of a very different character. They are obviously not expenses paid during the taxable year. They are bookkeeping charges representing credits to a reserve account . . . . But no liability accrues during the taxable year on account of cancellations which it is expected

(1) (1934) 291 U.S. 193.

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may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent.

The taxing authorities have throughout permitted the respondent company to deduct as losses in any fiscal year the amounts paid out for returns in that year, including returns then made in respect of sales made in the previous year. The appeal was taken solely in an effort to have the deduction made from the income of the year in which the sales were made. At the end of that year, however, the loss had not occurred and there existed only the possibility that it might occur. Any loss resulting from necessary refunds due to the return of the goods must, however, be borne in the year in which the refunds were made.

For these reasons, the appeal from the decision of the Income Tax Appeal Board will be allowed, its decision will be set aside and the assessment made upon the appellant for the year 1946 will be affirmed. The appellant is entitled to be paid his costs after taxation.

Judgment accordingly.