1954
Nov. 25-26, 29-30
1956
Dec. 28

BETWEEN:

PUBLISHERS GUILD OF CANADA LIMITED ..... APPELLANT;

AND

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

AND BETWEEN:

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

PUBLISHERS GUILD OF CANADA LIMITED ..... RESPONDENT.

Revenue—Income tax—Excess profits tax—Income War Tax Act, R.S.C. 1927, c. 97, ss. 3, 6(d), 68—Excess Profits Tax Act, 1940, S.C. 1940, c. 32—Taxpayer not entitled to anonymity—Duty of accountants in applying accounting systems—Taxpayer in business of selling books and magazines with sale price payable in instalments—Applicability of instalment system of accounting—Unrealized gross profit content of instalments remaining unpaid at end of year not income.

The taxpayer carried on the business of selling books and magazines through door to door canvassers. Its customers paid a small amount on signing the order for them, a further small amount on their delivery and the balance in weekly instalments of about $1 each. The cost of the books and magazines to the taxpayer was small, but the selling costs and other expenses of the business, including the costs of collecting the instalments, were high. The accounts were poor paying ones.

Prior to 1945 the taxpayer kept its accounts and made its income tax and excess profits tax returns on the accrual basis of accounting under which the amounts of the sale prices of the books and magazines were included in its profit and loss account for the year in which the sales were made, whether they were received or not, subject to an allowance for debts of a doubtful nature, and the expenses were charged as they were incurred, whether laid out or expended or not. In 1945 the taxpayer commenced to report its income on the instalment system of accounting under which it took into income for the year only the gross profit content of the instalment payments actually received by it in the year and charged against such income the expenses of carrying on the business as they were incurred, including commissions, handling and selling costs, general overhead and collected costs. In assessing the taxpayer for the years in dispute the Minister put its accounts back on the accrual basis. The taxpayer appealed to this Court against its income tax assessment for 1945 and its excess profits tax assessments for 1945, 1946 and 1947. It also appealed against its income tax assessments for 1946, 1947 and 1948 to the Income Tax Appeal Board which allowed its appeals and the Minister appealed from its decision. The appeals were heard together.

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Held: That, while section 68 of the *Income War Tax Act* gave the taxpayer the right to have the proceedings before the Court held in camera, the section was in derogation of the fundamental principle that court proceedings are open to the public and its operative effect should not be extended beyond its express terms. It did not entitle the taxpayer to the cloak of anonymity or to hide behind a number or conceal the fact that he had appealed against his income tax assessment.

2. That it is the duty of the accountant to apply to the business of his client the system of accounting that is appropriate to it and most nearly reflects its financial position, including its income position, at the time and for the period required.
3. That, in the absence of statutory provision to the contrary, the validity of any particular system of accounting does not depend on whether the Department of National Revenue permits or refuses to allow its use.
4. That if the law does not prohibit the use of a particular system of accounting the opinion of accountancy experts that it is an accepted system and is appropriate to the taxpayer's business and most nearly accurately reflects his income position should prevail with the Court if the reasons for the opinion commend themselves to it.
5. That the instalment system of accounting is a recognized and accepted method of accounting and computing income and is preferable to other systems in the case of articles sold for a price payable in instalments where the down payment is small and the collection risk is substantial.
6. That the unrealized gross profit content of the instalments remaining unpaid at the end of the year was not income of the taxpayer for the year.
7. That the instalment system of accounting adopted by the taxpayer under which it excluded from the computation of its income for the year the unrealized gross profit content of the instalments remaining unpaid at the end of the year was appropriate to the taxpayer's business and more nearly accurately reflected its income position than any other system of accounting would do.
8. That there was no prohibition, express or implied, in the *Income War Tax Act* against the use by the taxpayer of the instalment system of accounting in the computation of its income.
9. That the accrual basis system of accounting was inappropriate to the taxpayer's business and the Minister's assessments were erroneous.
10. That section 6 of the *Income War Tax Act* did not apply in the present case. The taxpayer did not transfer or credit any amount from its income to a reserve, contingent account or sinking fund.
11. That the taxpayer's appeals should be allowed and the Minister's appeal dismissed.

APPEALS against income tax and excess profits tax assessments and from decision of the Income Tax Appeal Board.

The appeals were heard together before the President of the Court at Toronto.

A. D. McAlpine for Publishers Guild of Canada Limited.

Joseph Singer, Q.C., and *T. Z. Boles* for Minister.

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

THE PRESIDENT now (December 28, 1956) delivered the following judgment.

These two appeals were heard together. The first is an appeal by the taxpayer against its income tax assessment for 1945 and its excess profits tax assessments for 1945, 1946 and 1947. The second is an appeal by the Minister from the decision of the Income Tax Appeal Board, sub nom. *No. 90 v. Minister of National Revenue*[1], dated March 6, 1953, allowing the taxpayer's appeals against its income tax assessments for 1946, 1947 and 1948.

At the request of counsel for the taxpayer the proceedings were held in camera, pursuant to section 68 of the *Income War Tax Act*, R.S.C. 1927, Chapter 97, which provides as follows:

> 68. Proceedings before the Exchequer Court hereunder shall be held in camera upon request made to the Court by any party to the proceedings.

But while this section gives a party the right to have the proceedings before the Court held in camera it does not entitle him to the cloak of anonymity. The section is in derogation of the fundamental principle that court proceedings are open to the public and its operative effect should not be extended beyond the permission of its express terms. It does not entitle the taxpayer to hide behind a number or conceal the fact that he has appealed against his assessment. All that it gives him is the right to have the proceedings before this Court held in camera. He is not entitled to any other secrecy. Consequently, in the case of an appeal directly to this Court against an income tax assessment the taxpayer's name remains in the style of cause of the proceedings and in the case of an appeal to this Court from a decision of the Income Tax Appeal Board where the Board has substituted a number for the name of the taxpayer in its reasons for judgment it is the practice of this Court to restore the name of the taxpayer to the style of cause and keep it there.

These appeals present a novel and difficult problem. While the issue in both of them is, of course, whether the

[1] (1953) 8 Tax. A.B.C. 161.

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assessments levied against the taxpayer for the years in dispute are correct, and there is a statutory presumption of their validity until they are shown to be erroneous either in fact or in law, the appeals involve consideration of the appropriateness of the instalment system of accounting to the taxpayer's business and the computation of its income. There are two questions for determination, the first being whether the instalment system of accounting is appropriate to the taxpayer's business and accurately reflects its income and profit position, and the second whether there is any provision in the governing *Income War Tax Act*, R.S.C. 1927, Chapter 97, that either expressly or by implication prohibits its use. That is the difficulty of the situation. Its novelty is that this is the first occasion on which this Court has been called upon to consider the appropriateness and legality of the instalment system of accounting.

The facts are not in dispute. The taxpayer carries on its business in Toronto and Vancouver, has its head office at Toronto and is the Canadian subsidiary of Publishers Guild Incorporated, a United States corporation having its head office in New York. Its business is the selling of books and magazines through door to door canvassers. Through them it makes three kinds of combination offers to its intended customers, one for $29.90 and two for $21.60 each. The terms of the offers are similar but, for convenience, I shall refer only to the $29.90 offer. For this amount it offers three books from a specified list and subscriptions to three magazines also from a specified list. The terms of the offer are that the customer will pay $3 to the canvasser on signing the order, $2.90 and delivery charges on the delivery of the books, and the balance of $24 in weekly instalments of $1 each. A person is not listed as a customer until the $2.90 and delivery charges have been paid. Thereafter, a delivery report is made showing the name of the canvasser, the name of the customer, the amount of the sale, the $3 deposit and the $2.90 delivery payment, and the various commissions paid. The taxpayer also keeps a ledger account for each customer showing the name of the canvasser, the books and magazines covered, the payments made, and the number of notices sent out. The taxpayer sends all details to its parent in New York which keeps a duplicate set of books.

The books sold on a $29.90 order vary in their cost to the taxpayer but their average cost is about $5.50. The magazine

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subscriptions cost about $2.50 so that the cost of the merchandise content of each $29.90 sale, meaning thereby the cost of the books and the magazine subscriptions, is about $8. Thus, its gross profit from the $29.90 sale, over and above the cost of the merchandise content, is about $21.90 which, in round figures, is 70 per cent of the sale price. This percentage was used in the course of the hearing and I shall continue to use it, although it was actually somewhat higher, varying in amount according to the cost of the books and the magazine subscriptions selected by the customer. The gross profit referred to is, of course, calculated on the assumption that the full amount of the sale price is paid.

The books come out of the taxpayer's stock. They are bought by its parent from the publishers and the taxpayer pays its parent for them. The magazine subscriptions are not ordered until after the $2.90 and delivery charges c.o.d. payment has been made. Thus, all the cost of the merchandise content of the $29.90 sale has been either actually laid out and expended or incurred before any of the $24 instalments have been received.

The direct selling costs are high. On each $29.90 sale the canvasser gets a direct commission of $5.50, the sales manager an over-riding commission of $2.40, the branch manager a commission of 90 cents, and the sales manager an additional expense allowance of $1.50, making a total direct selling cost of $10.30. When this is added to the cost of the merchandise the total merchandise and direct selling cost comes to $18.30 leaving a gross profit on the $29.90 sale of $11.60. But this is subject to deduction for handling and shipping costs and general overhead and office expenses including heavy expenses for the collection of overdue accounts and other correspondence relating to the sales, such as letters about damaged books, magazine subscriptions, changes of address, complaints and other matters. Approximately 80 per cent of the taxpayer's total office expenses is due to its intensive efforts to collect the unpaid instalments.

The evidence is conclusive that the accounts are poor paying accounts. The merchandise is sold without any inquiry as to the customer's credit rating. No security is given for the fulfilment of the promise to pay the balance of $24 except that the taxpayer retains title to the books

until the account is paid in full, but this right is of little value for, in practice, the books are not worth re-possessing, since used books cannot be delivered to a customer, and they are not repossessed on failure to pay. The accounts are of an uncertain character and difficult to collect. Many of the orders are signed by housewives whose husbands repudiate them. And it is the exception rather than the rule that the instalment payments are made as promised. Moreover, the collections made by the taxpayer are due to its intensive collection efforts. About 80 per cent of its office staff of from 10 to 17 persons is engaged on collections. It has over 40 form letters in its series of dunning letters and also about 30 others of various types. It continues its dunning efforts as long as there seems any possibility of collection. In addition, it gives inducements in the form of an additional book, such as an Atlas, which costs $2.65, for what is called "cashing-up" the remaining payments. The evidence of Mr. S. R. E. Wilner, the taxpayer's general branch manager at Toronto, was illuminating. He analysed 200 consecutive accounts in its ledger to illustrate the extent to which dunning letters have to be sent out in order to effect payments. Of these 15 per cent "cashed-up" as the result of the inducements held out, 20.5 per cent were good paying accounts requiring only from 1 to 4 dunning letters, 20 per cent required from 5 to 9 letters, 18.5 per cent from 10 to 20 letters, 16.5 per cent from 21 to 29 letters and 9.5 per cent 30 letters and over. Even with this intensive dunning 40 of the 200 accounts referred to remained unpaid.

After the taxpayer has exhausted its own efforts to collect from its customers it sends its delinquent accounts to the Guardian Credits Corporation for collection. It charges 50 per cent on what it collects but it handles the taxpayer's accounts only when it has no other accounts to process. They are its poorest accounts for collection. It collects less than 10 per cent of the accounts handed to it.

The taxpayer's unpaid accounts are not of the kind that can be discounted. Mr. R. H. Soren, the owner and manager of Guardian Credits Corporation, said that he did not know any finance company that would discount the taxpayer's unpaid accounts without a 100 percent recourse to it. He would not pay anything for the accounts turned over to him and would not go far beyond 15 to 20 per cent for all its unpaid accounts. On his cross-examination he expressed the

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opinion that a bank would not loan money on the accounts and this opinion was concurred in by Mr. F. Findley, the manager of the King and York branch of the Imperial Bank of Canada. A chartered bank would not discount the accounts or lend money on them although it would consider them in asertaining the worth of their owner.

Prior to 1945 the taxpayer kept its accounts and made its income tax and excess profits tax returns on what is known as the accrual basis system of accounting and computing profit. Under this system transactions are recorded in the accounts as they occur; as sales are made their amounts are included in the profit and loss account, whether they are received in the year or not, with a provision for an allowance for debts of a doubtful nature, and expenses are brought into account as a charge against income as they are incurred, whether they are laid out or expended in the year or not. This means, in the case of the taxpayer, that as soon as a customer paid the $2.90 and delivery charges on the delivery of the books, the $24 balance which he owed was brought into the taxpayer's income for the year, regardless of whether any instalment was payable or received in the year, and, on the other hand, all expenses were charged as expenditures for the year regardless of whether they had been actually laid out or expended or not.

For a good many years prior to 1945 the taxpayer's parent had kept its accounts and made its United States income tax returns on what is known as the instalment system of accounting and computing profit and the taxpayer desired to adopt a similar method. Before doing so its tax consultant, Mr. J. K. Punchard, consulted Mr. A. H. McLachlin, the Minister's supervisor in the corporation assessment section of the Department's Toronto office, and then, on December 17, 1945, wrote to the Inspector of Income Tax at Toronto as follows:

Dear Sir:

Attention: Mr. A. H. McLachlin
Re: Publishers Guild of Canada Limited

Relative to our discussion today regarding the basis of accounting used by this company, we wish to state that the officers of the company are desirous of using the instalment method of accounting in place of the accrual method in use to December 31, 1944. To be consistent with the practice of the parent organization in the U.S.A. and in accordance with the regulations provided by American taxing authorities, the company now seeks your approval to use the instalment method of accounting from January 1, 1945.

As we pointed out to you, the company is in the business of selling, by door to door canvass, magazine subscriptions together with a book as a premium. Payments receivable on the instalment basis usually spread over a twelve month period. In this class of business the risks are great and the possibility of recovery of the goods is limited.

We refer you to our letter of June 22, 1945 relative to Encyclopedia Library of Canada Limited to which was attached a summary showing the effect of the use of this basis on the accounts of the company. Both companies are comparable and to be consistent with American practice could readily adopt the instalment basis of accounting to which we have referred.

We should appreciate your examining this matter and advising us of your approval for the year 1945 and subsequently. The company is prepared to follow this practice continuously. We should be glad to discuss the matter further with you.

Yours very truly,

J. K. Punchard
VARDON, PUNCHARD & CO.

and, on December 20, 1945, the Toronto Inspector of Income Tax, per J. Roberts, the chief auditor for corporations, replied as follows:

Dear Sirs:—

Attention: Mr. J. K. Punchard, C.A.
Re: Publishers Guild of Canada Limited.

Your letter of Dec. 17, 1945 relative to the basis of accounting used by the above company is acknowledged.

It is noted that the company desires to change the basis from the accrual method to a basis of taking profits on sales into revenue account only as instalment payments are received and that this proposed method is in line with the practice of the parent organization in the U.S.A. As the company is prepared to follow this practice continuously this office will recommend that it be accepted for tax purposes, and applicable to the period ending Dec. 31, 1945.

Yours truly,

INSPECTOR OF INCOME TAX
Per: J. Roberts
Chief Auditor, Corporations.

On the receipt of this reply Mr. Punchard advised the taxpayer's parent in New York that the instalment system of accounting was to be recommended and he recommended that the taxpayer should change its accounting system accordingly. His recommendation was adopted and the taxpayer's income tax and excess profits tax returns for the years 1945 to 1948 were based on the instalment system of

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accounting and computing profit. I shall describe the operation of this system later. At the moment, it is sufficient to say that under it the taxpayer, subject to what I shall point out later, took into income for the year only the gross profit content of the instalment payments actually received by it in the year, or, to put it negatively, and more precisely, it excluded from its computation of income for the year the unrealized gross profit content of the instalments that remained unpaid at the end of the year.

When the Minister assessed the taxpayer for the years in dispute he put its accounts back on the accrual basis of accounting on which it had made its tax returns for the years prior to 1945. This appears from the notices of assessment, dated March 14, 1951. For example, for 1945 he added to the amount of taxable income reported by the taxpayer the sum of $74,071.93 as unrealized gross profit and deducted $14,816.85 as his allowance for bad debts making a net addition of $59,255.08. The sum of $74,071.93 represented the unrealized gross profit content of the instalments in respect of the taxpayer's 1945 sales that remained unpaid at the end of 1945 after it had written off $52,879.50 for bad debts, which amount the taxpayer had excluded from its computation of income for the year, and the sum of $14,816.85 was 15 per cent of $98,778.97, which was the amount of the taxpayer's unpaid instalments in respect of its 1945 sales at the end of 1945 after its write-off for bad debts. The Minister followed a similar course in assessing the taxpayer for 1946, 1947 and 1948 and it is not necessary to set out his figures for each of the years.

The taxpayer appealed to the Minister against the income tax assessment for 1945 and the excess profits tax assessments for 1945, 1946 and 1947, but he affirmed them and the taxpayer then appealed to this Court. The taxpayer also objected to the income tax assessments for 1946, 1947 and 1948 but the Minister confirmed them and the taxpayer appealed to the Income Tax Appeal Board which allowed its appeals and set aside the assessments. From this decision the Minister appealed to this Court. The issues in each case are the same and it was accordingly ordered that the appeals be heard together.

In order to determine whether the assessments appealed against are correct it is desirable to ascertain the manner

in which the taxpayer kept its accounts under the instalment system of accounting and how it differed from the accrual basis system.

Evidence relating to the instalment system was given by Mr. T. A. M. Hutchison, a chartered accountant of 25 years standing and a Toronto resident partner of the international accounting firm of Peat, Marwick, Mitchell and Company, and by Mr. J. K. Punchard, a chartered accountant of 25 years standing and the senior partner of the Toronto accounting firm of Punchard, Grant and Company, who was the taxpayer's tax consultant and prepared or supervised the making of its tax returns.

Mr. Hutchison stated that the essential feature of the instalment system of accounting and computing profit as adopted by the taxpayer is that the gross profit content of the payments made by purchasers of the taxpayer's books and magazine subscriptions is taken into income for the year only as the payments are received but the expenses of carrying on the business are charged against the income as they are incurred. Mr. Punchard put its essential feature negatively and, in my opinion, more precisely, when he said that the instalment system excludes from the computation of income for the year the unrealized gross profit content of the instalments remaining unpaid at the end of the year.

The application of the instalment system to the taxpayer's business was illustrated by reference to a single sale for $29.90 in respect of which only $5.90 had been paid in the year, the balance of $24 payable in weekly instalments of $1 each remaining unpaid. If the gross profit in the sale, if the price was all paid, would be 70 per cent of the sale price then all that is taken into income in respect of the $5.90 received is 70 per cent of it, namely, $4.13. All the payments received by the taxpayer in the year are treated in the same way, that is to say, only 70 cents of each dollar received is taken into income. This is so whether the payment is the initial one of $5.90 or an instalment and whether the sale in respect of which it is made was made in the year of the payment or previously. Thus, the total of the amounts of the gross profit content of the payments received by the taxpayer in the year is taken as the income for the year. To put it negatively, as Mr. Punchard did, the taxpayer excludes from its computation of income

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for the year the estimated gross profit content of the instalments that are not paid in the year and, consequently, not received by it. Against the income thus computed the taxpayer charges, subject to what I shall point out later, its expenses for the year, whether laid out or incurred, including commissions on the sales made in the year, handling and shipping costs, and general overhead and office expenses including collection costs.

The statement that only the gross profit content of the payments received by the taxpayer is taken into income for the year requires clarification. What is meant is that the full amount of each payment is taken into account but there is charged against it the cost of the merchandise content proportionate to it. Thus, if $8 was the cost of the merchandise content of the $29.90 sale, so that the gross profit would, in round figures, be 70 per cent of the sale price, then the cost of its merchandise content would, in round figures, be 30 per cent. Consequently, 30 per cent of the $5.90 received, or $1.77, is charged against it leaving the gross profit content of $4.13 above referred to. There is a similar charge against the amount of each payment received of the cost of the merchandise content proportionate to it.

It follows, of course, that since the unpaid instalments are not taken into account in the year the cost of the merchandise content proportionate to them is not charged against the income for the year. Thus, for example, out of the $8 cost of the merchandise content of the $29.90 sale there remains $6.23 which, although actually paid or incurred, is not charged as an expense against the income for the year. It remains really as inventory.

It is, of course, disclosed in the balance sheet that the accounts are kept on the instalment system of accounting and the unpaid instalments appear in it as an asset valued at the cost of the merchandise content proportionate to them. The unpaid instalments are the taxpayer's accounts receivable but their amount is reduced in value to the inventory cost of the merchandise content proportionate to them. Thus, in the illustration referred to, the $24 instalments remaining unpaid at the end of the year are valued at $6.23 and appear, in effect, on the balance sheet at such value. All the payments remaining unpaid at the end of the year are valued in the same way. In effect, it is said that the accounts

receivable, that is to say, the instalments remaining unpaid, are worth the cost of the merchandise content proportionate to their amount and it is at this valuation that they are included in the taxpayer's computation of income for the year.

While there is no specific reference to this valuation in the taxpayer's profit and loss statement and there is no actual appraisal in it of the value of the accounts receivable at this amount, it is really included in its income in the manner described. Thus, in the example used, since $6.23 has already been paid or incurred by the taxpayer for the merchandise content of the unpaid $24 instalments but has not been charged as an expense against the income for the year it remains in the income over and above the gross profit content of the $5.90 payment received. In this way the $24 account receivable is brought into account at the cost of the merchandise content proportionate to it, namely, $6.23, which works out at about 25 per cent of its full amount. All the instalments remaining unpaid at the end of the year are dealt with in the same way. Thus, it may be said that a valuation is made of the taxpayer's accounts receivable and that they are brought into account and, therefore, included in income at the cost of the merchandise content proportionate to their amount. This cost is, of course, taken into account in the year in which the sale is made and the taxpayer becomes entitled to the account receivable.

Thus, the taxpayer's income for the year includes the gross profit content of the payments received by it in the year and the valuation of its accounts receivable at the end of the year at the cost of the merchandise content proportionate to their amount.

Thus, it will be seen that the instalment system of accounting differs from the accrual basis system only in its computation of income. Instead of taking into income for the year the full amount of the sale price as soon as a sale is made, as the accrual basis system does, even although the instalments are not payable in the year and regardless of whether they are collectible or not, the instalment system takes into income for the year only the gross profit content of the instalments actually received in the year, that is to say, the full amount of such payments less the cost of the merchandise content proportionate to them. There is also the further fact that, while the instalment payments

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remaining unpaid at the end of the year are not taken into income at their face amounts, a valuation is placed on them at the cost of the merchandise content proportionate to them and the amount of such valuation is, in effect, included in the income in the manner described.

Mr. Punchard stated the difference between the two accounting systems more simply. As he put it, the instalment system differs from the accrual basis system only in that it excludes from the computation of income for the year the unrealized gross profit content of the accounts receivable, that is to say, the unrealized gross profit content of the instalments remaining unpaid at the end of the year. That is essentially the only difference between the two systems. Apart from this exclusion of unrealized gross profit content the two systems of accounting are similar.

I should also refer to the manner in which write-offs of bad debts and recoveries of bad debts, previously written off, are dealt with under the taxpayer's accounting system. An analysis of its bad debts was prepared by Mr. Punchard and filed as Exhibit 27. This showed for each year the amounts of the sales, the bad debts written off, the recoveries and the outstanding receivables. The amount of the write-off is fixed at the end of each year as the accounts are determined to be bad after a conference between the parent's auditor at New York and its accounting officials there. They are not written off the record at the taxpayer's offices at Toronto and Vancouver and it continues its efforts to collect them. There was some confusion implied in the questions put by counsel for the Minister to the taxpayer's witnesses which should be cleared up. The taxpayer's income for each year was not reduced by the amount of the bad debts written off in that year, notwithstanding the suggestion to the contrary by counsel for the Minister. He did not appear to understand the situation. The bad debts were written off against the gross sales of the year and not against the income for the year. Of that fact there can be no dispute. For example, the amount of the bad debts written off in 1945 was $52,879.50. This was the amount of the unpaid instalments at the end of the year that were determined to be bad debts by reason of their being overdue for too long a time. But the income for 1945 was not reduced by that amount. All that was charged against it was $13,220.36. This was the cost of the merchandise content

proportionate to the amount of the accounts written off. The reason for this being the only amount charged against the income is that it was the only amount that had been brought into account in respect of the accounts when it was included in the income in the first place in the manner I have described. Similarly, in 1946 the amount of the write-off of bad debts was $84,428.78 but the income for the year was reduced by only $23,515.62, that being the cost of the merchandise content proportionate to $84,428.78. And similarly in 1947, in respect of the $62,567.61 written off only $16,228.37 was charged against the income for the year. And in 1948, while $63,659.67 was written off, the income for the year was reduced by only $18,376.69. Counsel for the respondent was thus in error in suggesting in his cross-examination of the accountancy experts that the taxpayer's income was reduced in each year by the amount of the bad debts written off. It was reduced only by the amount of the cost of the merchandise content proportionate to such amount for, as already explained, that was the only amount that had been included in income as already described.

I should also add that there is no merit in counsel's suggestion that the taxpayer could have worked out a percentage for an annual allowance for bad debts. Any such attempt would have led to as arbitrary a figure as the Minister's allowance of 15 per cent.

As for the recoveries made in respect of accounts that had previously been written off the payments received by the taxpayer in respect of such accounts were treated in the same way as any other payments received by it. Their gross profit content was taken into the income of the year in which the recoveries were made.

I now come to the opinions of the accountancy experts. Mr. Hutchison explained the operation of the instalment system of accounting as I have described it and stated that it was a recognized and accepted method of accounting and computing income. In his opinion, it was a suitable system to apply to the taxpayer's business and produced a more accurate computation of its income than any other system would do. His reasons for his opinion may be summarized. The taxpayer's accounts receivable for its unpaid instalments are different in kind from ordinary trade accounts receivable where the credit period is for 30 days and also

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different in kind from accounts receivable for unpaid instalments on such articles as automobiles or radios or television sets where there is a valuable lien right and, in the case of automobiles, a protection by insurance, and the risks of collection are slight. Mr. Hutchison expressed the opinion that while the instalment system is accepted by accountants and could be applied in all cases where articles are sold for a price payable in instalments it is not the most appropriate system to apply to the sale of such articles as automobiles to which the accrual basis system is ordinarily applicable. But it is more appropriate than the accrual basis one in cases where the period of payment of the instalments is protracted, where collection of the instalments is uncertain and the cost of collection high, where the accounts are of such doubtful value that they cannot be discounted or readily sold and where there are no valuable rights of repossession of the articles sold. All these conditions exist in the taxpayer's case. Consequently, the instalment system of accounting is very appropriate to its business and its use results in an accurate computation of its profit.

Mr. Punchard, with his greater knowledge of the taxpayer's method of conducting its business, was more explicit in his reasons for his opinion. He considered that the accrual basis system of accounting was not appropriate to the kind of business conducted by it and the nature of its accounts receivable and was strongly of the opinion that the instalment system would produce the most accurate computation of its income and most nearly accurately reflect its profit position. He agreed with the reasons put forward by Mr. Hutchison but added to them. One additional reason for considering the accrual basis system inappropriate to the taxpayer's business was that there was a large interest content due to the delay between the incurring of the expenses of the business and the receiving of the instalment payments, which interest content it improperly disregarded. And he particularly stressed the fact that the value of the taxpayer's accounts receivable at the end of the year was contingent on the success of its collection efforts in the following year or years. I shall refer to his reasons in greater detail later. Mr. Punchard also went farther than Mr. Hutchison in his general approval of the instalment system. In his opinion, it would be appropriate in all cases of articles sold for a price payable in instalments.

The expert opinions expressed by Mr. Hutchison and Mr. Punchard were supported by reference to recognized accountancy authorities and excerpts from their works were filed as exhibits. I enumerate them as follows; namely, Statement dealing with the instalment system of accounting in the course of instruction for chartered accountants prepared by chartered accountants designated by the Institute of Chartered Accountants and handled by Queen's University, Exhibit 9; H. A. Finney on Principles of Accounting—Advanced, at page 89, Exhibit 10; R. H. Montgomery on Auditing, at page 429, Exhibits 11 and 20; Smails on Auditing, at pages 91-92, Exhibit 16; C. T. Devine on Inventory Valuation and Periodic Income, at page 11, Exhibit 17; H. A. Finney on Principles of Accounting—Advanced, at pages 73 to 75, Exhibit 18; S. Gilman on Accounting Concepts of Profit, at pages 602-603, Exhibit 19; Dickinson Lectures on Developments in Accounting Theory, at pages 99-100, Exhibit 21; W. A. Paton on Essentials of Accounting, at pages 600-601, Exhibit 22; R. Kester on Advanced Accounting, at page 502, Exhibit 23; H. R. R. Hatfield on Accounting, at page 251, Exhibit 24; and W. A. Staub on Auditing Developments During the Present Century, at page 26, Exhibit 25. Mr. Punchard made it clear that his concurrence with the opinions expressed by these authorities was with their general trend, rather than with every detail of them.

There is a general recognition by the accountancy authorities that instalment sales raise special accounting problems. For example, H. A. Finney in his work on Principles of Accounting—Advanced points out, as appears from Exhibit 18, that instalment sales may be subject to greater collection losses and expenses than are incurred on regular sales, that collection losses are likely to be heavy because the opportunity to purchase luxuries on the instalment plan appeals to people who are not in a financial position to pay for them outright, and who, in many cases, are unable to pay for them even in instalments, and that expenses are also likely to be heavy since the instalment method involves additional collection and accounting costs. Then Finney points out, and his remark is particularly pertinent in the present case, that the expenses applicable to the sale are incurred in accounting periods subsequent

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to the period of sale. This led him to the following statement:

> The accounting procedure must be based upon a recognition of this fact as it would be incorrect accounting to take up all the profit during the period of sale without making provision for expenses to be incurred in subsequent periods.

Then he recognizes the fact that, because losses and expenses incident to instalment selling are incurred in large amounts in periods subsequent to the period of sale, there is considerable difficulty in devising a method of taking up profits in a logical and conservative way. According to him two methods have been used. One is that all the profits should be taken up in the period of sale and that reserves should be set up for losses on bad debts, collection expenses and costs of reconditioning repossessed merchandise and the other that the profits should be taken up in instalments on the basis of cash collections. The latter method involves accounting by the instalment system. I think that I may safely say that it is generally recognized by the authorities that the instalment system of accounting is preferable to other systems in the case of instalment sales where the down payment is small and the collection risk is substantial. Finney refers to three forms of instalment systems showing the manner in which the cash collections are dealt with:

> (a) The first collections are considered a return of cost and no profit is taken until the collection exceeds the cost.
>
> (b) The first collections are considered profit and the last collections are considered a return of cost.
>
> (c) Each collection is regarded as including profit and a return of cost in the same proportion that these two elements are included in the total selling price.

These three ways of dealing with the payments received in respect of instalment sales are also referred to by Kester in his work on Advanced Accounting, at page 502, as set out in Exhibit 23. Montgomery on Auditing prefers the first form of the instalment method in cases where the collection risk is extreme. At page 429, as appears from Exhibit 20, he says:

> When the collection risk is considered to be extreme it is good practice to defer the recognition of profit until the entire cost has been recovered.

In the case of the $29.90 sale, which I have been using by way of illustration, this would mean that no portion of the

sale price would be taken into income until after the full amount of the cost of the merchandise content of the sale, that is to say, $8 had been paid. Mr. Hutchison stated that in pure theory this form of the instalment system could be followed but he agreed with Finney and Kester that it would be too conservative and he referred to the form of the system which the taxpayer adopted, which was the third one mentioned by Finney, as a compromise. This is not a precisely accurate statement. What he meant was that it is a middle form of the instalment system between the other two forms, both of which are extreme, one too conservative and the other too optimistic.

At this stage it would, I think, be appropriate to make some remarks of a general nature regarding the role of accountancy experts in income tax cases. The accountancy profession is not a static one and the system of accounting which accountants should apply to the accounts of the businesses in which they are called upon to act are not immutable. A system of accounting that would be appropriate to one kind of business is not necessarily appropriate to a different kind. Only an arbitrary minded person would contend that there is only one system of accounting of universal applicability. No reasonable person would do so. But while accountants devise changes in systems of accounting to meet the changing conditions in the business world and new ways of conducting business their guiding principle must always be the same. Accounting is really the recording in figures, instead of words, of the financial implications of the transactions of the business to which it is applied. The accountant is thus the narrator of the transactions, his narrative being in the form of figures instead of words. His narrative should be such as to disclose to persons understanding his language of figures the true position of his client's business at any given time or for any given period. The accountant cannot fulfil the duty thus required of him unless he has carefully considered the manner in which his client carries on his business and has applied to it the system of accounting that is appropriate to it and most nearly accurately reflects its financial position, including its income position, at the time or for the period required.

But the Court must not abdicate to accountants the function of determining the income tax liability of a taxpayer.

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That must be decided by the Court in conformity with the governing income tax law. It is an established principle of such law in this Court that there is a statutory presumption of validity in favor of an income tax assessment until it is shown to be erroneous and that the onus of doing so lies on the taxpayer attacking it. But while the Court must be mindful of this principle it must in its effort to apply the law objectively keep a watchful eye on arbitrary assumptions on the part of the tax authority such as, for example, that it is within its competence to permit or refuse any particular system of accounting and that its decision in the matter is conclusive. I cannot express too strongly the opinion of this Court that, in the absence of statutory provision to the contrary, the validity of any particular system of accounting does not depend on whether the Department of National Revenue permits or refuses its use. What the Court is concerned with is the ascertainment of the taxpayer's income tax liability. Thus the prime consideration, where there is a dispute about a system of accounting, is, in the first place, whether it is appropriate to the business to which it is applied and tells the truth about the taxpayer's income position and, if that condition is satisfied, whether there is any prohibition in the governing income tax law against its use. If the law does not prohibit the use of a particular system of accounting then the opinion of accountancy experts that it is an accepted system and is appropriate to the taxpayer's business and most nearly accurately reflects his income position should prevail with the Court if the reasons for the opinion commend themselves to it.

That, in my opinion, is the situation in the present case. Mr. Hutchison and Mr. Punchard were exhaustively and vigorously cross-examined by counsel for the Minister but he was unable to weaken their opinion. Indeed, his cross-examination served to strengthen it. It is, I think, noteworthy that their opinion was not contradicted. Counsel for the Minister did not call any witnesses. It could, therefore, be held, even on the brief summary of the reasons given by the accountancy experts which I have set out, that the instalment system of accounting as adopted by the taxpayer is an acceptable system, is appropriate to the taxpayer's business and more accurately reflects its income position than any other system of accounting would do. But in view of the importance of the question it would,

I think, be desirable to amplify the reasons that have led me to this finding.

Taxable income is defined by section 3 of the *Income War Tax Act*, in part, as follows:

> 3. For the purposes of this Act, "income" means the annual net profit or gain . . . . directly or indirectly received by a person from . . . . any trade, manufacture or business, ...

And section 9 provides that it is upon the income during the preceding year that the tax is to be assessed. Consequently, in respect of each of the years in question the taxpayer is subject to income tax on the net profit received by it from its business during such year. That statement is substantiated by the decision of the Supreme Court of Canada in *Capital Trust Corporation Limited v. Minister of National Revenue*[1] where it was held that a sum received by the executor of an estate was all assessable for tax in the year of its receipt because it had been received during such year, notwithstanding the fact that it had been earned over a period of years. The test of taxability of income fixed by this decision is whether the income was received by the taxpayer during the taxation year. If it was, it is subject to tax regardless of when it was earned. It must, I think, follow from the decision that if the income, meaning thereby "the net profit or gain", was not received by the taxpayer during the taxation year he is not subject to income tax in respect of it. And it follows that he is then not subject to excess profis tax for such year.

It is clear that in assessing the taxpayer the Minister rejected the instalment system of accounting on which it had based its tax returns. This appears from an examination of its tax returns and the notices of assessment. For example, for 1945 the Minister added to the amount of taxable income reported by it the sum of $74,071.93, less an allowance of $14,816.85 for bad debts, or a net addition of $59,255.08. The amount of $74,071.93 represents the difference between $98,778.87, the total amount of the taxpayer's accounts receivable in respect of its 1945 sales at the end of that year, after it had written off $52,879.50 as bad debts, and $24,706.94, the cost of the merchandise content proportionate to $98,778.87. This $74,071.93 is the amount that would have been the gross profit content of the instalments

[1] [1937] S.C.R. 192.

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of $98,778.87 if they had been received by the taxpayer in 1945, but which it excluded from its computation of income for 1945, as being the unrealized gross profit content of the instalments remaining unpaid at the end of that year, and, therefore, not profit received by it in 1945. But the Minister's net addition of $59,255.08 to the taxpayer's reported taxable income is, in effect, an assertion by him that the taxpayer's accounts receivable, amounting to $98,778.87, after the write-off for bad debts, constituted a "net profit" of $59,255.08 "received" by it during 1945, over and above the amount of taxable income reported by it.

Thus the issue, so far as 1945 is concerned, is whether the defendant's accounts receivable at the end of 1945, meaning thereby the amount of the unpaid instalments in respect of its 1945 sales, constituted a receipt by it during 1945 of $59,255.08 over and above the amount of taxable income, meaning thereby "net profit or gain", reported by it for that year.

I have no hesitation in finding, on the evidence before me and the opinions of the accounting experts, that the taxpayer did not in 1945 receive the additional profit or $59,255.08 which the Minister's assessment thus ascribed to it and that his assessment for that year is to that extent, erroneous in fact.

There are several reasons for this finding. It is important to take a realistic view of the facts rather than the arbitrary one taken by the Department. In the first place, the evidence is conclusive that the taxpayer's accounts receivable at the end of the year, meaning thereby the instalments in respect of sales remaining unpaid, were quite different in character from ordinary trade accounts receivable which are likely to be paid within the short period of credit allowed to them without any considerable risk of loss or expense being incurred to effect their collection. The situation in the taxpayer's case was basically different. For example, its gross sales in 1945 amounted to $467,170.80 but only $315,519.13 was collected in that year leaving $151,651.67 unpaid at the end of it. In 1946 there was a further collection of $77,788.66 in respect of the 1945 sales but at the end of 1946 $73,863.01 still remained unpaid in respect of them. In view of these undisputed facts it is unrealistic and untrue to say that the taxpayer's accounts receivable

at the end of 1945 for its instalments then remaining unpaid, amounting to $98,778.87, after the write-off of $52,877.50 for bad debts, constituted a receipt of profit by it during 1945 of $59,255.05. I say, as emphatically as possible, that it did not.

The Minister seems to have admitted, although perhaps inadvertently, the inappropriateness of the accrual basis system of accounting, as it is ordinarily understood, to the taxpayer's business for he did not fully apply it. If he had done so he would have added a much larger amount than $59,255.05, namely, the difference between $151,651.67, being the amount of the taxpayer's accounts receivable at the end of the year, before its write-off of $52,879.50 for bad debts, and the cost of the merchandise content proportionate to it, less an allowance of 15 per cent of $151,651 for bad debts, which amount would have been in excess of $90,000. It might, perhaps, not be fair to say that in adding $74,071.93 to the taxpayer's income less his allowance of $14,778.87 rather than the larger sum referred to the Minister recognized the propriety of the taxpayer's write-off of $52,879.50 for bad debts, but that is the effect of what he did and, to that extent, the Minister applied a modification of the accrual basis system of accounting to the taxpayer's business. But even this modification shows a profit for the year that the taxpayer did not, in fact, receive during such year.

I now proceed to refer in greater detail than I have done to the reasons that led Mr. Punchard to his opinion that the accrual basis system of accounting is not appropriate to the taxpayer's business and its accounts. He drew attention to the fact that in each year the taxpayer incurred costs in the purchase of merchandise and paid commissions in respect of its sales but had to wait a long time before the instalment payments equalled the amount of its merchandise cost and commission payments. There was thus an interest cost that ought to be charged as an expense but the accrual basis system of accounting disregarded this interest factor.

The system was also defective in that it showed in respect of the taxpayer's accounts receivable at the end of the year a so-called profit that by reason of the nature of the accounts cannot fairly be described otherwise than as an anti-

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cipated profit. And, as Mr. Punchard put it, "the accountant, as a matter of principle—which is very much a part of his training—abhors any anticipation of profit". This is as it should be. When an accountant shows a profit from a business there ought to be something to show for the profit shown that is worth somewhere within reach of the amount shown, so that it can be used for the purposes for which a profit is ordinarily used. The Minister's addition of $59,255.08 to the amount reported by the taxpayer does not meet this requirement. It was not an existing profit in 1945 but only an anticipated one. Liabilities cannot be met or dividends paid with such an anticipated profit consisting of accounts receivable of uncertain value that cannot be discounted.

I again use the example of the $29.90 sale by way of illustration. The evidence is that in the year of the sale $8 is paid or incurred for its merchandise content and $10.30 by way of commissions making a total of $18.30 and leaving $11.60 which amount is subject to its proportion of shipping and delivery costs and overhead and office expenses including the cost of collection. The $18.30 for merchandise and commissions is all paid or incurred before the weekly instalments are received and there cannot be any profit in respect of the sale available for any purpose until after sufficient instalment payments have been made to cover the cost of the merchandise content of the sale, the commissions paid for its acquisition and the proper proportion of the costs and expenses referred to. But the evidence shows that this does not happen in the year of the sale. For example, as I have pointed out, in respect of the sales of $467,170.80 in 1945, the sum of $151,651.67 remained unpaid at the end of the year and the sum of $73,863.01 still remained unpaid at the end of 1946. How then could it fairly be said that the amount of $151,651.67, or $98,778.87 after the write-off of $52,878.50, represented an item of taxable income, meaning thereby net profit or gain, received by the taxpayer in 1945, which it had improperly excluded from its tax returns for that year? The question answers itself in the negative. There was certainly no existing profit out of which it could pay income tax if it were called upon to do so and it ought not to be required to borrow money to pay income tax on what was at the time only an anticipated profit realizable

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in the future only to the extent of the success that might attend the taxpayer's efforts to collect the unpaid instalments.

But Mr. Punchard's basic reasons for his opinion seem to me to be conclusive. The evidence establishes that the taxpayer's accounts receivable are, at the time of their receipt, of uncertain value. They cannot be discounted and they are saleable only for a small percentage of their face amounts. Mr. Soren said that he would not pay more than 15 or 20 per cent for all of them. Moreover, and this is a most important factor, such value as they may have in the future is contingent on the success of the taxpayer's intensive and costly efforts to collect them. And it is certain that if its collection efforts were not made or should be relaxed the instalment payments would cease or fall off. Approximately 80 per cent of the taxpayer's office expense is incurred in the collection of its unpaid instalments. While the large cost of collection is, no doubt, taken into account as a factor in the determination of the sale price, this factor should also be taken into account in determining the real profit content of the unpaid instalments. A profit shown by taking the amount of the gross sales into income and deducting therefrom the cost incurred up to the date of the sale without taking into account the cost of collecting the unpaid instalments necessarily incurred after the date of the sale is not a true profit.

There are really two aspects of the problem. If, for example, the taxpayer had ceased business at the end of 1945 its accounts receivable would have had little, if any, value. They could not have been discounted and it is extremely doubtful that anyone would have bought them at all. Mr. Soren's statement that he would not pay more than 15 or 20 per cent for all the taxpayer's accounts would not be applicable to the assumed situation. It would be astonishing if they would have been worth more than the amount of the cost of the merchandise content proportionate to them which the taxpayer left in its income for 1945 in the manner described earlier. How then could it possibly have been said that the taxpayer's accounts receivable at the end of 1945 constituted a receipt by it during the year of $59,255.05 of net profit or gain over and above the amount reported by it? It certainly did not. The negative answer

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becomes even more emphatic when it is remembered that of the $151,651.67 of accounts receivable at the end of 1945 only $77,788.66 was collected in 1946, and then only by reason of the collection effort made in 1946, and $73,863.01 remained uncollected.

Now let us look at the other aspect of the problem with the taxpayer continuing in business after 1945. Then its accounts receivable at the end of 1945 would acquire value but only by reason of its intensive efforts to collect them. But such value would be acquired in a year subsequent to that of their receipt and as the result of collection efforts involving a substantial expenditure in such subsequent year. Thus it is apparent that the gross profit content of the instalments in respect of 1945 sales remaining unpaid at the end of 1945 is contingent on the success of expensive collection efforts to be made subsequently to 1945. It seems to me that if a system of accounting is to produce a true computation of the profit of a business such as that of the taxpayer it ought to take the factor which I have just referred to into proper account. The accrual basis system does not do so.

The real fact is that the taxpayer is engaged in two activities; it sells books and magazine subscriptions at a price which has taken into account the risky factors of such a business and it runs an intensively organized collection office. Its profit on the sale of its merchandise is contingent on the success of its collection efforts. Without such success there would not be any profit from the sale of the merchandise. On this point the evidence is conclusive. This led Mr. Punchard to his statement that he could not reconcile with good accounting the practice of giving full value to the amount of the taxpayer's accounts receivable at the end of the year when it was plain that such value as they might have was contingent on the success of the taxpayer's collection efforts to be made subsequently to the year of their receipt and necessarily involving a substantial expenditure in the year of its efforts and also subject to considerable loss even after its intensive and costly collection efforts.

Thus, in respect of the taxpayer's sales in 1945, it would be more reasonable and more consistent with sound accounting to take the gross profit content of the instalments remaining unpaid at the end of the year, that is to say, the

amount of the payments less the cost of the merchandise content proportionate to them, into income for the year in which they were received by the taxpayer as the result of its successful efforts to collect them and in which its costs of collection were incurred, rather than to take them into income for 1945 when their profit content was contingent on the success of future collection efforts and its amount could not be determined with any substantial certainty.

I am, therefore, in complete agreement with Mr. Punchard's opinion that the accrual basis system of acounting is inappropriate to the taxpayer's business. Its use, if applied for 1945, would take the amount of the taxpayer's gross sales in the year into income for the year, deduct therefrom the amount of its expenses laid out or incurred during the year and show the balance, less an arbitrary allowance of 15 per cent for bad debts, as the net profit received by it during the year. But the system would fail to take into account the nature of the taxpayer's business, the uncertain nature and contingent and doubtful value of its accounts receivable, the delay in the payment of the instalments, the intensive and costly efforts necessary to collect them in a year or years subsequent to 1945, and the certainty of substantial loss, notwithstanding such efforts. Thus, the use of the system would show a profit for the year that did not in fact exist. Certainly, it would not represent a profit received by the taxpayer during the year. What I have said applies also to the modification of the accrual basis system, which the Minister applied when he made his assessment.

I am also in agreement with the opinion of the accountancy experts that the instalment system of accounting is appropriate to the taxpayer's business. In respect of the sales in 1945 it properly excludes from the computation of income for 1945 the unrealized gross profit content of the instalment payments remaining unpaid at the end of the year and takes such profit content as may be realized subsequently to 1945 into income for the year in which the instalments are successfully collected as the result of the taxpayer's collection efforts, and their gross profit content may fairly be regarded as profit received by it during such year. It follows, of course, that under the instalment system only the gross profit content of the payments received by the taxpayer during 1945 is taken into income for the year,

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subject, of course, to the fact that the amount of the cost of the merchandise content proportionate to the amount of the instalment payments remaining unpaid at the end of the year after the write-off for bad debts against the amount of the unpaid instalments remains included in the income for the year in the manner described. I am convinced that the instalment system of accounting produces a much more nearly accurate computation of the taxpayer's profit than the accrual basis system would do.

For these reasons I have come to the conclusion that the Minister's assessment of the taxpayer for 1945 was erroneous in fact. It would be unrealistic, and contrary to fact, to say that the amount of $59,255.08 which the Minister added to the amount of taxable income reported by the taxpayer for 1945 represented a profit received by it during that year within the meaning of section 3 of the *Income War Tax Act*. The added amount was, therefore, improperly included in the assessment.

What I have said about the assessment for 1945 applies, *mutatis mutandis*, to the assessments for 1946, 1947 and 1948. For reasons similar to those which I have stated I find them all erroneous in fact.

These findings really dispose of the appeals herein in favor of the taxpayer unless there is some provision in the *Income War Tax Act* or some rule of income tax law that in a case such as the present prohibits the use of the instalment system of accounting and compels the use of the accrual basis system. Before dealing with the legal contentions put forward by counsel I should refer briefly to some matters of a particular nature. It was urged by counsel for the Minister that the result produced by the instalment system of accounting as applied by the taxpayer was anomalous in that it showed a loss by the taxpayer of $12,014.04 for 1945 whereas it had had a profit of $23,203.09 for 1944, notwithstanding the fact that it did more business in 1945 than it had done in 1944, namely, that its gross sales in 1945 amounted to $467,170.80 whereas in 1944 they had come to only $362,888.26. The answer to the comment is obvious, namely that for 1944 the taxpayer had made its tax returns according to the accrual basis system of accounting whereas for 1945 it based them on the instalment system. There was bound to be a difference of result due to the fact

that in 1944 the taxpayer had taken into income for 1944 items that ought to have been excluded from its computation of income for 1944 and included in its computation of income for 1945. If the taxpayer had changed over to the instalment system in 1944 instead of in 1945 it would have excluded from its computation of income for that year the unrealized gross profit content of the instalments remaining unpaid at the end of 1944 in respect of its 1944 sales instead of including it, as it did under the accrual basis system, and paying income tax on a profit which it had not in fact received during 1944. Moreover, the result in 1945 would have been that the taxpayer would have taken into income for that year not only the gross profit content of the payments received by it during the year in respect of its 1945 sales but also the gross profit content of the payments received by it during the year in respect of its 1944 sales. The result in such case would have been that in 1944 its taxable income would have been less than that on which it had paid tax and that in 1945 it would have had a taxable income instead of a loss. The fact is that the taxpayer had paid tax for 1944 on a so-called profit that it had not received in 1944 but had in part received in 1945. The fair way to look at the matter is to do so over a period of years. The results of the application of the system for 1946 illustrate what I mean. During that year the taxpayer received a profit of $15,516.86 whereas, as I have mentioned, it had had a loss of $12,014.04 for 1945, notwithstanding the fact that it did less business in 1946 than it had done in 1945, namely, that its gross sales in 1946 amounted to $399,521.40 whereas in 1945 they had come to $467,170.80. Here again the reason is clear, namely, that in 1946 the taxpayer took into income for the year not only the gross profit content of the payments received by it during the year in respect of its 1946 sales but also the gross profit content of the $77,788.66 of payments received by it during the year in respect of its 1945 sales which were the result of its successful efforts in 1946 to collect such payments. There is thus no merit in the contention of counsel based on the result shown for 1945 by the instalment system as compared with that shown for 1944 by the accrual basis system.

Nor is there any substance in the suggestion by counsel for the Minister in the course of his cross-examination of

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the accountancy experts that the application of the instalment system of accounting to the taxpayer's business and its accounts would reduce the amount of its income tax liability. If it should do so by reason of the fact that the system more nearly accurately reflects the taxpayer's income position than the accrual basis system or the Minister's modification of it would do there could not be any lawful objection to such a result. But the fact is that the use of the system does not produce any such result. There is no diminution of the taxpayer's taxable income by reason of its application of the instalment system of accounting. Mr. Punchard was emphatic in his statement to that effect. And Mr. Hutchison made it clear that all that happens is a change in the timing of the incidence of the applicable tax. How this happens has really been already fully explained. For example, in accordance with the principles of the system, the taxpayer excluded from its computation of income for 1945 the unrealized gross profit content of its accounts receivable at the end of 1945, but, as I have pointed out, brought into income for 1946 the gross profit content of the $77,788.66 of payments received by it during 1946 in respect of its 1945 sales and into income for 1947 the gross profit content of the payments received by it during 1947 in respect of its 1946 or 1945 sales, and so on. In other words, the gross profit content of payments received by the taxpayer during the year is taken into income for the year in which they are received, regardless of whether the sales in respect of which the payments were made were sales made in the year of the payment or in a previous year. This, in my opinion, is as it should be, for the gross profit content of the payment received was an item of taxable income received by the taxpayer in the year of the receipt of the payment, within the meaning of section 3 of the *Income War Tax Act*, and was not an item of taxable income received by it during any previous year. Thus, the use of the system does not reduce the amount of the taxpayer's income. All that it does is to allocate it to the year in which it properly belongs as being net profit or gain received by the taxpayer during such year within the meaning of the governing Act.

And there cannot be a valid objection to the instalment system of accounting on the ground that its use in Canada

is new and that this is the first case in which the appropriateness of its application in the computation of the taxable income falls to be considered. The system is not new in the United States. There its use has been recognized since 1924. Section 453(a) of the *Internal Revenue Code* of 1954 of the United States provides:

> 453 (*a*) Dealers in Personal Property—Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the instalment plan may return as income therefrom in any taxable year that portion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears the total contract price.

It will be seen that the use of the instalment system of accounting is recognized for all sales of personal property for a price payable by instalments. The evidence is that the taxpayer's parent in New York had used the instalment system for some years so that it was not unreasonable that the taxpayer should desire to keep its accounts according to the same system and, as I have stated, it decided to do so after Mr. Punchard had recommended the change-over after he had discussed the matter with the Toronto Office of the Department.

While it is true that the taxpayer is the only person that has adopted the system in Canada, it was Mr. Punchard's opinion that the Department's opposition to the system has discouraged its use and that, if there had not been such opposition, other persons would have adopted it.

Counsel for the Minister took objection to the taxpayer's exclusion of the amounts of its accounts receivable from its computation of income for the year on the ground that it constituted the setting up of a reserve or contingent account contrary to the prohibition of section 6(*d*) of the *Income War Tax Act*. In his cross-examination of the accountancy experts he attempted to obtain an admission from them that the deferring of the accounts receivable as income was a reserve but both Mr. Hutchison and Mr. Punchard were clearly of the opinion that there was no question of any reserve or contingent account. They were, in my opinion, clearly right. Section 6(1)(*d*) of the Act provides as follows:

> 6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*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;

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The section does not apply to what the taxpayer did. What it prohibits is the deduction from what would otherwise be assessable profits or gains of any amount transferred or credited to a reserve, contingent account or sinking fund, except as permitted. Here there was no such transfer or credit. What the taxpayer did was to exclude from its computation of income for the year the unrealized gross profit of its accounts receivable at the end of the year on the ground that such gross profit did not constitute income for the year that could enter into the computation of profits or gains to be assessed. It was not a case of deduction from income at all. The excluded unrealized gross profit content was not income for the year. Both Mr. Hutchison and Mr. Punchard were clearly of the opinion that there was no transfer or credit of anything to a reserve or contingent account and I am in full agreement with them. Moreover, as Mr. Punchard explained, there is no place in the instalment system of accounting for any reserve or contingent account for bad debts. The two ideas are inconsistent with one another. There cannot be any provision in the system for setting aside any amount for bad debts, for the unpaid instalments, which might become bad debts, are not taken into income at all, except that the cost of the merchandise content proportionate to them, by not being charged as an expense, is left included in income in the manner earlier described. What happens with regard to bad debts, as I have already explained, is that after certain debts have been determined to be bad their amount is written off against the amount of the gross sales for the year and all that is written off against income for the year is the amount of the cost of the merchandise content proportionate to the amount of the bad debts written off, for that is all that was left included in the income proportionately to the amount of the accounts before they were written off as bad. Thus, I find that the taxpayer's use of the instalment system did not result in any violation of the prohibitions of section 6(*d*).

But the main argument of counsel for the Minister was that the taxpayer should have applied the accrual basis system of accounting to its accounts and the computation of its taxable income. His submission, as I summarize it, was that the expression "net profit or gain . . . . received", as used in Section 3 of the *Income War Tax Act*, was wide

enough to include receivables as well as receipts, that since the inception of the Act in 1917 tax returns had been made to the Department according to the accrual basis system of accounting and that prior to 1945 the taxpayer had made its returns according to that system, that the Department had accepted that system and its long practice in doing so lends validity and a measure of law to the fact that the accrual basis system is a proper and the most appropriate one to use to determine net profit, unless, as counsel conceded, the taxpayer can satisfy the Court that he has used a more appropriate system, that the taxpayer ought, therefore, to have brought into income for the year the full amount of the instalments in respect of its sales in the year, that over a period of years it knew or should have known the percentage of its likely loss from bad debts and could have protected itself in respect of its accounts receivable by deducting the appropriate amount for bad debts to the extent that the Minister would allow such deduction, and that it could also work out an estimate of the collection expenses that would have to be incurred to collect the unpaid instalments.

There are several flaws in the argument thus put forward. It is not strictly correct to say that generally tax returns have been made to the Department according to the accrual basis system, for they have been made in a great many cases, possibly the majority, on the cash basis system. It is mainly in the case of trade accounts that the accrual basis has been used but, as Lord Greene M.R. pointed out in *W. S. Try, Ltd. v. Johnson*[1], it is really an exception to the general rule that tax is collected on the basis of the receipts of a business that trade debts are brought into income. The general rule is, as put by Rowlatt J. in *Leigh v. Commissioners of Inland Revenue*[2] that, "receivability without receipt for the purpose of Income Tax is nothing at all": *Vide* also *Dewar v. Commissioners of Inland Revenue*[3] to the same effect. Moreover, the Department has not hesitated to depart from the accrual basis system when it has suited its purpose to do so: *vide*, for example such cases as *Capital Trust Corporation Limited v. Minister of National Revenue*[4]; *Trapp v. Minister of National Revenue*[5]. But

[1] [1946] 1 All E.R. 532 at 539.
[2] (1927) 11 T.C. 590 at 595.
[3] (1935) 19 T.C. 561 at 577.
[4] [1937] S.C.R. 192
[5] [1946] Ex. C.R. 245.

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even if its practice had been uniform that would not have determined the matter. There has been too much thinking on the part of the Department that its permission, even in the absence of statutory authority, is necessary to the validity of a particular system of accounting. What is basically to be determined under the *Income War Tax Act* is the amount of "net profit or gain . . . . . received" by the taxpayer during the year. It was established by the House of Lords in *Sun Insurance Office v. Clark*[1] that "the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business". Thus, what is to be determined here is, not whether the Department has accepted the accrual basis system of accounting and rejected the instalment system, but rather which system more nearly accurately reflects the taxpayer's income position. I have already answered this question in detail. The Court is not called upon in this case to express any opinion on the appropriateness of the accrual basis of accounting to the business of an ordinary trader and ordinary trade accounts. But that is not the situation here. Here, as the evidence substantiates, the taxpayer's accounts were very different from ordinary trade accounts. And the Court has had the benefit of the uncontradicted opinions of two chartered accountants of experience, carefully expressed and exhaustively tested on cross-examination, that the accrual basis system of accounting is inappropriate to the taxpayer's business and its accounts and that the instalment system is appropriate and more accurately reflects the taxpayer's income position than any other system would do.

I have already, earlier in these reasons, stated that there is no merit in the submission made by counsel regarding the steps that the taxpayer might have taken to protect itself against loss in respect of its accounts receivable. That also applies to the suggestion that the taxpayer could estimate its collection costs. At best, the estimates thus suggested would have been of a speculative and arbitrary nature and subject to adverse comment similar to that made by Lord Greene M.R. in the *W. S. Try Ltd.* case (*supra*) in respect of the amount there discussed.

[1] [1912] A.C. 443.

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In support of his argument counsel for the Minister relied upon the decision in *Kent v. Minister of National Revenue*[1] in which Mr. Fisher accepted and adopted, *inter alia*, the following statement, taken from Mr. R. G. H. Smail's work on Accounting Principles and Practice, at page 412:

> Income is realized just as fully when an asset is sold for a promise of cash as when it is sold for cash down.

Mr. Hutchison did not agree that this statement was applicable in the case of sales such as those made by the taxpayer and Mr. Punchard also disagreed with it. My comment on it will be brief. It may well be that the statement is justifiable in cases where the promise to pay is readily convertible into cash, as appears to have been done in the *Kent* case, but to say that it is applicable to the kind of promises to pay made to the taxpayer in the present case is, to put it bluntly, to make a statement that is wholly devoid of reality and quite untrue.

Counsel for the Minister was in error in assuming that under the instalment system of accounting the taxpayer excluded from income for the year the whole amount of its accounts receivable at the end of the year as not having any value. That is not correct. What was excluded was the unrealized gross profit content of the unpaid instalments. But, as I have explained earlier, the unpaid instalments at the end of the year were valued at the amount of the cost of the merchandise content proportionate to them and the amount of such valuation was included in the taxpayer's income for the year in the manner which I have fully described. That is certainly not far from their value at the end of the year. Certainly, it is more than anyone would then have paid for them.

This brings me to my conclusion. I have not been able to find any prohibition, express or implied, in the *Income War Tax Act* against the use by the taxpayer of the instalment system of accounting in the computation of its income. In my opinion, its use results in a more nearly accurate computation of the taxpayer's taxable income, within the meaning of section 3 of the governing Act, than the system applied by the Minister would do.

[1] (1952) 6 Tax A.B.C. 181.

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It follows that the assessments appealed against must be set aside. There will, therefore, be judgment that the taxpayer's appeals against its income tax assessment for 1945 and its excess profits tax assessments for 1945, 1946 and 1947 are allowed and that the Minister's appeal from the decision of the Income Tax Appeal Board is dismissed. The taxpayer will be entitled to its costs of the appeals but since they were heard together there will be only one counsel fee.

Judgment accordingly.