

Income Tax Reserves

*A Better Understanding Through An Analysis of the Principles Relating To The Treatment of Reserves In Canada and The United Kingdom **

* Introductory Note — With certain modifications and updating, this article is based primarily on a Master of Laws thesis submitted to the University of Toronto in 1973. The discussion is on the basis of the law existing as at August, 1973.

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I. INTRODUCTION

A study of the leading cases on reserves in Canada, and the United Kingdom leads one to the conclusion that reserves are at the heart of any system of taxation which measures business income. The subject provides a battleground for great conflict between the tax-payer and the tax-gatherer. In this paper we shall study the subject of reserves, the reason for their inclusion in our taxing statute¹ and their use by Canadian tax-payers.

The word "reserve" is used to apply to different tax problems inherent in measuring business income. Consequently, this paper shall deal with the following four basic uses of "reserves":

- a) reserves for estimated expenses and contingent liabilities,
- b) reserves for doubtful and bad debts,
- c) reserves for deferral of prepaid income,
- d) reserves for profit content of instalment receivables.

We shall not deal with reserves as they pertain to specific industries or situations such as, reserves in the year of death,² the reserve for quadrennial survey,³ bank reserves,⁴ reserves for unrealized proceeds of disposition of resource property,⁵ reserves for unearned insurance commissions,⁶ mortgage lender reserves,⁷ reserves for computing income from a professional business⁸ and the significance of reserves with regard to sales of businesses.⁹ Nor shall we deal with capital cost allowance, a provision which might also be considered a "reserve".

A. *The Meaning of the Word "Reserve"*

In *Crane Ltd. v. M.N.R.*¹⁰ Kearney, J.¹¹ commented on the meaning of the term "reserve" as follows:

1. Unless otherwise indicated all statutory references are to the Income Tax Act, S.C. 1970-71, c. 63, (herein called "the new Act").

2. S. 72. For a discussion of this subject, see Warren Grover, "Income Taxes Payable at Death", *Estate Planning Seminar*, York University, 1972; and J.A. Langford, "The Tax Reform Bill and the Death of a Taxpayer", (1971) *Can. Tax J.* 508.

3. S. 20(1)(o).

4. S. 26.

5. S. 64.

6. S. 32.

7. S. 33.

8. S. 34.

9. S. 22. For complete discussion of this subject, see Martin L. O'Brien, "Sale of Assets: The Vendor's Position", *Corporate Management Tax Conference*, 1972, Canadian Tax Foundation, pp. 1-21 and David A. Ward, "Tax Considerations Relating to the Purchase of Assets of a Business", *op. cit.*, pp. 22-50.

10. 60 D.T.C. 1248.

11. *Id.*, at p. 1251.

In ordinary parlance the word "reserve signifies something set aside that can be relied upon for future use; and in good accounting practice, since 1954 it has been recognized¹² that it is a misnomer to apply the word to an amount which the taxpayer never anticipated receiving and never received.

The reason for having a reserve from an accounting point of view is best expressed by Lord President Clyde as follows:¹³

It is, however, quite consistent with this that a prudent commercial man may put part of the profits made in one year to reserve, and carry forward that reserve to the next year, in order to provide against an expected, or (it may be) an inevitable, loss which he foresees will fall upon his business during the next year. The process is a familiar one. But its adoption has no effect on the true amount of the profits actually made, and does not prevent the whole of the profits, whereof a part is put to reserve, from being taken into computation in the year in question for purposes of assessment. On the contrary, the balance of profits and gains is determined independently altogether of the way in which the trader uses that balance when he has got it; and, if he puts part of it to reserve and carries it forward into the next year, that has no effect whatever upon his taxable income for the year in which he makes the profit.

To conclude this brief introduction, in understanding the role of reserves in the new Act, it is important to remember that:¹⁴

To the accountant and the businessman, in determining income earned, the question of whether income has been actually received or not is completely irrelevant. The important point is to match costs against revenue on an annual basis for the purpose of determining profits and reporting them to the proprietors. Goods may be sold with payments therefore receivable over a period of years but income has nevertheless been earned, if the sale is firm, the only question involved being one of determining the amount of the sale to be included in income. It would naturally be appropriate accounting and business procedure to make some provision for the cost of collection of the amounts receivable and of course for any probable loss arising from uncollectibility of the accounts. On the other hand payment may be received for goods to be supplied or services to be rendered in the future and no part of the amounts received can be considered as earned until such time as the goods have been supplied or the service has been performed.

As was noted at the outset, reserves are of cardinal importance in the computation of profit. It is to an examination of the role of reserves in the computation of profit that we now turn.

B. *The Profit Concept*

Let us begin with the fundamental proposition that the new Act defines income from business or property as follows:

12. Kearney, J. was implicitly referring to Bulletin 9 of Canadian Institute of Chartered Accountants; for a discussion of Bulletin 9, see *Infra*.

13. *Edward Collins and Sons Ltd. v. C.I.R.* (1924) 12 T.C. 773 at 781 relied upon by Thorson, J. in *Kenneth B.S. Robertson Ltd. v. M.N.R.* (1944) C.T.C. 75 at p. 87 (E.C.C.).

14. T.A.M. Hutchison, "Business Income—A Conflict between Tax Laws and Accounting Principles" (1953) 1 *Can. Taxjo.* 7 at p. 10.

9(1) Subject to this Part, a tax-payer's income for a taxation year from a business or property is his *profit* therefrom for the year.

But what is profit?

The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts... Unless and until you have ascertained that there is such a balance, nothing exists to which the name 'profits' can properly be applied.¹⁵

Lord Haldane stated that profit must be ascertained in accordance with ordinary business practice as follows:¹⁶

It is plain 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. Questions of law can only arise when ... some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap.

The Supreme Court of Canada has held that profit must be determined in accordance with ordinary commercial principles. In *Dominion Taxicab Association v. M.N.R.*¹⁷ Cartwright, J., (as he then was) speaking for a majority of the court, said that:

The expression 'profit' is not defined in the Act. It has not a technical meaning and whether or not the sum in question constitutes profit must be determined on ordinary commercial principles unless the provisions of the Income Tax Act require a departure from such principles.

But how is profit to be determined for the purposes of the new Act?

1. *Accounting Methods for Computing Profit: The Canadian Scene: Carter*

S. 4 of Bill 454 (which came before Parliament in 1947 and which later was enacted in 1948 as the Income Tax Act) provided that "income for a taxation year from a business or property shall be determined in accordance with generally accepted accounting principles". Heated debate ensued in the accounting profession concerning this provision because its members could not agree as to what were these "accepted accounting principles". The provision was dropped in favour of the present wording of s. 9 but we are still left with the computation of profit "determined by taking recognized accounting practices into account subject to the express provisions of the legislation and applicable court decisions."¹⁸

15. *Russell v. Town and Country Bank* (1888) 13 App. Cas. 418, per Lord Herschell, at p. 424.

16. *Sun Insurance Office v. Clark* (1912) A.C. 443, at p. 455.

17. 54 D.T.C. 1020, at p. 1021.

18. Edwin C. Harris, "Application of Accounting Principles and Practice", 1967 *Conference Report*, Canadian Tax Foundation, 93, at p. 94.

The Carter Commission considered the issue of whether the taxing statute should contain a provision to the effect that "business income is to be computed according to recognized accounting practices" and "whether such provision would now usefully be inserted in the tax legislation".¹⁹ The Commission turned the problem over to the Canadian Institute of Chartered Accountants' Committee on Accounting and Auditing Research. The Commission agreed with the majority view of the Committee "that a specific reference to accounting principles or practices in the income tax legislation would not be desirable."²⁰

However, Chairman Carter dissented from the majority view of the Commissioners and stated:²¹

The *Report* (General Business Income, Chapter 22) states our concurrence in the view of The Canadian Institute of Chartered Accountants that tax legislation should contain no specific reference to accounting principles or practices in the determination of profit.

I concur in this statement in the *Report* for I consider that in this particular we should not depart from the authoritative opinion of an institution so closely associated with the point at issue.

My personal view does not accord with that of my profession for I prefer that the law state that profits for tax purposes should be determined in accordance with recognized accounting practices.

I choose the word "practices" rather than "principles" for the latter are the underlying rules that govern practice and the public is concerned only with practices. For its own particular purposes, tax legislation must continue to provide for departures from accepted accounting practices, but in my view they should be as few as possible and all set forth in the taxing statutes. The most obvious of the departures is capital cost allowances.

2. *The Reliance in the United Kingdom on "Ordinary Commercial Principles" for Computing Profit*

In the United Kingdom, the law relating to the method of determining "profits or gains" under s. 115(1) of the Income and Corporation Taxes Act, 1970 (herein called "the U.K. Act") is identical with that of Canada since there is no express statutory direction or formula for the use of accounting principles for determining profit. "It appears to be that the profits and losses of a trading concern are to be ascertained by using the ordinary principles of commercial accountancy".²² Lord President Clyde

19. *Report of the Royal Commission on Taxation* (Queen's Printer, Ottawa, 1966) Vol. IV, p. 219.

20. *Ibid.*

21. *Report of the Royal Commission on Taxation* (Queen's Printer, Ottawa, 1966) Vol. 1, p. 113. For an interesting commentary in support of Mr. Carter's views, see Edwin C. Harris, *op. cit.*, *supra* n. 18, at p. 96-98.

22. Robert Burgess, "Revenue Law and Accountancy Practice", (1972) 5 *B. Tax Rev.*, 308, at p. 308.

in *Whimster and Co. Ltd. v. I.R.C.* stated the above principle as follows:²³

In computing the balance of profits and gains for the purpose of Income Tax, or for the purposes of Excess Profits Duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn *those receipts*. In the second place, the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes.

A most recent and lucid explanation of the phrase "the ordinary principles of commercial accounting" was provided by Pennycuik, V.C. in *Odeon Associated Theatres Ltd. v. Jones* as follows:²⁴

I think that in deference to the arguments of both counsel for the Crown and to the authorities which were cited I ought to say a few words by way of explanation of the time-honoured expression "ordinary principles of commercial accountancy". The concern of the court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accounts. That evidence is conclusive on the practice of accounts in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so. Again there may be a divergency of view between the accountants, or there may be alternative principles, none of which can be said to be incorrect, or, of course, there may be no accountancy evidence at all. The cases illustrate these various points. At the end of the day the court must determine what is the correct principle of commercial accountancy to be applied. Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation. The expression 'ordinary principles of commercial accountancy' is, as I understand it, employed to denote what is involved in this composite process. Properly understood it presents no difficulty, and I would not be at all disposed to attempt any alternative label.

The courts in the United Kingdom determine profit by applying the accounting principles most suitable to the particular facts of each

23. (1926) 12 T. C. 813, at p. 823.

24. (1971) 2 A.E.R. 407, at p. 414 (Ch.D.); (1972) 1 A.E.R. 681 (C.A.)

situation but the following words of Lord Loreburn in *Sun Insurance Office v. Clark* should always be remembered:²⁵

I am equally anxious that your Lordships should not be supposed to have laid down that the method applied... in the present case has any universal application. If the Crown wishes in any future instance to dispute it the Crown can do so by evidence, and it is not to be presumed that it is either right or wrong. A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, namely, that the true gains are to be ascertained as nearly as can be done.

3. *The Cash Method of Accounting*

The cash method of accounting "requires profits to be ascertained by simply deducting payments actually made from sums actually received during the relevant period".²⁶ Obviously, the cash method is inappropriate for computing profit from a property or a business because the trader's income may widely fluctuate between years of high revenues and/or expenses and years of high expenses but low revenues. However the cash method is most often used by farmers, fishermen, authors, actors and artists.

4. *The Accrual Method of Accounting*

This method reports income in the year when it is receivable and expenditures when they are incurred. The new Act²⁷ explicitly requires taxpayers to include amounts receivable in their business and property income according to the accrual system which has been explained as follows:²⁸

Long established accounting theory and practice sanctions the use of the so-called accrual method of computing income, whereby amounts of payment are brought into the income account of the taxpayer when it has become payable to the taxpayer and production cost is allowed to be deducted when it has become payable by him. In other words, income arises when it is receivable and actual receipt is not necessary.

The use of the accrual method of accounting is justified because:²⁹

The flow of business activity does not stop and start with the beginning and end of a year, and the realistic measurement of annual income requires the apportionment of many revenues and expenses over more than one year. Costs are matched to revenues to which they relate, or are allocated overtime if this treatment is more appropriate. At the end of each year there is a wide variety of

25. (1912) A.C. 443, at p. 454 (H.L.).

26. Whiteman and Wheatcroft, *Whiteman and Wheatcroft on Income Tax and Surtax*; (London, 1971) p. 255.

27. S. 12(1)(b).

28. Labrie, *The Principles of Canadian Income Taxation*, (CCH Canadian Limited, Don Mills 1965) p. 314.

29. Russel G. Disney "Timing of Income and Deduction Items" *1968 Conference Report*, Canadian Tax Foundation 225 at p. 226.

deferred revenues, prepaid expenses and accrued expenses held over to be taken into account in calculating the profit of a future year or years.

But the new Act does not permit the deduction of all expenditure which has been incurred to the extent permitted by the accrual system. It is at this point that the subject of reserves from an accounting point of view conflicts with the method of determining profit used by the courts and the revenue authorities.

5. *The Instalment Method of Accounting*

There is a third method of accounting which is a hybrid - a blend between the cash and the accrual methods. This is known as the instalment method of accounting. It is used in isolated situations as in *Publishers Guild v. M.N.R.*³⁰ where the taxpayer was in the business of selling books and magazines through door to door canvassers. Thorson, P. reviewed the complex facts of the case and then explained the instalment method of accounting as follows:³¹

...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 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.... 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.

One may observe that by excluding the unrealized gross profit content of accounts receivable the result is the same as if a reserve for the same amount were deducted.

6. *Reserves: The Reasons for Their Inclusion in the New Act* (a) *Reserves and the Matching Principle*

The new Act recognizes that certain amounts received or receivable for goods or services to be delivered or rendered in future taxation years

30. (1957) C.T.C. 1.

31. *Id.*, at p. 11.

may be deducted in computing income from a business through the use of reserves. (s. 20 and s. 12 of the new Act contain paragraphs which are identical to provisions contained in s. 85B of the Income Tax Act, R.S.C. 1952 C. 148 (herein called "the old Act"). This naturally leads us to "the matching principle", for the reason for reserves as we know them under the new Act is well stated as follows:³²

This section appears to be an attempt to give some statutory recognition to the matching principle, which requires quite logically that unearned or virtually gratuitous receipts should not be taken into income when received but only as earned, that is, when the related expense has been incurred.

The matching principle has also been defined in accordance with a cause and effect relationship as follows:³³

Costs recorded in the accounts should be matched with revenues for the purpose of determining income of individual accounting periods in a manner which best reflects the 'cause and effect' relationship existing between costs and revenues. To formulate particular rules to implement the matching principle, costs incurred are customarily divided into several categories - viz. costs of acquiring and producing goods for resale, costs of capital assets, other costs of goods or services that may be expected to assist in earning future revenue and costs of goods or services from which no benefit is derived beyond the period in which the costs are incurred.

(b) The Doctrine of Beneficial Receipt

Tied in with the idea of the matching principle and reserves, is that:³⁴

mere beneficial entitlement to money or money's worth without receipt thereof does not constitute income. The converse also holds true. Mere receipt of payment without benefit to the recipient is not income. Both propositions may be viewed as expressions of the basic requirement that income, either in the form of money or money's worth, may be regarded as received only when it becomes effectively at the disposal of the alleged recipient.

If a widget manufacturer receives payment for an order of \$10,000 worth of widgets in year 1 for delivery in year 2, he will be taxed on the \$10,000 in year 1 in situations where he is free to use the funds as he wishes as soon as he receives them. He has beneficially received them in year 1 if the funds are not received in trust or there are no restrictions, contractual or otherwise, on his use or enjoyment of the funds. The \$10,000 will be taxable in such circumstances in year 1 under the doctrine of beneficial receipt. On the other hand, the system of reserves will allow him to deduct the \$10,000 in year 1 from his receipts and he will bring the sum into the computation of his profit for year 2 when he

32. Frederic C. Burton, "Measuring Business Income" 1967 Conference Report, Canadian Tax Foundation, 104, at p. 105.

33. Skinner, *Accounting Principles: A Canadian Viewpoint*, (Toronto, 1972), p. 3.

34. Labrie, *op. cit.*, *supra* n. 28, at p. 305.

manufactures and delivers the widgets. He may deduct a reserve but not on the ground of lack of beneficial receipt.

(c) *Reserves: An Historical Perspective*

At this juncture, it may be useful to set out the reasons given in 1953 for enacting s. 85B of the old Act. The provision was originally aimed at reversing the trend of earlier Tax Appeal Board cases concerning returnable books,³⁵ milk tickets³⁶ and bus tickets.³⁷ In his budget speech of February 19, 1953, the then Minister of Finance, the Honourable Douglas Abbot stated:³⁸

During the past year certain other features of the income tax have given rise to considerable concern. The subjects are quite technical and, accordingly, they are not appropriate for full elaboration in the budget speech but I should like to comment briefly on some of them. For example, the income tax appeal board in a number of cases involving the sale of tickets for goods and services to be delivered or performed in the future have dismissed appeals against assessments which disallowed claims for certain so-called reserves. In the meantime the general question has been given careful study, and while I cannot go into all the details I can say that I believe a proper solution has been found for most of the problems of this sort.

At the 1953 Tax Conference of the Canadian Tax Foundation, S. 85B of the old Act appears to have been greeted with enthusiasm.³⁹ However, since then the section has received severe criticism. For example, Arthur S. Pattillo, in an address given to the 1960 Tax Conference of the Canadian Tax Foundation criticized the section in the following manner:⁴⁰

Care must be taken, I think, in enacting special rules to meet special cases, that they do not by inference erode or derogate general rules. A good example of this can be found in the history and application of section 85B. I have always understood that the section was enacted to clarify the decisions in the 'returnable container' and 'milk ticket' cases where some of the companies were required to take the full amount received in the sales of milk and other goods into income and were not allowed any reserve for amounts for which they were contingently liable on the return of the tickets. Indeed, the body of this section does permit reserves in these cases, but the general sections, 85B 1(a) and (b), swept into income all the amounts received or receivable in respect of property sold or services rendered in the year, although on general principles the entire amount might not be reasonably charged to income in the year for one reason or another.

Provisions of this sweeping generality are really a statutory gloss on the computation of income and seriously erode the principle that the determination of income is a question of fact to be decided on general business principles. I

35. *William Collins and Co. Ltd. v. M.N.R.* (1951) 4 Tax A.B.C. 142.

36. *No. 64 v. M.N.R.* 52 D.T.C. 295 (T.A.B.).

37. *Capital Transit Co. v. M.N.R.* (1952) 7 Tax A.B.C. 35.

38. Vol. II Hansard (1952-53), at p. 2129.

39. See the address given by Mr. Laird Watt, 1953 *Conference Report*, Canadian Tax Foundation, pp. 3-4.

40. Arthur S. Pattillo, "More Written Rules for Taxation", 1960 *Conference Report*, Canadian Tax Foundation, pp. 204-5.

doubt if the effect of this section was generally appreciated at the time it was introduced in 1953 and it is significant that there was no discussion when this bill was passed in the House of Commons, save for the Minister's request to add what is now section 85B(5) dealing with the policy reserves of insurance corporations. Now this raises very interesting questions... How did a section with such important consequences to the computation of income generally get into the Act with no effective complaint being raised?

(d) The Use of the Word "Reserve"

The Canadian Institute of Chartered Accountants issued Research Bulletin No. 9 in January, 1953 concerning the use of the word "reserve" (herein called "Bulletin 9"). Bulletin 9 indicates that the word should be used only to describe an appropriation of net profits or surplus but not to describe amounts which are required to be brought into account in the determination of net profit. Bulletin 9 goes on to suggest that in certain instances the word "reserve" was being used inappropriately and that it should be replaced by words describing the precise nature of the deduction made in the accounts; for example, "allowance for doubtful debts", "services paid for in advance" and so on.

Bulletin 9 recommends that the word "reserve" *not* be used to designate amounts provided in respect of actual liabilities, deferred income or diminutions in the value of assets such as:

- (a) "reserve" for doubtful accounts
- (b) "reserve" for depreciation
- (c) "reserve" for commissions or taxes
- (d) "reserve" for services or goods to be supplied in the future

Bulletin 9 recommends that "reserve" be used only to designate an amount which, though not required to meet a liability or contingency known or admitted, or a decline in value which has already occurred as at the statement date, has been appropriated (i) at the discretion of management such as a reserve for future plant extension or (ii) as required by statute or the charter of the corporation. Since January 1953 when Bulletin 9 was published, the accounting profession has used the term "reserve" according to the guidelines of Bulletin 9 in preparing financial statements. Unfortunately, the new Act and the Courts still use the word "reserve" and often in situations deemed inappropriate by Bulletin 9.

(e) Carter and Reserves

In its submission to the Carter Commission, the Canadian Institute of Chartered Accounts recommended "that the Act be amended to bring the use of the word 'reserve' into line with the recommendation of Bulletin No. 9"⁴¹ The Institute made the further recommendation:⁴²

41. "Submission to the Royal Commission on Taxation", Canadian Institute of Chartered Accountants, December, 1963, p. 12.

42. *Ibid.*

At present, Section 12(1)(3) (now s. 18(1)(e)) of the Income Tax Act prohibits the deduction of "reserves" except as permitted by Sections 85B and 11(1)(e) (now paragraphs (1) (m) and (n) of s. 20(1)). Unfortunately, these sections prohibit the deduction of a number of items which are proper charges in computing business income. The Committee believes that any reasonable charge against income acceptable for accounting purposes should be allowable for tax purposes. It is therefore suggested that Section 12(1) (e) and Section 85B put an undue restriction on the taxpayer and that the revenue is adequately protected by the provisions of Section 12(2).⁴³ The Committee, therefore, recommends:

That Section 12(1) (e) and 85B be repealed.

The Carter Report agreed with the submission of the Canadian Institute of Chartered Accountants and expressed the hope that the courts would rely to a greater extent on accounting and business practices relating to the measurement of business income. In their report the Commissioners made the following comment with regard to s. 85B reserves:⁴⁴

These provisions may have been necessary in the days when the businessman determined arbitrarily the amount set aside from profits for various purposes. However, we believe that the general prohibition of reserves has led to an over-emphasis by the tax authorities on the time at which revenues are recognized, and that in the present state of accounting and business practice such a provision is undesirable.

The Carter Commission then made the following recommendations:⁴⁵

In view of the foregoing considerations, we recommend the following:

1. The general disallowance of reserves should be deleted from the legislation.
2. The present specific provisions for reserves, namely, sections 85B (now paragraphs (1) (m) and (n) of s. 20(1)) and 11(1)(e), (now s. 18(1)(e)) should also be repealed; with the result that the general statutory test of reasonableness would then apply to allowances for unearned income, to allowances for estimated losses in the value of accounts receivable, and to allowances in respect of the losses that could result from guarantees, indemnities and warranties.
3. In those cases where a test of reasonableness is difficult to apply and where it would be feasible to employ an arbitrary standard, the legislation should contain specific provisions with arbitrary rules to eliminate uncertainty. However, such rules should be framed so as to permit the most accurate estimate to be made of the average losses anticipated and should not make any allowance for contingencies. Thus, in Chapter 24, which deals with financial institutions, we recommend that specific arbitrary percentages should be established for the use of banks in valuing their loan accounts, and for all taxpayers in valuing real property mortgages receivable.

43. S. 67 (formerly s. 12(2)) permits the deduction of outlays or expenses only to the extent that they are reasonable.

44. **Report of the Royal Commission on Taxation** (Queen's Printer, Ottawa: 1966) Vol. iv, p. 226.

45. *Id.*, at p. 227.

7. *The Conflict Between Tax Accounting and Financial Accounting: Reserves - A Battleground for Revenue Versus the Business Concept of Profit.*

It is in the area of reserves and their relationship with the matching principle that the accountants' theory of financial accounting conflicts with the revenue authorities' view of tax accounting.

The argument stems from the different objectives of financial and tax-accounting. Financial accounting seeks to be conservative by keeping income at a minimum and consistent so that different periods may be compared. In order to be conservative and consistent, financial accounting attempts to match expenses against income produced by the expenditure. It seeks to deduct in advance for possible future expenses which are connected with present sales and to be cautious in considering an item as income, but generous in treating a transaction as a loss or expense. Only the accrual method will satisfy these objectives.

Tax accounting, because of the need for collecting revenues, takes a very different point of view. It advances the time that items are treated as income and delays the right to take a deduction or to recognize a loss. Essentially, tax accounting proceeds from the concept of ability to pay. If an item of income has been received, it becomes subject to tax because the taxpayer has the funds to pay the tax. On the other hand, taxes should not be reduced by the possible need to make an expenditure in the future. Instead, a deduction may be taken when the expenditure is actually made and taxes may be reduced at that time.⁴⁶

The accountants and their clients wish to deduct from their revenues all amounts of expenditure or cost which in their view, without the deduction, will produce a distorted view of profit. Throughout this paper, the conflict shall arise time and again - the businessman anxious to have what he considers to be a true picture of his profit from his business and the tax gatherer on the other hand, anxiously guarding his tax revenues by arguing that desired deductions are prohibited either because they were not made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property, or alternatively that the amount desired to be deducted by the taxpayer represents a nondeductible contingent liability in the nature of a reserve.

Now that the controversy surrounding the subject of reserves has been indicated, let us examine the extent and effectiveness of their operation under the new Act. In Part II we shall examine what amounts must be included in income; then in Part III, we shall discuss how amounts may be deducted from income through the use of reserves.

46. Jules Silk, "Advance Payments - Pre-paid Income - Recent Developments: An Old Problem Put to Rest" (1972) (Part 2) 30 - N.Y.U. Inst. on Fed. Tax 1651, at p. 1652-3

II. AMOUNTS INCLUDED IN INCOME

A. *Prepaid Income: Amounts received for services to be Rendered and Goods to be Delivered*

1. *The Concept of Income: Canada*

Before proceeding with our detailed discussion of reserves, let us first begin with an examination of s. 12(1)(a) and (b)⁴⁷ of the new Act which pertain to amounts to be included as income from a business or property. These provisions directly affect the use of permitted reserves contained in paragraphs (1), (m) and (n) of s. 20(1) of the new Act. It is to be noted that paragraphs (a) and (b) of s. 12(1) alter the classic statement by Thorson, J. (as he then was) about the quality of income:⁴⁸

The question remains whether all of the amounts received by the appellant during any year were received as income or became such during the year. Did such amounts have, at the time of their receipt, or acquire during the year of their receipt, the quality of income to use the phrase of Mr. Justice Brandeis in *Brown v. Helvering*, 291 U.S. 193. In my judgment, the language used by him, to which I have already referred, lays down an important test as to whether an amount received by a taxpayer has the quality of income. Is his right to it absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment⁴⁹ To put it in another way, can an amount in a taxpayer's hands be regarded as he holds it subject to specific and unfulfilled conditions, and his right to retain it and apply it to his own use has not yet accrued, and may never accrue⁵⁰

In our view, the above clearly articulates the notion of beneficial receipt.⁴⁹ An amount can not be included as income if the taxpayer is not "beneficially" entitled to it.

Thorson, J., further clarified "income" by distinguishing a deposit from an income receipt in the following manner:⁵⁰

Where an amount is paid as a deposit by way of security for the performance of a contract and held as such, it can not be regarded as profit or gain to the holder

47. Formerly s. 85B (1) (a) and (b) of the old Act, s. 12 (1) (a) and (b) state:

12.(1) There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:

SERVICES, ETC., TO BE RENDERED

(a) any amount received by the taxpayer in the year in the course of business.

(i) that is on account of services not rendered or goods not delivered before the end of the year or that, for any reason, may be regarded as not having been earned in the year or a previous year, or

(ii) under an arrangement or understanding that it is repayable in whole or in part on the return or resale to the taxpayer of articles in or by means of which goods were delivered to a customer;

AMOUNTS RECEIVABLE IN RESPECT OF SERVICES, ETC., RENDERED

(b) any amount receivable by the taxpayer in respect of property sold or services rendered in the course of a business in the year, notwithstanding that the amount may not be receivable until a subsequent year, unless the method adopted by the taxpayer for computing income from the business and accepted for the purpose of this Part does not require him to include any amount receivable in computing his income for a taxation year unless it has been received in the year;

48. *Kenneth B. S. Robertson Ltd. v. M.N.R. (1944)* C.T.C. 75 at p. 91 (E.C.).

49. *Supra* at p. 17 for an explanation of the doctrine of beneficial receipt.

50. *Kenneth B. S. Robertson Ltd. v. M.N.R. (1944)* C.T.C. 75 at p. 92.

until the circumstances under which it may be retained by him to his own use have arisen and, until such time, it is not taxable income in his hands, for it lacks the essential quality of income, namely, that the recipient should have an absolute right to it and be under no restriction, contractual or otherwise, as to its disposition, use or enjoyment.

Thus s. 12(1)(a) and s. 12(1)(b) reinforce the income tests set out by Thorson, J. in the *Robertson* case to the extent that an amount received will be included in income in the year in which it is received even though it may not be regarded as having been earned in the year. It is to be noted, however, that amounts received in trust by a taxpayer will not be included in income.⁵¹

2. *Prepaid Income in Canada: s. 12(1)(a) of the new Act*

S. 12(1)(a) brings into income the following amounts:

- (a) all amounts actually received on account of services not rendered or goods not delivered,
- (b) all amounts actually received which for any other reason are regarded as not having been earned in the year of receipt.,
- (c) all amounts actually received in the year in the course of carrying on a business under an arrangement that they must be returned when the taxpayer receives back from a customer articles used to deliver goods to him such as oil drums or wire and cable reels.

The *Atlantic Engine Rebuilders* case⁵² is one of the leading decisions interpreting s. 12(1)(a) as it relates to the subject of reserves and amounts received in the year. The taxpayer's business was that of rebuilding Ford engines for dealers, who, for each rebuilt engine received, were required to turn in another rebuildable engine in addition to paying the set price. A dealer who was unable to supply a rebuildable engine immediately was required to pay a "core deposit" (about three times the value of the used engine) which was refundable if and when the dealer supplied the rebuildable engine (which was the case 96% of the time).

The Minister asserted that the unredeemed core deposits ought to be included in the taxpayer's income but denied a corresponding deduction in respect of Atlantic's liability to refund the deposits. In the Exchequer Court Thurlow, J. held that the deposits were receipts of an income nature arising in the ordinary course of the taxpayer's trading transactions and that it was "inexorably" entitled to an equivalent deduction in respect of its liability to refund them. However, Cartwright,

51. *Canadian Fruit Distributors v. M.N.R.* (1954) C.T.C. 284; *M.N.R. v. Atlantic Engine Rebuilders* (1967) C.T.C. 230; No. 382 v. M.N.R. 16 Tax A.B.C. 274

52. *M.N.R. v. Atlantic Engine Rebuilders Ltd.* (1967) C.T.C. 230 (S.C.C.); (1964) C.T.C. 268 (E.C.C.); see also an earlier decision concerning "core deposits", *Western Engine Works v. M.N.R.* (1959) 22 Tax A.B.C. 399 which had similar facts to the *Atlantic Engine* case but the taxpayer's appeal was dismissed. The *Western Engine* case was referred to in the dissenting judgment of Judson, J. in the report of the *Atlantic Engine* case at p. 233 as being correctly decided.

J. (as he then was) in the Supreme Court of Canada disagreed with Thurlow, J. and held that these deposits could not be included as trading receipts in computing the "true profit"⁵³ of the taxpayer.

Cartwright, J. (speaking for Martland and Ritchie, J.J.) said:

The question of substance in this case appears to me to be whether in stating what its profit was for the year the respondent could truthfully have included the sum in question. To me there seems to be only one answer, that it could not. It knew that it might not be able to retain any part of that sum and that the probabilities were that 96% of it must be returned to the depositors in the near future. The circumstance that the respondent became the legal owner of the moneys deposited with it and that they did not constitute a trust fund in its hands appears to me to be irrelevant; the same may be said of moneys deposited by a customer in a bank which form part of the bank's assets but not of its profits. To treat these deposits as if they were ordinary trading receipts of the respondent would be to disregard all the realities of the situation.⁵⁴

What appears to me to be decisive is the fact that there is no basis, having regard to the realities of the situation, on which these deposits can properly be treated as ordinary trading receipts of the respondent which it was entitled to include in calculating its profits for the year.

Of course it would be within the power of Parliament to enact that a receipt which could not on any principle of sound accounting be regarded as forming part of a company's profit should none the less be treated as profit for the purposes of taxation; but to bring about such a result clear and intractable words would be necessary. In my opinion, nothing in the *Income Tax Act* requires these deposits to be treated as profits of the respondent.⁵⁵

Judson, J., (concurring in by Abbot, J.) dissented from the majority decision. He agreed with Thurlow, J., of the Exchequer Court that the deposits were of an income nature but would have allowed the Minister's appeal because the liability to make the refund was contingent upon the delivery of a rebuildable engine and that the deposits should only be deducted when refunded. He stated his dissent in part as follows:⁵⁶

The taxpayer was not definitely committed in the year of income to make this disbursement or outlay or expense until the rebuildable engine was delivered...

I also think that the company fails under Section 12(1)(e) (now s. 18(1)(e)). This amount, shown as a liability, is an amount transferred or credited to a reserve. It may be good commercial or accountancy practice to make provision for these liabilities but this is subject to the express provisions of the Act and the Act does not make an express provision here.

The *Atlantic Engine* case is enlightening because it sets out what we believe to be the Supreme Court's endorsement of "sound accounting"

53. (1967) C.T.C. 230 at p. 232 (S.C.C.).

54. *Id.*, at p. 231.

55. *Id.*, at p. 232.

56. *Id.*, at p. 234.

and indicates the court's view on the quality of amounts to be included as income. However, the decision is very confusing because Cartwright, J. (as he then was) stated that the core deposits were not includible in income. What is their quality in the hands of the taxpayer? Did they fall in a suspense account? If so, the core deposits would be falling into a contingent reserve account prohibited under s. 18(1) (e). The dissenting judgment of Judson, J. shows the wide divergency of opinion held by the judges of our highest court concerning the nature of income. Obviously, each case will be determined on its own facts but there is an element of uncertainty in that Cartwright, J., in referring to the *Dominion Taxicab*⁵⁷ decision, uses the phrase "contingent liability"⁵⁸ with regard to refunding the core deposits. If the liability to refund the deposit was a contingent liability then it would be logical that there should be no deduction (because of the provisions of s. 18(1) (e)) until actual refund of the deposit. However the case appears to be silent on this aspect except for the dissenting judgment of Judson, J. The decision of Cartwright, J., (as he then was) appears to avoid this problem by stating that the deposits never fell into the trading receipts of the taxpayer. The core deposits appear to have been in limbo, untaxed, but nevertheless the taxpayer would have the use of the money until refunded. Accordingly the taxpayer should have been taxable under the doctrine of beneficial receipt. On the other hand the *Atlantic Engine* decision is not all that surprising because deposits are not included in income. For example, there have been several decisions to the effect that deposits which were not held in trust and which were received by land developers from building contractors to be applied on the purchase of lots were not includible in income under s. 12(1)(a).⁵⁹

While the system of reserves assists the accrual method of accounting in achieving the proper operation of the matching principle,⁶⁰ s. 12(1)(a) and s. 12(1)(b) sweep into income every amount received or receivable regardless of whether any profit has been earned. Additionally while an amount may be included under s. 12(1)(a) and (b), there may not be a corresponding deduction of an allowable reserve under s. 20(1). In the *Atlantic Engine* case none of the provisions allowing a reserve under s. 20(1) (m) (iv)⁶¹ would have assisted the taxpayer since this provision relates to containers and not to the engines required to be delivered. A more flexible system of deducting a reasonable reserve, as recommended by the Carter report,⁶² is required where amounts

57. *Dominion Taxicab Association v. M.N.R.* (1954) S.C.R. 82.

58. *M.N.R. v. Atlantic Engine Rebuilders* (1967) C.T.C. 230 at p. 234.

59. *Riverview Development (Ottawa) Limited v. M.N.R.* (1967) Tax A.B.C. 115, at p. 120; *Dartmouth Developments v. M.N.R.* (1967) Tax A.B.C. 780, at p. 795-6; *Calgary Suburban Developments Ltd. v. M.N.R.* (1968) Tax A.B.C. 188.

60. *Supra* for a discussion of the matching principle.

61. The provisions of s. 20(1)(m)(iv) are discussed *infra*.

62. The recommendations of the Carter Commission are set out *supra*.

received are included in income but no corresponding reserve is available under the present provisions of the new Act.

3. *Prepaid Income: The Reliance in the United Kingdom on "ordinary commercial accounting principles"*

As indicated earlier,⁶³ the English authorities are clear that profit is to be ascertained in accordance with ordinary commercial accounting principles applied to the particular facts of each case unless there is an express statutory rule or provision directly applicable to the particular circumstances. In the area of what constitutes profit the courts in the United Kingdom attempt to apply the matching principle⁶⁴ wherever possible. "It is plain that the question of what is or is not profit or gain must principally be one of fact and of fact to be ascertained by the tests applied in ordinary business."⁶⁵

Accordingly prepaid income will not be included in a taxpayer's accounts where there is a liability in the future to deliver goods or render services if the taxpayer is able to affirmatively answer the first question postulated by Lord Radcliffe in *Southern Railway of Peru v. Owen*⁶⁶ namely:

Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations?

Furthermore if the obligation can be reasonably qualified, then the prepaid income will not be included in the taxpayer's profit for tax purposes until the year in which the goods are delivered or the services are performed. This proposition is further buttressed by Lord Hanworth's definition of profit as follows:⁶⁷

Profits in relation to any trade or business are... the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts.

B. *Amounts Receivable for Services Rendered and Property Sold*

1. *Amounts Receivable: Canada: s. 12(1)(b) of the new Act*⁶⁸

S. 12(1) (b) of the new Act implicitly requires a taxpayer to use the accrual method of accounting and provides that there will be included

63. *Supra*, for discussion on the reliance in the United Kingdom on ordinary commercial principles for computing profit.

64. The matching principle is discussed *supra*.

65. Per Lord Tucker; *Petermerchant Ltd. v. Stedeford* (1943-9) 30 T.C. 496 at p. 509 quoting from the judgment of Lord Haldane in *Sun Insurance Office v. Clark* (1912) 6 T.C. 59, at p. 78.

66. (1957) A.C. 334 at p. 357; this important decision is discussed *infra*.

67. *The Naval Colliery, Ltd. v. I.R.C.* (1928) 12 T.C. 1017 at pp. 1033-4 (H.L.); this decision is discussed in detail, *infra*.

68. Formerly s. 85B (1) (b) of the old Act;

in computing the income of a taxpayer for a taxation year as income from a business or property any amount receivable in respect of property sold or services rendered in the course of a business in the year notwithstanding that the amount may not be receivable until a subsequent year unless the Minister has accepted the taxpayer's method of computing his income from the business according to the cash method of accounting.

From the above we may make the following observations:

- (a) there must be property sold or services rendered⁶⁹
- (b) there must be an amount receivable

With regard to paragraph (b) above, in the decision of *Adam Neisner v. M.N.R.*,⁷⁰ Mr. Weldon relied on the judgment of Kearney, J. in *M.N.R. v. John Colford Contracting Co. Ltd.*,⁷¹ to define "receivable" as follows:

That case held that for any amount to constitute a receivable, the recipient must have a clearly legal, though not necessarily immediate, right to receive it.

*Weinstein v. M.N.R.*⁷² is authority for the proposition that a taxpayer's failure to challenge the use of the accrual system by the Minister in assessing the income of the taxpayer constitutes adoption of that method by the taxpayer.

Gibson, J. stated:⁷³

The conclusion I reach firstly, is that on a true interpretation of Section 85B(1) (b) (now s. 12(1)(b)) of the *Income Tax Act* the adoption of a method for computing income from a business and the acceptance of it by the respondent for the purpose of that subsection of the Act does not have to follow that chronology, that is, adoption first by the taxpayer and acceptance by the Minister. The reverse may obtain.

Another case involving "receivable" is that of *Willow Manufacturing Co. Ltd. v. M.N.R.*⁷⁴ where rent receivable in an amount dependent upon the lessee's sales volume was held to be "receivable" by the landlord despite the fact that the exact amount could not be computed.

Mr. Davis first stated that s. 85B(1) (b) (now s. 12(1) (b)) requires "nothing more than a legally enforceable right to payment".⁷⁵ He then

69. See the decision on this point by Mr. Weldon in *Calgary Suburban Developments Ltd. v. M.N.R.*, *supra* n. 59 at p. 197.

70. (1963) 34 Tax A.B.C. 53 at p. 63.

71. (1960) C.T.C. 178.

72. (1968) C.T.C. 357; discussed *infra*.

73. *Id.*, at p. 359.

74. (1967) Tax A.B.C. 406.

75. *Id.*, at p. 413.

made the following statement with regard to this provision and the accrual system:⁷⁶

It is also beyond question that the appellant company, under the provisions of Section 85B of the *Income Tax Act*, is obliged to use the accrual system of accounting, which calls for a matching of cost and income and requires the accrual of liabilities and accounts receivable as and when goods and services are received or rendered.

2. *Holdbacks: The Canadian Construction Industry*⁷⁷

There have been several decisions concerning the receivable nature of holdbacks in the construction industry which assist in understanding what the word "receivable" means. These judgments shall be examined only as they relate to the word "receivable" and not to their general effect on the Canadian construction industry.⁷⁸ In *M.N.R. v. Colford Contracting Co. Ltd.*⁷⁹ Kearney, J., distinguished the earlier conflicting decision of *Wilson and Wilson Ltd. v. M.N.R.*⁸⁰ and gave the following definition of 'amount receivable' or 'receivable':⁸¹

As 'amount receivable' or 'receivable' is not defined in the Act, I think one should endeavour to find its ordinary meaning in the field in which it is employed. If recourse is had to a dictionary meaning, we find in the *Shorter Oxford*, Third Edition, the word 'receivable' defined as something 'capable of being received'. This definition is so wide that it contributes little towards a solution. It envisages a receivable as anything that can be transmitted to anyone capable of receiving it. It might be said to apply to a legacy bestowed in the will of a living testator, but nobody would regard such a legacy as an amount receivable in the hands of a potential legatee. In the absence of a statutory definition to the contrary, I think it is not enough that the so-called recipient have a precarious right to receive the amount in question, but he must have a clearly legal, though not necessarily immediate, right to receive it. A second meaning, as mentioned by Cameron, J., is 'to be received', and Eric L. Kohler, in *A Dictionary for Accountants*, 1957 edition, p. 408, defines it as 'collectible, where or not due.' These two definitions, I think, connote entitlement.

In the *Colford* decision, Kearney, J., held that the holdbacks did not take on the quality of receivables until the year in which architect's or engineer's certificates were issued accepting and approving the work done.

76. *Id.*, at p. 415.

77. See also Interpretation Bulletin IT-92, issued February 20, 1973 dealing specifically with the income of contractors.

78. See P. N. Thorsteinson, "The Income Nature of Construction Contract Holdbacks", (1962) 10 *Can. Tax J.* at p. 415. In the United States, Regulation 1.451-3 was passed in 1957 providing methods of determining income from construction contracts according to either the percentage of completion method or the completed contract method depending on which method most clearly reflects income of the taxpayer.

79. 60 D.T.C. 1131 (E.C.C.).

80. 60 D.T.C. 1018 (E.C.C.). Cameron, J., held that s. 12(1) (b) brought into income all progress payments billed whether or not the money was received in the year and whether or not the engineer's certificate, which was a condition of payment, had been received.

81. 60 D.T.C. 1131, at pp. 1134-5.

By a unanimous judgment,⁸² without written reasons, the Supreme Court of Canada dismissed the Minister's appeal from the judgment of Kearney, J., in the *Colford* case. By implication, the Supreme Court has agreed with Kearney, J.'s above definition of receivable over the definition given by Cameron, J., in the *Wilson* case.⁸³ The following conclusions concerning the nature of 'amount receivable' within the meaning of s. 12(1)(b) of the new Act may therefore be made:⁸⁴

- (1) before a legal debt is created, there is no receivable for purposes of section 12(1)(b)
- (2) upon the creation of a debt, a receivable comes into existence;
- (3) the creation of a debt gives rise to a receivable because now the creditor has an existing right that he can sue to enforce immediately, or if not immediately, subject only to the passage of a period of time;
- (4) expressed another way, a receivable must represent an amount to which the creditor has a present vested right, subject to no condition or contingency other than the simple passage of time.

By way of concluding this discussion of s. 12(1) (a) and (b), s. 12(2) provides that "paragraphs (1)(a) and (b) are enacted for greater certainty and shall not be construed as implying that any amount not referred to therein is not to be included in computing income from a business for a taxation year whether it is received or receivable in the year or not." Thus s. 12(2) clarifies that any amounts received or receivable which are not described in paragraphs (1)(a) and (b) of s. 12 will be required to be included in computing income for the year from a business.

3. *Amounts Receivable for Services Rendered and Property Sold in the United Kingdom*

The position in the United Kingdom with regard to "receivables" and their proper accounting treatment is best explained by the following statement of Viscount Simon in *C.I.R. v. Gardner Mountain & D'Ambrumeil Ltd.*:⁸⁵

In calculating the taxable profit of a business on Income Tax principles... services completely rendered or goods supplied, which are not to be paid for till a subsequent year, cannot, generally speaking, be dealt with by treating the taxpayer's outlay as pure loss in the year in which it was incurred and bringing in the remuneration as pure profit in the subsequent year in which it is paid, or is due to be paid. In making an assessment of Income Tax... the net result of the transaction, setting expenses on the one side and a figure for remuneration on the other side, ought to appear (as it would appear in a proper system of accountancy) in the same year's profit and loss account, and that year will be the year when the service was rendered or the goods delivered... This may involve, in

82 (1962) C.T.C. 546 (S.C.).

83 *Supra* n 80

84 P. N. Thorsteinson, *op. cit.*, *supra* n 78 at p 417

85 (1940-51) 29 T.C. 69 at p 93 (H.L.)

some instances, an estimate of what the future remuneration will amount to... a provisional estimate of what the amount would be might be inserted in the first place and could be corrected, when the precise figure was known, by additional assessment or by a return of any excess within six years of the original assessment.

In the United Kingdom, amounts receivable for services rendered or property sold will be included in income in the year of sale but with an allowance of a corresponding deduction for the cost of producing or selling the goods or services so that the true "profit" is ascertained.⁸⁶

III. THE FOUR BASIC RESERVES

The following four basic reserves shall be examined:

- (a) reserves for estimated expenses and contingent liabilities,
- (b) reserves for doubtful and bad debts,
- (c) reserves for deferral of prepaid income,
- (d) reserves for profit content of instalment receivables

A. *Reserves for Estimated Expenses and Contingent Liabilities*

1. *Canada: Reserves Distinguished from Liabilities*

A reserve must be distinguished from a liability since the latter may be deducted under 18(1) (a) if made or incurred by the taxpayer for the purposes of gaining or producing income from a business or property. In *No. 297 v. M.N.R.*,⁸⁷ the Tax Appeal Board held that a fund entitled "Reserve for Employees' Bonuses" on the accounts of the taxpayer was a deductible liability because it was not set aside as a provision against the happening of an uncertain event in the future; it had to be paid in full every year and could not be treated as a reserve. Mr. Monet stated:⁸⁸

The essence of the word 'reserve' as found in Section 12(1)(3) (now s. 18(1)(e)) of the Act involves an element of contingency, an element of doubt or an element of discretion which is not an earmark of this particular fund, and the mere fact that discretion was involved in the amounts, and, to a limited extent, to whom these amounts were to be paid, is not evidence that there was any discretion with respect to the total amount itself. It did not affect its character as a liability of the company. This fund was a liability of the company at the end of the fiscal period 1952. It was then due, but it was not payable until December of the following year. The amount of the fund in question here was not set aside as a provision against the happening of an uncertain event in the future; there was nothing doubtful, contingent or estimated with respect to it: it had to be paid in full every year..... the said amount can not be treated as a reserve.

86. The related subject of reserves for instalment receivables in the United Kingdom is described *infra* at p. 128.

87. (1955) 14 Tax ABC 100.

88. *Id.*, at p. 102.

A decision to the opposite effect and also concerning employees bonuses is that of *Kerr Farms Ltd. v. M.N.R.* where Mr. Davis, stated:⁸⁹

The bonus payment was therefore contingent upon the continuity of employment of the person to which it was payable and the company had no legal obligation to make the payment until the expiration of the time allotted for the fulfillment of certain conditions of payment; in this case a minimum of one year and a maximum of two years. In such circumstances, according to the provisions of paragraph (e) of Section 12(1) (now s. 18(1)(e)) of the *Income Tax Act*, which states specifically that no deduction shall be made in respect of an amount transferred or credited to a reserve, *contingent account* or sinking fund unless expressly permitted by Part I of the said Act, it would seem that the appellant is not permitted to claim any part of the bonus fund as a deduction until it has actually been paid out by the company in accordance with the terms of the arrangement whereby it was established.

In *Acadia Overseas Freighters (Halifax) Ltd. v. M.N.R.*⁹⁰ the Minister refused to allow the taxpayer to deduct amounts set aside for the future payment of dues under a mutual insurance scheme and an amount set aside as a reserve to cover the cost of repatriating foreign seamen. Mr. Boisvert agreed with the Minister's contention that such expenses were properly deductible only in the year in which they occurred and also distinguished a reserve from a liability as follows:⁹¹

What the taxpayer sought to deduct from income was not an actual outlay, but a sum it set aside so as to enable it to meet payments at some unascertainable dates and for unascertainable sums, either under contracts of employment with Lascar seaman, or an insurance contract with The United Kingdom Mutual Steam Ship Assurance Association Limited. A liability to pay *in futuro* is a contingency, that is, something 'doubtful of uncertain, conditioned upon the occurrence of some future event which is itself uncertain or questionable' (*Black's Law Dictionary*); therefore, it is not an outlay or expense within the meaning of Section 12(1) (a) (now s. 18(1) (a)) of the Act, and it is expressly prohibited by paragraph (e) of said Section 12(1) (now s. 18(1)).

Again, the taxpayer was faced with the traditional argument that while it may be proper to deduct a reserve for estimated expenses under sound accounting or business practice, the governing legislation must decide whether such deduction is permissible for tax purposes. Mr. Boisvert quoted from Thorson, P., as follows:⁹²

...But it is well established that for income tax purposes accountancy practice, however sound it may be, must give way before the provisions of the *Income War Tax Act*, and that if there is any conflict between them the provisions of the Act must prevail.

89. (1971) Tax ABC 804 at p. 814; see also *Supreme Mechanical Contractors Limited v. M.N.R.* (1971) Tax ABC 202 and *Quebec Photo Service Inc. v. M.N.R.*: 67 D.T.C. 315, at p. 319 (T.A.B.).

90. (1962) 28 Tax ABC 331; see also *North American Automobile Association Ltd. v. M.N.R.* (1963) 33 Tax ABC 395 also relating to estimated insurance premiums; a deduction was not allowed on the same reasoning as in *Acadia Overseas Freighters (Halifax) Ltd. v. M.N.R.*

91. *Id.*, at p. 335.

92. *Trapp v. M.N.R.* (1946) Ex. C.R. 245, at p. 249.

Then Mr. Boisvert concluded that “deductions are not allowable for anticipated or inevitable losses nor contingent liabilities”,⁹³ relying on the following statement of Lord President Clyde:⁹⁴

It is a general principle, in the computation of the annual profits of a trade or business under the Income Tax Acts, that those elements of profit or gain, and those only, enter into the computation which are earned or ascertained in the year to which the enquiry refers; and in like manner, only those elements of loss or expense enter into the computation which are suffered or incurred during that year. ... There is no precedent that I know of for a claim such as that made by the Appellants in the present case, although all commercial enterprise is subject to vicissitudes which may be, and now and then are, serious enough to cause grievous loss and even disaster. I confess to thinking that it would be a dangerous innovation to allow apprehended losses *in futuro* to constitute proper matter for deduction from the present profits of commercial undertakings.

Finally, Mr. Boisvert stated that s. 18(1)(e) would not apply only if the amounts which the taxpayer was seeking to deduct were deductible reserves under s. 20(1)(m).⁹⁵ He found that the insurance dues and the repatriation expenses could not be deducted as a reserve for “services” under s. 20(1)(m) (11).⁹⁶ Furthermore, the provisions of s. 20(7)(a) preventing the deduction of reserves in respect of guaranties, indemnities or warranties and s. 20(7)(c) prohibiting the deduction of reserves in respect of insurance would prevent the deductions which the taxpayer was seeking.

2. *Prohibited Reserves: Canada: s. 18(1)(3) of the new Act*

The problem with reserves for contingent liabilities is that they are expressly prohibited by s. 18(1)(e) which states:⁹⁷

18.(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

RESERVES, ETC.

(e) an amount transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by this Part;

The problem is further complicated by s. 20(7)(a) which does not allow a deduction as a reserve in respect of indemnities or warranties.⁹⁸

The case of *Kenneth B.X. Robertson, Limited v. M.N.R.*⁹⁹ provides a good example of how s. 18(1)(e) operates. The taxpayer was an insurance

93. (1962) 28 Tax ABC 331, at p. 336.

94. *Edward Collins & Sons Ltd. v. C.I.R.* (1924) 12 T.C. 733, at p. 780.

95. *Infra*, at p. 91 where s. 20(1)(m)(ii) is discussed.

96. *Ibid.*

97. Formerly s. 12(1)(e) of the old Act and s. 16(1)(d) of the *Income War Tax Act*, c. 97 R.S.C.

98. The subject of reserves for guaranties, indemnities or warranties is discussed *infra*, at pp. 96-97.

99. (1944) C.T.C. 75;

broker and set up a reserve for unearned commissions because of the possibility of policy cancellations in future taxation years. The Minister successfully asserted that amounts received by the appellant were income and that the amounts deducted by way of reserve were not allowed by virtue of the provisions of s. 18(1)(e).

Despite the fact that such reserves represented the application of sound accounting principles, Thorson, J. held that:¹⁰⁰

...It does not follow that, because an accounting practice is a sound one, it is permissible for income tax purposes. If there is a conflict between sound accounting practice and the clear intentment of the taxing Act, the latter governs.

Thorson, J., reduced the problem into two aspects; namely that the amounts received by the appellant fell into profits for the year and accordingly s. 18(1)(e) prohibited a transfer of any part of profits into a contingent account. If the amounts received by the taxpayer had not fallen into income and therefore profits of the year, s. 18(1)(e) would not have applied.

Thorson, J. held that the taxpayer was attempting to deduct a contingent liability:

...a taxpayer cannot deduct from his income any amount to meet contingent liabilities. The fact that it would be wise or prudent to do so has no bearing on the matter ... every reserve set up out of profits or gains of whatever kind, which seeks to provide against the happening of uncertain future events, is excluded as a deduction, except insofar as the Act permits.¹⁰¹

Thorson, J. then held that the amounts received by the appellant had to be included in income and stated:

...the test of taxability of the income of a taxpayer in any year is not whether he earned or became entitled to such income in that year but whether he received it in such year, and the taxpayer has no right to have income received by him during a taxation year distributed for tax purposes over the years in respect of which he may have earned or become entitled to such income.¹⁰²

The *Robertson* case should perhaps be contrasted with the *Atlantic Engine Rebuilders*¹⁰³ case where the Supreme Court held that the amounts received by the taxpayer did not form part of its income. However since the taxpayer had the use of the money, it is arguable that the Supreme Court was really allowing the deduction of a reserve for a contingent liability but faced with the provisions of s. 18(1)(e), the

100. *Id.* at p. 85.

101. *Id.* at pp. 88-9.

102. *Id.*, at p. 89; this dictum is now reversed by the provisions of s. 12(1)(b) which includes a "receivable" in income; s. 12(1)(b) is discussed *supra* at p. 34.

103. *Supra*, n. 52. The *Atlantic Engine Rebuilders* decision is discussed *supra*.

Supreme Court evaded the issue by holding that the taxpayer had received amounts which did not form part of its income. It really amounts to the same thing and the *Atlantic Engine Rebuilders* case remains an enigma which may only be understood by the above approach.

On the other hand, the judgment of the Supreme Court of Canada in *Time Motors Limited v. M.N.R.*¹⁰⁴ is more encouraging. Here the taxpayer was a used car dealer which issued credit notes as part payment in purchasing used cars. The Minister argued that such credit notes did not create a current liability but rather a prohibited contingent reserve under s. 18(1)(e).

On this occasion, the Supreme Court, sided with the taxpayer's use of "proper accounting principles" in holding that s. 18(1)(e) did not apply. Here the Supreme Court held that the credit notes represented a liability rather than a contingent reserve. In allowing the appeal, Pigeon, J., delivering a unanimous judgment, stated:¹⁰⁵

The wording of that provision clearly refers to accounting practice. The only expression applicable to the present case is not 'contingent liability' but 'contingent account'. This means that the provision is to be construed by reference to proper accounting practice in a business of the kind with which one is concerned. In the present case, the only evidence of accounting practice is that of appellant's auditor, a chartered accountant. His testimony shows that in appellant's accounts credit notes are treated according to standard practice as current liabilities until they are redeemed or expired. They are not classed as contingent liabilities. When asked why he considered the obligation under a credit note as current liability and the obligation under a warranty as contingent, he said:

... the credit note, while it is a liability, is also an existing obligation today. A warranty may be a liability in the future. It may be determinable in the future but isn't an existing obligation until the future. At least, this is my interpretation of the difference.

With respect, Gibson, J. was in error in holding that whether or not appellant's financial statements were drawn up according to general accepted accounting principles they could be disregarded. On the contrary, the wording of the relevant provision of the *Income Tax Act* implies that this is the essential question.

The pendulum had swung in favour of a taxpayer's use of generally accepted accounting principles. However any optimism for such a refreshing approach is dashed by the reasoning of Noel, J. in *J.L. Guay Ltee v. M.N.R.*¹⁰⁶ where the taxpayer was a building contractor which paid its subcontractors monthly but retained 10% of the amount due until the job was finished. These holdbacks became payable 35 days

104. (1969) C.T.C. 190 (S.C.C.).

105. *Id.*, at pp. 192-3.

106. 71 D.T.C. 5423 (F.C.T.D.); upheld an appeal, (1973) C.T.C. 506.

after the issuance of the architect's certificate that the work was completed. The Minister denied a deduction of \$277,000 of holdbacks in 1965 on the basis that the amounts were neither due nor payable during 1965 arguing that it was not always certain that the architect would give his approval. As the work had not been certified in 1965 by the architects, the Minister asserted that they could not be deducted in 1965. The taxpayer, on the other hand, argued that eventually the subcontractors would be entitled to payment. Even if their work was unsatisfactory, another contractor would have to be paid for remedying the defective workmanship so that because the amounts would have to be paid inevitably, regardless of whether the identity of the payee was ascertained, the amount sought to be deducted could not be construed as credited to a reserve or contingent account within the meaning of s. 18(1) (e). However, Noel, J., held otherwise and favoured the statutory rules for determining profit over "generally accepted accounting principles" Noel, J., stated:¹⁰⁷

In determining the taxable profits of a taxpayer we can take as a starting point the profit and loss statement prepared according to the rules of accounting practice. However, the profit shown on this statement has always to be adjusted according to the statutory rules used in determining taxable profits.

After reviewing *Southern Railway of Peru Ltd. v. Owen*,¹⁰⁸ where the House of Lords refused to allow the deduction of a reserve which their Lordships considered to be made for uncertain amounts which the company might be called upon to pay in the future, Noel, J., concluded his judgment in the following manner:¹⁰⁹

As a general rule, if an expenditure is made which is deductible from income, it must be deducted by computing the profits for the period in which it was made, and not some other period.

The procedure adopted by appellant, of deducting from its income amounts withheld by it, which it may one day be required to pay its sub-contractor, but which the latter may not claim until 35 days after the work is approved by the architect, is, as we have just seen, contrary to the rule that an expenditure may only be deducted from income for the period in which it was made, and this would suffice to dispose of the present appeal. However, as we have seen above, there is an additional reason for dismissing the appeal: this is that we are dealing with amounts withheld which are not only uncertain as to quantum if partial damages result from badly done work, but which will no longer even be due or payable if damages exceed the amounts withheld. How can it be claimed in such circumstances that a certain and current expense is involved, and that the amounts withheld which appellant has full enjoyment of until it pays the amounts owing to the sub-contractor, or until compensation becomes due, may be deducted by appellant as it receives them from the owner.

107. *Id.*, at p. 5426.

108. (1957) A.C. 334 (H.L.). this important decision is discussed *infra*, at pp. 54, 57 and 97.

109. 71 D.T.C. 5423, at p. 5427.

This judgment not only deals with contingent amounts, but also implicitly deals with the matching principle i.e. costs should be deducted in the fiscal period in which the revenues which they produce are recognized. However, there will be some distortion of the profit and loss statement according to the method prescribed by Noel, J. The taxpayer's approach, in our view, would result in more consistency. Under the taxpayer's method, there would not be wide swings between profit in one year and loss in the next. Moreover, with respect, Noel, J.'s judgment is based upon a misreading of the decision of the House of Lords in *Southern Railway of Peru v. Queen*.¹¹⁰ In the *Southern Railway of Peru* case, the taxpayer charged against each year's receipts the cost of making provision for the retirement payments which would ultimately be thrown on it, calculating what sum would be required to be paid to each employee if he retired without forfeiture at the close of the year and setting aside the aggregate of what was required insofar as the year had contributed to the aggregate. Their Lordships dismissed the appeal because in calculating the deduction, the taxpayer had ignored the factor of discount. However, Lord Radcliffe expressly stated that reserves may be deducted where they have been reasonably quantified. The appeal was dismissed because there did not appear to be any accurate method of computing a reserve. Lord Radcliffe stated:¹¹¹

But there is no difficulty if we accept the main argument of the Crown. That argument is that, quite simply, there is a rule of law which forbids the introduction of any provision for future payments in or payments out, if the right to receive them or the liability to make them is in legal terms contingent at the closing of the relevant year. The rule, it seems, is absolute and must be adhered to whatever the current principles or practices of commercial accountancy may require as a method of ascertaining the year's profits... Now, in my opinion, there is no such rule of law governing the ascertainment of annual profits.

Further in his judgment Lord Radcliffe lucidly stated:¹¹²

...I think that for liabilities as for debts their proper treatment in annual statements of profit depends not upon the legal form but upon the trader's answers to two separate questions. The first is: Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations? The second is: Do the circumstances of the case, which include the techniques of established accounting practice, make it possible to supply a figure reliable enough for the purpose?

It is arguable that the taxpayer in the *Guay* case would have answered the above questions affirmatively. On the other hand, the reasoning of Noel, J. may be considered just as logical where he states:¹¹³

110. (1957) A.C. 334 (H.L.).

111. *Id.*, at p. 355.

112. *Id.*, at p. 357.

113. 71 D.T.C. 5423, at p. 5426.

It seems to me, therefore, that it is far from certain that the amounts so withheld will be paid in full to the sub-contractor. In fact, the payment of these amounts to the sub-contract is perhaps to be regarded, if damages are incurred, as contingent. It is true that, once fixed, such damages may be offset by the amounts withheld, and that the general contractor will not benefit therefrom, but the damages have not yet been liquidated for 1965, and compensation cannot be paid until they are. Until then, and even after, until the architect has issued his certificate and 35 days have elapsed, the general contractor is under no obligation to pay this amount, and it is not claimable by the sub-contractor.

The subject of whether a deduction is a contingent liability within s. 18(1) (e) has plagued the courts in Canada in the past and will continue to do so as long as the provision remains part of our taxing statute. Much depends on the definition of a contingent liability. Is it an obligation that may arise out of present circumstances provided certain possible events occur? *Simon's Income Tax*¹¹⁴ reviews the subject of contingent liability as follows:

In computing the profits of a trade it is the normal accountancy practice to allow as an expense any sum in respect of liabilities which have accrued over the accounting period, and to make a deduction of such sums from the receipts. But generally no deduction can be made in computing the profit of a given accounting period, for a liability which has not yet accrued, even though there is a contingency that it will accrue in the future. But there is no universal rule on this topic and the question has to be decided on the facts of each case, and particularly on the facts showing the nature of the business in question, and those indicating the degree of contingency. If the contingency is near to a certainty, there may be good reason for a deduction.

The *Concise Oxford Dictionary* defines "contingent"¹¹⁵ as follows:

Of uncertain occurrence, accidental; incidental to; true only under existing conditions; non-essential; conditional.

"Contingency"¹¹⁶ is defined as follows:

Uncertainty of occurrence; chance occurrences; thing that may happen hereafter; thing dependant on an uncertain event; thing incident to another, incidental expenses, etc.

These definitions still do not give us much assistance since each case will be dependent upon its own facts. We shall return to this difficult and confusing area of reserves for contingent liabilities in

114. Mustoe, *Simon's Income Tax* (London: 1965) Vol. II Replacemenn 1964-65, at p. 342.

115. Fowler and Fowler, *The Concise Oxford Dictionary of Current English* 5th ed., (Osford, 1964, at p. 264.

116. *Ibid.*

Canada in our conclusion ¹¹⁷. However a list of cases is set out below ¹¹⁸ which includes nearly all the reported Canadian cases with decisions turning on an interpretation of s. 18(1) (e).

3. *Contingent Liabilities and "Rough Reserves": ¹¹⁷ in the United Kingdom.*

There are no specific statutory prohibitions in the U.K. Act relating to the use of reserves. The extent to which reserves may be used in England must of necessity be gleaned from a study of the relevant case law of the United Kingdom.

(a) *Contingent Liabilities in the United Kingdom.*

The most recent case in England relating to reserves is *Southern Railway of Peru v. Owen* ¹¹⁸ where Lord Radcliffe gave approval to the use of reserves in the following manner ¹¹⁹:

It is clear . . . that there is nothing improper in admitting valuations or estimates if by so doing a truer balance is arrived at between the receipts of a year and the cost of earning them or the expenses of a year and the fruits of incurring them . . . however desirable it may be to bring in a valuation or estimate in order to give a better balance to a year's accounts, it cannot be right to do so if the figure which is to be inserted, 'hedged round . . . with every kind of contingency and speculation', is too uncertain to be fairly treated as a receipt. What is true of receipts is true of liabilities. In my opinion, it is that point which constitutes the real difficulty of the present case.

Lord Radcliffe dealt with the real problem relating to reserves: the amount of the reserve must be exactly quantified, for otherwise the taxation of profits will depend on uncertainties and contingencies. His Lordship went on to postulate two questions the answers to which will be determinative of the use of reserves.

But, whatever the legal analysis, I think that for liabilities as for debts their proper treatment in annual statements of profit depends not upon the legal form but

117. *Infra* at p. 192.

118. *Western Vinegars Ltd. v. M.N.R.* (1938) Ex. C.R. 45, a reserve for returnable containers was allowed; *D. v. M.N.R.* (1950) 2 Tax ABC 1, volume rebates for customers was held to be a contingent liability; *Wood-Mosaic Ltd. v. M.N.R.* (1950) 3 Tax ABC 174, reserves for deferred maintenance and repairs was held to be prohibited by s. 18(1) (e); *William Collins & Co. Ltd. v. M.N.R.* (1951) 4 Tax ABC 142; *Harlequin Books Ltd. v. M.N.R.* (1954) Tax ABC 286, in each case, no reserve was allowed for returnable books; *No. 49 v. M.N.R.* (1952) 6 Tax ABC 145, no reserve was allowed for typesetter's returnable type; *Capital Trust Ltd. v. M.N.R.* (1952) 7 Tax ABC 19; *No. 64 v. M.N.R.* (1952) 7 Tax ABC 35; *J. J. Joubert Ltee v. M.N.R.* (1952) 8 Tax ABC 268, all involved the disallowance of reserves for unredeemed tickets (prior to the enactment of s. 85B of the old Act); *Quebec Photo Service Inc. v. M.N.R.* (1967) Tax ABC 425, employer's liability for sick leave credits of employees was held to be owing to employees and not a reserve prohibited by s. 18(1) (e); *Canada Packers Ltd. v. M.N.R.* (1968) Tax ABC 847, holiday pay was charged to expenses at a flat weekly rate, the excess was disallowed as a contingent reserve under s. 18(1) (e); *Supreme Mechanical Contractors Limited v. M.N.R.* (1971) Tax ABC 202, salaries were accrued and unpaid but the payees were not identified, it was held that the account was a prohibited reserve under s. 18(1) (e).

117. Per Lord Radcliffe in *Southern Railway of Peru v. Owen* (1957) A.C. 334 at p. 358.

118. (1957) A.C. 334 (H.L.); the facts of the case are set out *supra*.

119. *Id.*, at p. 355.

upon the trader's answer to two separate questions. The first is: Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations? The second is: Do the circumstances of the case, which include the techniques of established accounting practice, make it possible to supply a figure reliable enough for this purpose? The authorities . . . are, no doubt, very relevant in answering the second question, as must be the mere fact that an obligation is in its own terms contingent; but I regard them rather as illustrations of the kind of answer that should be given than as laying down any general principle or rule of law.¹²⁰

*Sun Insurance Office v. Clark*¹²¹ further illustrates the difficulties encountered with contingent liabilities. Here the taxpayer, an insurance company,¹²² annually charged off to reserve in its accounts 40% of its annual premium receipts in order to provide for estimated losses on unexpired risks. The House of Lords agreed with the taxpayer that the percentage was a fair and reasonable allowance on the facts of the case and that the amounts put to reserve formed no part of the profits or gains of the year.

Earl Loreburn, L.C. attempted to summarize when "estimates" (i.e. reserves) could be used as follows:¹²³

In the hope that it may help to prevent future misunderstanding I will recapitulate my own opinion. There is no rule of law as to the proper way of making an estimate. There is no way of estimating which is right or wrong in itself. It is a question of fact and figures whether the way of making the estimate in any case is the best way for that case. Experience seems to have satisfied courts of law for a considerable time that the method . . . is a useful working rule. But no one has said in this House that there is any constraint to accept it. It may be that the character or mode of carrying on this insurance business may alter or may have altered, and what was a good method once may become inaccurate or even obsolete.

In referring to the earlier case of *Gresham Life Assurance Society v. Styles*,¹²⁴ Lord Atkinson directly alluded to the matching principle by stating that reserves were deductible in circumstances where they represent the cost of earning the receipts of the taxpayer:¹²⁵

That case clearly decided that the receipts of a business are not in themselves profits and gains within the meaning of the Income Tax Act; but that it is what remains of those receipts after there has been deducted from them the cost of earning them which constitutes the taxable profits and gains.

120. *Id.*, at p. 357.

121. (1912) A.C. 443 (H.L.).

122. "There is no ground for holding that the decision of this House in *Sun Insurance Office v. Clark* must be confined exclusively to insurance companies". Per Lord Tucker in *Southern Railway of Peru v. Owen*, *supra* n. 117 at p. 361.

123. (1912) A.C. 443 at p. 454.

124. (1892) A.C. 309 (H.L.).

125. (1912) A.C. 443 at p. 460.

Consequently, it was Lord Atkinson's view that the reserves sought to be deducted by Sun Insurance Office merely represented "the cost of earning" its premium income and therefore the reserves were properly deductible.

On the other hand, the *Southern Railway of Peru* and *Sun Insurance Office* decisions must be contrasted with *Peter Merchant, Ltd. v. Stedeford (Inspector of Taxes)*¹²⁶ where the Court of Appeal held that a distinction had to be drawn between a properly deductible liability and a non deductible contingent liability. The taxpayer operated cafeterias in factories where the factory owner leased the cafeteria, including all the crockery, cutlery and utensils, and other necessary equipment to the taxpayer on a profit sharing basis. Because of the war conditions, the taxpayer was unable to comply with its covenant under such leases to "maintain" the crockery, cutlery and utensils in their original quality and quantity by replacing any that disappeared or became obsolete or damaged.

Owing to the scarcity of supplies due to war conditions, in its annual accounts, the taxpayer deducted a sum to reserve for its liabilities to effect replacements as soon as the required equipment became available. The Court of Appeal held that the amounts put to reserve were not permitted deductions because the provision was made for a non-existent liability. But the decision is really based upon a narrow interpretation of the contract between the taxpayer and factory owner because the Court of Appeal held that the taxpayer had a liability to replace broken crockery only upon the termination of any particular lease. In refuting the evidence of an independent chartered accountant that the accounts had been prepared according to sound commercial accounting, and that he would not have certified the financial statements of the taxpayer unless the reserves were deducted, Tucker, L. J., stated:¹²⁷

But, whatever view may be taken with regard to that, it is quite clear that this deduction has been made by him because he has interpreted this contract as imposing an obligation on the caterers to make good, on the year when the losses occurred, the utensils lost, at their then value, which, incidentally, it is to be observed is in each case at a very high figure, because it is only when the cost is prohibitive or when the articles are unprocurable that this method is used; and, therefore, the accountant has clearly formed the view, and it is the basis upon which he has proceeded, that that was the liability of the caterers; that is to say that the factory owners in any one year could have sued the caterers when they had failed to replace any of these utensils and got damages from them based on the then prohibitive cost of the article.

126. (1943-9) 30 T.C. 496 (C.A.).

127. *Id.*, at pp. 509-10.

In my view this contract imposes no such obligation on the caterers . . . It is assumed that they were liable to make good, at the highest figure, these articles whenever they were lost or damaged.

Now, I do not think that was the obligation. No doubt, when these contracts terminate — which may be many years hence if they go on running until terminated in accordance with the paragraph to which I have referred — if at that time any of the articles are missing or have not been replaced, no doubt there will be an obligation on the part of the caterers to make good the loss, but that would be based upon the cost of replacement at that date, and in the meantime they have opportunity under the contract to replace these articles as and when they can at times when the price may have fallen. In fact that is the very object of postponing the replacement, to wait until there may be a fall in the value of the articles.

In my view the factory owners would be unable to prove during the currency of the contract that they had suffered any damage by the omission merely to replace the articles. At any rate they would not be able to recover damages based upon the then value of the articles. That is the very basis of the deduction, and I think it is founded on an erroneous interpretation of the obligations of the caterers under this contract.

Tucker, L.J. then went on to state that the taxpayer was attempting to deduct a contingent liability:¹²⁸

The real liability under the contract, so far as the replacement of the utensils goes, was a contingent liability; it was a liability which would not arise until the termination of the contract, and it was contingent upon the inability of the caterers in the meanwhile to replace to utensils. In that sense it is, I think correct to say that the real liability under the contract was a contingent one. The actual liability that the accountant was dealing with was, I think, not contingent.

However that may be, for these reasons I think the very basis of Mr. Grant's case fails, because the expression of opinion by the accountant as to this being a proper item to deduct is founded upon an erroneous interpretation of the obligation of the caterers under the contract.

The *Peter Merchant* case illustrates the quandry of the taxpayer in preparing his accounts. The taxpayer has a quite different view of what is his real profit compared with the view of the tax gatherer. This case is an ideal example of the conflict between financial accounting and tax accounting.¹²⁹

The difficulty and obstacles that are presented by the revenue authorities and the courts in preventing the deduction of a reserve for an estimated expense is further illustrated by *The Naval Colliery, Ltd. v. I.R.C.*¹³⁰ In this case, the House of Lords held that the reserve sought to be deducted by the taxpayer represented a certain ascertained amount

128. *Id.*, at pp 510-11

129 The conflict between financial accounting and tax accounting is reviewed *supra*

130. (1928) 12 T.C. 1017 (H.L.)

but there was no liability to incur the expenditure provided for by the reserve. The sum could be deducted from the accounts for tax purposes only when the expenditure was actually made. The taxpayer operated a mine and in the last three months of its 1921 taxation year the mine was shut owing to a strike. Consequently, the mine was flooded because the taxpayer had no employees who were willing to cross the picket lines to operate the pumps to prevent such flooding and other damage. The taxpayer entered an amount to reserve for the cost of reconditioning the mine although no expenditure was made until the end of the accounting period when the strike was settled and the men went back to work.

In the Court of Appeal, Lord Hanworth, M.R. was of the view that the amount could not be deducted because it was not an expenditure which produced any receipts in the year: ¹³¹

In the present case such profits and gains as were realized by the sale of coal during the accounting period were made and gained wholly apart from this proposed expenditure. The sum reserved would be expended for the purpose of obtaining receipts in the future, but had no connection with obtaining the coal sold up to the 30th June, 1921. Profits in relation to any trade or business are defined by Lord Herschell (in *Russell v. Town and Country Bank*) to be 'the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts.' Tested by this, the sum reserved was not necessarily for earning the receipts realized in the accounting period.

Ignoring the question of whether or not the sum sought to be deducted was really on account of capital which was dwelt upon at some length, ¹³² Lord Wrenbury was of the view that there could be no profits during 'the accounting period from which to deduct the expenditure.' Lord Wrenbury stated: ¹³³

Nothing turns upon the fact that no payment was made during the accounting period. Had the business of mining coal been carried on during the accounting period and had the work been done during the accounting period with a view to earning profit during that period, the cost of the work would I think have been properly deducted in arriving at a profit for the period, for it would have been necessary current expenditures which must have been incurred if profit was to be earned and none the less so if it was not paid for until later. But the facts are that the Appellants were not seeking to earn a profit by mining coal during the period — they did not and could not do so. Their business of mining coal was necessarily suspended during the period — and in that business neither could profit be earned nor could loss be sustained. In the next accounting period (had there been one) when the mine was opened up again the cost of reconditioning

131. *Id.*, at pp. 1033-4. In essence Lord Hansworth, M. R. was agreeing with the opinion of Rowlatt, J. in the court below, where at p. 1029 Rowlatt, J. stated:

The sum sought to be deducted is not an expense of the accounting period, but it is an expense of running the mine after the accounting period, if you do so.

132. *Id.*, at p. 1044 per Lawrence, L. J.

133. *Id.*, 2 T.C. 321 at p. 327.

would no doubt have been deductible. But in the accounting period in question in my opinion it was not.

Sargent, L.J. ruled in favour of the taxpayer and in his dissenting judgment, his Lordship was of the view that the amount should have been permitted to be deducted in the taxation year in which the loss arose.¹³⁴

To my mind the foregoing contentions of the appellants prevail ... They were providing against a definitely ascertained loss which had accrued by the end of the accounting period, and which they were bound to defray, both as a necessity for the purpose of carrying on their business and under the direct stress of their obligations to their landlords. It was an existing loss chargeable against the profits of the period in which it was made, and liable to be defrayed in the ordinary course out of any moneys that might come to their hands in the succeeding period. It was throughout an income loss, and the date of the making of the loss, not the date when it was ultimately discharged, was the crucial date for determining the period to which the loss should be assigned.

The *Naval Colliery* case is again a splendid but unfortunate example of the plight of a taxpayer attempting to pay income tax on what he thinks is his "true profit". However the revenue authority and the courts thought otherwise and refused the desired deduction. While the amount would have been deductible in the following year, the taxpayer was attempting to reduce his liability for Excess Profits Tax which, only coincidentally, ended in the taxation year in question.

(b) Anticipated or Apprehended Losses in the United Kingdom

There are several English cases which have held that reserves for apprehended or anticipated losses in the future are not allowable. In *Edward Collins & Sons Ltd. v. C.I.R.*,¹³⁵ the taxpayer purchased raw materials for future delivery after its year end. Before the end of its taxation year, the market value of the materials fell and the taxpayer, in computing its profits for tax purposes, attempted to deduct the excess of the contract price of the undelivered goods over their current market value. It was held that the loss reserved against was not permitted because it was only an apprehended future one which had not been actually sustained in the accounting period in question.

Lord President Clyde first acknowledged that some elements in the computation of profit must of necessity depend on estimates.¹³⁶ However, he went on to state that apprehended losses are not allowable in computing the "true profit of a trader" as follows:¹³⁷

134. *Id.*, at pp 1039-40

135. (1924) 12 T.C. 773 (S.C.), followed by *Whimster & Co. v. C.I.R.* (1926) 12 T.C. 813 (S.C.) See also *Young v. I.R.C.* (1925) 12 T.C. 827 (S.C.).

136. *Id.*, at p 780

137. *Id.*, at p 783.

But, as it appears to me, this only serves to make it plain that what they are seeking to do is to put against the actual ascertained receipts from their business in one period a loss which is neither suffered nor incurred in that period. I know of no justification for this, either under the rules or principles of the Income Tax Acts, or in ordinary commercial accounting ... But it is not an exceptional experience to find that a commercial contract unexpectedly turns out to be unsuccessful, or that a commercial engagement undertaken in a sanguine spirit is seen to be fraught with unfavourable results long before the hour for its fulfilment arrives. After all, the problem is to ascertain the profits actually earned by the Appellants in their last accounting period.

With regard to anticipated losses which were the subject of a later case, Lord President Clyde stated:¹³⁸

It is quite possible that, although a balance sheet and profit and loss account shew favourable results at their date, the trader may be aware of circumstances affecting his line of trade which make the outlook for the immediate future pregnant with loss. The circumstances in question may be in anticipation only; or they may have already occurred, but their inevitable effect has not had time to reflect itself in the returns of his business. In such a case the trader may, as a matter of ordinary commercial prudence, decline to treat the profits shewn in his accounts in the same way as he would have done if the circumstances of his business had been liable only to the normal fluctuations of trade. He may, for instance, prefer to carry his profits forward, or put them to reserve, rather than consume or divide them. But they are none the less profits of the year or accounting period to which the accounts relate, and as such assessable to Income Tax or Excess Profits Duty.

By way of conclusion, let us stress that a reserve for a contingent liability will be allowed in situations where the following "vital" question is answered affirmatively - "is the sum provided an essential charge against the receipts of the trade in order to enable a true profit from that source to be stated for the year in question?"¹³⁹

B. Reserve for Doubtful and Bad Debts

1. Purpose and Application: Canada

Under s. 12(1) (d) of the new Act, all amounts deducted under s. 20(1) (1) as a reserve for doubtful debts in the immediately preceding year are included in computing the taxpayer's income for the immediately following taxation year. Under the complementary provisions of s. 12(1) (d) and s. 20(1) (1), reserves deducted in prior years are added back and a new reserve may then be deducted depending upon prevailing circumstances. "The reserve for doubtful debt provision is a standard accounting technique of general acceptance and can be recognized as a

138. *Whimster & Co. v. C.I.R.* (1926) 12 T.C. 813 at p. 823 (S.C.); see also *J. h. Young & Co. v. C.I.R.* (1925) 12 T.C. 827 at p. 839 (S.C.) where Lord President Clyde stated:

Moreover, anticipated loss in a future year or period, however inevitable it may be thought to be, is not, and cannot be, a loss on the trading of the present year, upon which it has not in fact fallen.

139. Per Lord Radcliffe, *Southern Railway of Peru v. Owen*, (1957) A.C. 334 at p. 361.

further refinement on accrual accounting in an attempt to match revenues and expenditure to obtain a truer estimate of the income ultimately derived from the business activity of any taxation year."¹⁴⁰ The interplay between s. 12(1) (d) and s. 20(1) (1) enables the Minister to annually review the entire reserve taken for prior years without the taxpayer arguing that the Minister is statute barred¹⁴¹ from reviewing amounts deducted under s. 20(1) (1) in previous years. This method applied to all reserves taken under s. 20.

2. *The Reserve for Doubtful Debts: Canada*

(a) *S. 20(1)(1) of the new Act*

This provision states:

20(1) Notwithstanding paragraphs 18(1) (a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

RESERVE FOR DOUBTFUL DEBTS

- (1) a reasonable amount as a reserve for
- (i) doubtful debts that have been included in computing the income of the taxpayer for that year or a previous year, and
 - (ii) doubtful debts arising from loans made in the ordinary course of business by a taxpayer part of whose ordinary business was the lending of money;

(b) *The Reserve for Doubtful Debts Which Have Previously Been Included in Income: s. 20(1)(1)(i)*

Under this sub-paragraph, doubtful accounts which are not yet considered as "bad" under s. 20(1) (p) may be partially deducted. As a condition to the deduction of a reasonable amount as a reserve under sub-paragraph (1) (i), the debt must have been included in computing the income of the taxpayer for the year or a previous year in which the reserve is deducted. Thus the deduction in sub-paragraph (1) (i) is restricted to ordinary trade accounts receivable arising from sales of merchandise or services and in general no deduction is permissible for doubtful debts arising outside the ordinary course of the taxpayer's business. The fact that the receivable has been included in income in prior years will enable its subsequent deduction if its collection becomes doubtful under s. 20(1) (1). In *Acadia Overseas Freighters Ltd. v. M.N.R.*,¹⁴² the appellant made loans to two Panamanian borrowers and then accrued the interest receivable thereon including the sums of

140. Labrie, *op. cit.*, *supra* n. 28 at p. 320

141. See s. 152(4) of the new Act.

142. (1964) 36 Tax ABC 246; see also the related cases of *Acadian Overseas Freighters (Halifax) Ltd. v. M.N.R.* (1964) 36 Tax ABC 252; *Falaise Steamships Co. Ltd. (No. 3) v. M.N.R.* (1963) 33 Tax ABC 1; these cases basically involved similar circumstances and the taxpayers had similar success before the Tax Appeal Board

doubtful receivability in income of prior years. The taxpayer was held to be able to deduct a reserve under s. 20(1) (1) (i) even though the loans did not arise in the ordinary course of its business. The crux of the decision was based on the fact that the taxpayer included the accrued interest, though of doubtful collectability, in its income of prior years.

The case of *Aldo Vickery v. M.N.R.*,¹⁴³ involving a dispute between two partners, further enlightens our understanding of s. 20(1) (1) (i). The taxpayer claimed a doubtful debt reserve for an amount owing to him by a realty firm in which the taxpayer claimed to be an equal partner. Mr. Weldon held that the taxpayer was not entitled to a reserve for doubtful debts. He stated that s. 20(1) (1) did not apply to partnership profits that were due and owing to a partner and that s. 20 (1) (1) only applied to doubtful trade debts. Mr. Weldon explained the purpose of s. 20(1) (1) as follows:¹⁴⁴

Section 11 (1) (e) (now s. 20 (1) (1)) appears to have been enacted to cover the situation where the taxpayer has been keeping his accounts on an accrual basis and has included in the taxation year in question or in a previous taxation year certain trade accounts which are receivable but have not been paid, and which he regards to be of a doubtful nature i.e., the debts may be uncollectable. In those circumstances, the said section permits the taxpayer to deduct from his income in the taxation year in question a reasonable amount as a reserve to cover the possibility of the doubtful debts not being paid in whole or in part and his business thereby suffering a loss in respect thereof. However, by reason of Section 6(1) (e) (now S. 12(1) (d)) of the Act, the amount of the reserve, claimed as aforesaid, must be added to or included in the taxpayer's income in the next succeeding taxation year. If, in that taxation year, the doubtful debts are still unpaid in whole or in part, a reasonable amount as a reserve for doubtful debts may again be deducted from the taxpayer's income, and so on from year to year.

On the basis of the above brief explanation as to what appears to be the purpose of Section 11(1) (e) now s. 20(1) (1) of the Act it is obvious that the said section was intended to cover the type of situation where the taxpayer has doubtful trade debts which have actually been included in his income for the taxation year in question or in a previous taxation year, and does not cover the type of debt which is in question in this appeal, namely, a debt - if it actually is a debt - which has arisen out of a dispute between the two partners and erstwhile business associates, Aldo Vickery and Byron Price.

It was not equitable to have denied the taxpayer his deduction in this case. However, Mr. Weldon was faced with the provisions of the old Act to the effect that the taxpayer was deemed by s. 6(1) (c) of the old Act (replaced by the combined operation of s. 96(1) (f) and s. 12(1) (1)) to have received the amount owing to him by the partnership. However he was denied the deduction of a reasonable amount as a reserve because the "deemed amount" did not constitute an account receivable. Essentially, the taxpayer in the Vickery case was forced to pay tax on

143. (1968) Tax ABC 1168.

144. *Id.*, at pp. 1174-4.

money which he might never receive. In light of the decision in the *Acadia Overseas Freighter*¹⁴⁵ case, this decision appears even more inequitable. Presumably if a similar case involving partners arises under the new Act, the amount included in the income of the taxpayer by s. 96(1) (f) and s. 12(1) (1) will be added to the adjusted cost base of the taxpayer's interest in the partnership under s. 53(1)(e)(i) and any amounts of partnership income actually distributed to the partner will be deducted in computing the adjusted cost base under s. 53(3) (e)(v). While a complete examination of the taxation of partnerships under the new Act is certainly beyond our scope, it would appear that the harshness arising from the decision in the *Vickery* case may be somewhat alleviated by s. 53(1) (e)(i) since a subsequent sale by the taxpayer at less than adjusted cost base would result in a capital loss to the taxpayer one-half of which would be deductible from income.

(c) The Reserve For Doubtful Debts Arising From Loans Made in the Ordinary Course of Business: S. 20(1) (1) (ii)

(i) Loans Required by Custom of the Trade

The condition necessary for the deduction of a reserve for doubtful debts under sub-paragraph (1) (ii) is that they must arise from loans made in the ordinary course of business by a taxpayer part of whose ordinary business was the lending of money. If it is the "custom of the trade" to make advances or loans to persons on whom the profitability of the business depends, this will be sufficient for the purposes of paragraph (1)(ii).¹⁴⁶ Many cases have arisen in the Canadian lumber and fishing industry. In *Maritime Lumber Distributors Limited v. M.N.R.*,¹⁴⁷ the taxpayer sought to deduct a reasonable amount as a reserve under paragraph (1)(ii) and the Minister claimed that the deduction should be disallowed under s. 18(1)(e). In this decision, Mr. Fisher held that lending money to lumber operators was an integral part of the appellant's business and the taxpayer was therefore entitled to deduct a reserve for doubtful debts. Mr. Fisher stated:¹⁴⁸

The evidence showed that it was the general practice of lumber dealers in Nova Scotia to operate in this, or a similar, manner in connection with these small lumber operators, and it was stated that, unless financing of the lumber operators was carried out in this way, the business of the lumber wholesalers such as the appellant would be very considerably restricted. The method of financing carried out as indicated above enables the appellant to get a much larger volume of business and makes it possible for it to compete with others who follow the same procedure.

145. *Supra* no 142.

146. *H. R. Morris Ltd. v. M.N.R.* (1967) Tax ABC 582.

147. (1953-54) 9 Tax ABC 1.

148. *Id.*, at p. 5.

While not directly pertaining to s. 20(1)(1), in a case²³³ involving a movie theatre company, the taxpayer advanced monies to a film distributor to assist in bringing a film to Canada for future showing at its theatre. The film later was banned from exhibition to the public and the taxpayer sought to deduct the unrecovered amount as a bad debt under s. 11(1)(e) of the 1948 Income Tax Act (now s. 20(1)(p)). The Minister disallowed the deduction asserting it did not fall within the bad debt provisions and that it was not made or incurred for the purpose of gaining or producing income. (s. 18(1)(a).) In giving judgment for the taxpayer Mr. Fisher stated:¹⁵⁶

After hearing the evidence produced by the taxpayer, I am satisfied that, in the ordinary course of its business and in accordance with the custom of the business in connection with the specialty type of picture which was involved in this transaction, the appellant made the advance to Maynard - which it had the power to do under the provincial legislation - for the express purpose of enabling it to obtain the film for exhibition in its theatre in order to earn income thereby, and that this expenditure was not a capital investment made by it. The monies in question here were, in my opinion, advance rental paid to the distributor by the company, which rental it was anticipated would be recouped out of the box office proceeds from the exhibition of the film in the appellant's theatre if it had not been repaid earlier, but that the situation which developed, through no fault of the taxpayer, under which the showing of the film was cancelled by the Board of Movie Censors, caused the appellant to suffer a business loss which should be allowed as a deduction when determining its taxable income, as such a deduction is not prohibited by either of the sections of the Act upon which counsel for the Minister relied at the hearing.

Even if a taxpayer does not fall exactly within the provisions of s. 20(1)(1)(ii), it may be possible for him to argue, in any event, that the advance or loan was made as "seed money" for the purpose of gaining or producing income and consequently deductible under the provisions of s. 18(1)(a).

(ii) Whether Taxpayer a Money Lender

There have been a great many cases where the taxpayer has been denied the deduction under s. 20(1)(1)(ii) because he was not in the money lending business. Let us determine the criteria for establishing whether one is in the money lending business. The word "business" in the new Act is defined in s. 248(1) as follows:

'Business' includes a profession, calling, trade, manufacture or undertaking of any kind whatever and includes an adventure or concern in the nature of trade but does not include an office or employment.

This wide definition must however be read in the light of the leading Canadian decision on the subject of money lending, *C.A. Orban v.*

149. *Danforth-Woodbine Theatre Limited v. M.N.R.* (1953-54) 9 Tax ABC 382.

150. *Id.*, at p. 385.

*M.N.R.*¹⁵¹ Here the taxpayer made three loans in three years and sustained a loss which he sought to deduct by claiming that he was a money lender. The Minister disallowed the deduction asserting that the loss was a capital one within the meaning of s.18(1) (b). Mr. Fordham dismissed the taxpayer's appeal stating that he was not a money lender. Mr. Fordham, reached his decision by reviewing three earlier English decisions under the British Money Lenders Act of 1900 as follows:¹⁵²

If the appellant is to succeed, it must be established that he qualifies as a professional money-lender. The determination of this point has afforded me some difficulty and resort has been had to reported cases on the subject. In *Litchfield v. Dreyfus*, (1906) 1 K.B. 584, at page 489, Farwell, J., said:

But not every man who lends money at interest carries on the business of money-lending. Speaking generally, a man who carries on a money-lending business is one who is ready and willing to lend to all and sundry, provided that they are from his point of view eligible ... it is a question of fact in each case.

He found that the plaintiff in that case, a long established art dealer, was not a money-lender also. Referring to that case later, Walton, J., said in *Newton v. Pyke* (1908), T.L.R. 127, at page 123:

Whether a man was carrying on a business as a money-lender must be, as was pointed out in *Litchfield v. Dreyfus*, a question of fact in each case. It seems impossible to lay down any definition or description which would be of much assistance, but I feel that it is not enough merely to shew that a man has on several occasions lent money at remunerative rates of interest; there must be a certain degree of system and continuity about the transactions.

In *Nash v. Layton*, (1911) 2 Ch. 71, at page 82, Buckley, L.J., said:

Whether a man is a money-lender or not is an investigation whether he has done such a succession of acts as that upon the facts proved by establishing that those acts were done the Court arrives at the conclusion as matter of law that he falls within the definition of a money-lender...

In dismissing the taxpayer's appeal, Mr. Fordham, concluded by stating:¹⁵³

On the facts established and considering the foregoing authorities, I cannot find that appellant was a money-lender, properly so called. It appears to me that he was more of an investor. He did not hold himself out as being a money-lender, and that he had some money available was known to only a few individuals with whom he was acquainted. He neither advertised himself nor was listed anywhere as a money-lender. I have reached the conclusion that, unfortunate as it may be, what the appellant lost must be regarded as a capital loss and not deductible from his net income and that no ground raised by him in his notice of appeal can the relevant assessment be disturbed.

151. (1954) 10 Tax ABC 178

152. *Id.*, at pp. 179-180

153. *Id.*, at pp. 180-181.

S. 20(1) (1) (ii) is far too restrictive in the requirement of carrying on a money-lending business. If a pool of venture capital is required for the expansion of Canadian business it seems only equitable that those Canadians who take the risk of lending to new businesses should be permitted to deduct all of their losses from income. Admittedly, the new Act contains new provisions for the taxation of one-half of capital gains realized and the deduction of one-half of capital losses sustained but these provisions do not go far enough. The new Act should encourage greater Canadian investment. The case of *W.H. Enterprises Limited v. M.N.R.*¹⁵⁴ is illustrative of this point. Here the appellant deducted a reserve for a doubtful debt. The Minister disallowed the claim because no part of the appellant's business consisted of lending money. After selling its business in 1963 for a substantial sum, the appellant's name was changed and it was empowered "to acquire for the purpose of deriving income therefrom" stocks and securities. Twelve financing arrangements (some taking the form of mortgage loans) were subsequently entered into over a period of two years, two of which resulted in the disputed loss deductions. The appellant claimed to be in the business of lending money within the ambit of s. 20(1)(1) but the Minister succeeded in arguing before the Board that the amounts sought to be deducted were non-deductible outlays on account of capital because the taxpayer was an investor rather than a money lender. Mr. Davis reviewed the authorities previously referred to and stated:¹⁵⁵

The evidence in the present matter, lengthy and involved as it was, established that in all cases where the appellant advanced funds it was moving into an area of assisting companies desirous of developing new ventures related to the plastic industry in which Mr. Wasyluk had great personal interest and for which he had great sympathy as a result of the fact that he himself had pioneered a company and a new packaging concept which had been very successful and out of which he had made the substantial amounts of money which he now had to invest.

Here was a case where an entrepreneur was taking the risk of providing "venture capital" yet he was denied a deduction under s. 20(1)(1). The legislation should be amended to make the deduction of a reserve for a doubtful debt more flexible and less arbitrarily based upon decisions arising from the interpretation of the Moneylenders Act of 1900. Surely a new approach is needed in the '70's!

The *W.H. Enterprises* case should be contrasted with the decision in *Liberty Watch Case Co. Ltd. v. M.N.R.*¹⁵⁶ where Mr. Boisvert, did not have the *Orban* decision¹⁵⁷ brought to his attention and found in favour of the taxpayer by holding that it was in two businesses one of which was

154. (1971) Tax ABC 530.

155. *Id.*, at p. 547.

156. (1969) Tax ABC 78.

157. (1954) 10 Tax ABC, *supra*.

the lending of money. Accordingly a reserve for a doubtful debt under s. 20(1)(1)(ii) was allowed. However, in a later case,¹⁵⁸ Mr. Fordham regarded the *Liberty Watch* decision as being incorrectly decided. The *Liberty Watch* decision is intriguing because it indicates how flexible the courts and the statute should be on the subject of doubtful debts. The *W.H. Enterprises* case will not be appealed by the taxpayer. However other taxpayers in similar circumstances may take some comfort in light of the faint glimmer of hope given by the decision in *Valutrend Management Service Ltd. v. M.N.R.*¹⁵⁹ (which surprisingly is not being appealed by the Minister). Here Mr. Fordham, found that the taxpayer was a money lender to "certain selected borrowers" but was only entitled to a "minimal" reserve. More importantly, the *Orban* line of cases was distinguished in the following manner:¹⁶⁰

Mr. Thomas put before the Board some well-known cases such as *Orban v. M.N.R.*, 10 Tax ABC 178, but these have no place in a proceeding of this kind and relate to the makers of small individual short-term loans. Here, what was done was the advancing of large sums on loans for longer or shorter periods at an agreed rate of interest. One may call it financing, if one will, but it was still the placing of money on loan. While the appellant could not profess to be a money-lender within the restricted meaning of *Orban v. M.N.R.* (*supra*), it was nevertheless a lender of money but to a much larger degree in that it dealt in the thousands and made only what may be designated as commercial loans. Hence, I am of the opinion that such loans as are involved in this matter were made in the ordinary course of appellant's business and, where they have not proved satisfactory and collectable, are qualified to be classified as doubtful debts and made the subject of a reasonable reserve accordingly.

According to the Canadian decisions¹⁶¹ where a taxpayer seeks a deduction under s. 20(1)(1)(ii), the following criteria will be considered in determining money lender status:

- (a) the taxpayer must be ready and willing to lend to all and sundry; loans must not be made exclusively to personal friends or to people with whom there is some affiliation
- (b) there must be a degree of organization, system and continuity about the transactions

158. *Anderson and Miskin Limited v. M.N.R.* (1969) Tax ABC 809 at p. 811, here the taxpayer made non arms length loans and unsuccessfully claimed a doubtful debt reserve on the basis that it was a money lender; see also *Spencer Investments Ltd. v. M.N.R.* (1972) C.T.C. (TAB) 2001 which is similar to *Valutrend* and which the Minister is not appealing.

159. (1972) CTC 2170 (TAB).

160. *Id.*, at p. 2172-3.

161. *Aaron Saltzman v. M.N.R.* (1964) 35 Tax ABC 93, here the taxpayer was held not to be a money lender and a reserve for doubtful debts was not allowed on mortgage loans made through a law firm on behalf of the taxpayer; *Liberty Watch Case Co. Ltd. v. M.N.R.* (1969) Tax ABC 79, here, there were several loans and the taxpayer was successful in claiming a doubtful debt reserve but the decision was repudiated in *Anderson and Miskin Limited v. M.N.R.* (1969) Tax ABC 809, where there were non arms length advances and the taxpayer was held not to be in the business of money lending so the doubtful debt reserve was not allowed; the *Liberty Watch* decision was repudiated because the *Orban* case was not cited; *W. H. Enterprises Limited v. M.N.R.* (1971) Tax ABC 570, discussed *supra* at p. 76; *Michael Manczasc v. M.N.R.* (1971) Tax ABC 595, shareholders loans and loans to personal friends were made but a reserve for doubtful debts was not allowed because the taxpayer was held not to be in the business of money lending.

- (c) the taxpayer is a corporation, its charter should contain lending objects ... however these will be of persuasive value only
- (c) the taxpayer must hold himself out as a money lender by advertising or by a telephone listing
- (d) if the taxpayer is a corporation, its charter should contain lending objects ... however these will be of persuasive value only
- (e) a degree of formality is required, i.e. documentation and some form of security should be taken
- (f) shareholder loans will not qualify for a doubtful debt reserve deduction

Additionally in light of the provisions of s. 125 of the new Act, regard should be had to the Minister's view of what constitutes an active business in Information Bulletin IT - 72¹⁶² as this may be of further assistance in determining whether a taxpayer is in the money lending business.

3. *Computation of Reasonable Reserve: Canada*

Whether a debt is doubtful will depend on the facts that circumstances of each case. The case law on the subject indicates that each account must be examined and analyzed taking into account its age and the financial ability and prospects of the debtor. The Minister accepts a reserve computed as a percentage of the doubtful accounts which percentage must be reasonable in light of actual loss experience. *No. 81 v. M.N.R.*¹⁶³ indicates that it is unacceptable to compute a reserve equal to a percentage of the total accounts receivable. In a well reasoned judgment, Mr. Monet decided that the amount deducted as a reserve for doubtful debts must be reasonable in light of the circumstances of each case and that an unreasonable amount of reserve resulted where the taxpayer only took into consideration the time element of the account. Mr. Money gave the following criteria for the application of s. 20(1)(1):¹⁶⁴

Among the factors which may be taken into consideration by a taxpayer who claims a deduction under the provisions of Section 11(1)(d) (now s. 20(1)(1)) of the Act would be: the time element, the history of the account, the financial position of the client, the past experience of the taxpayer with the writing off of his bad debts, the general business condition in the country in a case like in the present one where the taxpayer is doing business all over Canada, the business condition in the locality where the client lives, the increase or decrease in the total sales and accounts receivable at the end of the year for which the deduction is claimed, as compared with previous years.

Additionally Mr. Money gave the following meaning for "doubtful debts" and "reserve":¹⁶⁵

162. Issued October 16, 1972

163. (1953) 8 Tax ABC 85.

164. *Id.*, at p. 98.

165. *Id.*, at p. 95; Further cases involving the meaning of "doubtful debt" and the computation of a reasonable reserve include *B. Newton Brignall v. M.N.R.* (1961) 27 Tax ABC 233; *Atlas Steels Limited v. M.N.R.* (1961) 27 Tax ABC 331; and *Crawford Fittings (Canada) Ltd. v. M.N.R.* (1967) Tax ABC 89.

I am of the opinion that the meaning to be attributed to the words 'doubtful debts' found in Section 11(1) (d) (now s. 20(1)(1)) is the following: debts which are likely to become bad, and that the word 'reserve' found in the same section means: an estimate of the amount required to compensate for some overvaluation of assets which is known to exist when the precise incident or amount of the over-valuation cannot be determined at the time the balance sheet of the taxpayer is prepared.

To conclude, by virtue of s. 12(1)(d), all amounts deducted as a reserve under s. 20(1)(1) in the preceding year, are included in computing the income of a taxpayer for the taxation year immediately following. A fresh reserve can then be deducted having regard to prevailing circumstances.

4. *Amounts Deductible as Bad Debts: Canada*

S. 20(1) (p) of the new Act states:

20.(1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

BAD DEBTS

- (p) the aggregate of debts owing to the taxpayer
 - (i) that are established by him to have become bad debts in the year, and
 - (ii) that have (except in the case of debts arising from loans made in the ordinary course of business by a taxpayer part of whose ordinary business was the lending of money) been included in computing his income for the year or a previous year;

Our discussion of the reserve for doubtful debts cannot be complete without alluding to the deduction for bad debts contained in s. 20(1) (p). This provision permits an outright deduction for bad debts. It does not use the reserve method of deduction. Amounts deducted under this section which are subsequently collected are included in computing the income of the taxpayer for the year in which it is eventually received under s. 12(1)(i). Under s. 20(1)(p) there may be deducted the aggregate of debts owing to the taxpayer that:

- (i) are established by him to have become bad debts in the year, and
- (ii) have been included in computing income of the prior year or years (except for a moneylender who will never have included the amount in prior years' income).

Bad debts are deductible in the year in which they are established to have become bad and no attempt is made to relate this deduction to the year in which the debts became owing. "However, a measure of matching of revenue and expense in relation to bad debts is introduced

by s. 20(1)(1) which permits the deduction each year of a reasonable amount as a reserve for doubtful debts."¹⁶⁶

Many of the cases which have depended upon the interpretation of the wording of s. 20(1)(p) are centred on three factors, namely, whether:

- (a) the taxpayer is a moneylender;¹⁶⁷
- (b) the debt became bad in the year in which the taxpayer claimed the deduction. This will depend on prudent business judgment of the facts of non payment in each particular case; and
- (c) the deduction claimed has not been incurred on revenue account but rather on account of capital and is therefore not deductible.¹⁶⁸

One of the leading Canadian cases on the subject of bad debts is *Associated Investors of Canada v. M.N.R.*¹⁶⁹ where the taxpayer, in the business of selling investment certificates, made advances to its commission salesmen. The taxpayer advanced a total of \$85,000 to one particular salesman in excess of the total commissions owing to him. A total of \$50,000 was then written off from the receivable by equal deductions of the years 1960 and 1961. The Minister only allowed the excess of the advances over the amount of the commissions credited to the employee arguing that the advances should have been deducted in the year they were made or not at all. The Minister further asserted that the amount deducted represented a non deductible capital loss and that the receivable failed to qualify as a bad debt under s. 20(1)(p). Jackett, P., allowed the appeal and held that the advances were essentially short term loans which did not result in the creation of a capital asset. Quite apart from s. 20(1)(p), they were an integral part of the business operations of the taxpayer and any losses incurred had to be included in computing the profits of the taxpayer's business according to ordinary commercial principles in the year in which the taxpayer as a business man recognized the loss. In brief, Jackett, P., permitted the matching principle to operate; i.e. expenses should be deducted in the accounting period in which the associated revenues are recognized.

The Minister's argument was disposed of as follows:¹⁷⁰

Section 11(1)(f) (now s. 20(1)(p)) does not, in terms prohibit any deduction for 'bad debts'. It does, however, expressly authorize in qualified terms a deduction that could have been made, in accordance with ordinary business principles, in the computation of profit from a business. It might therefore have been thought,

166. Labrie, *op. cit. supra* n. 28 at p. 318.

167. The question of whether a taxpayer is a money lender is discussed *supra*.

168. See *Woodlon Motor Sales Ltd. v. M.N.R.* 55 D.T.C. 295 (TAB); *Walker and Hall Ltd. v. M.N.R.* 63 D.T.C. 997 (TAB).

169. (1967) CTC 138 (E.C.C.).

170. *Id.*, per Jackett, P., at p. 149.

as the respondent contends, that a deduction for a 'bad debt' that is excluded from Section 11(1)(f) by the qualifications expressed in it is impliedly prohibited. Such an interpretation would, however, have results that cannot, in my view, have been contemplated. For example, a bond dealer, who, in effect, buys and sells 'debts', would, on such an interpretation, be precluded from taking into account losses arising from bonds becoming valueless by reason of the issuing company becoming insolvent. If Section 11(1)(f) is not to be interpreted as impliedly prohibiting such an obvious and necessary deduction in arriving at the profits of a business, I am of opinion that it is not to be interpreted as impliedly excluding the deduction of the losses that are in question in this appeal, which, in my opinion, are just as obvious and necessary in computing the profits from the appellant's business.

This decision reflects a more logical approach to measuring business income according to practical business and accounting principles.

5. *Reserves for Doubtful and Bad Debts in the United Kingdom*

S. 130(1) of the U.K. Act provides for the following deduction:

Subject to the provisions of the Tax Acts in computing the amount of the profits or gains to be charged under Case I and Case II of Schedule D, no sum shall be deducted in respect of any debts, except bad debts proved to be such, and doubtful debts to the extent that they are respectively estimated to be bad, and in the case of the bankruptcy or insolvency of a debtor the amount which may reasonably be expected to be received on any such debt shall be deemed to be the value thereof.

"The effect of section 130(i) is clear; a trader can only make a deduction in respect of debts if they are bad or to the extent that they are doubtful; he is not entitled to create a reserve against bad debts on the basis that a certain percentage of the total indebtedness owing will eventually prove to be bad."¹⁷¹

The U.K. Act contains no provision for a reserve for doubtful debts comparable to s. 20(1)(1) of the new Act. "The common accountancy practice of making a reserve against bad debts as a percentage of the total amount of debts, is not consistent with the Income Tax Acts."¹⁷²

Moreover, a deduction will only be available under s. 130(i) of the U.K. Act if it results from a trading transaction. In the words of Rowlatt, J.:¹⁷³

When (s. 130(i) of the U.K. Act) speaks of a bad debt it means a debt which is a debt that would have come into the balance sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profits.

While it has been stated that the authorities¹⁷⁴ on the subject indicate that a taxpayer cannot set up a reserve for bad or doubtful debts, a close

171. Whiteman and Wheatcroft, *op. cit.*, *supra* n. 26 at p. 333.

172. N.E. Mustoe, *op. cit.*, *supra* n. 114 at p. 387.

173. *Curtis (H. M. - Inspector of Taxes) v. J. & G. Oldfield Limited* (1925) 9 T.C. 319 at p. 330 (K.B.). The managing director of the taxpayer appropriated funds to his personal use; held not a debt on revenue account.

174. Whiteman and Wheatcroft, *supra* n. 26 at p. 333 and N.E. Mustoe, *op. cit.*, *supra* n. 114 at p. 387.

reading of Lord Atkin's judgment in *Absalom v. Talbot*¹⁷⁵ indicates that, while the word is not used, a reserve may be permitted by discounting a debt which is either payable at a future date or payable over a long period of time by a person of little financial means. The debt should be valued under all the circumstances and that value brought into the accounts.

In the *Absalom* case the taxpayer was a housebuilder who sold houses to "members of the working class"¹⁷⁶ with a small down payment, a first mortgage given by a building society and with the taxpayer taking back a second mortgage payable over twenty years for the balance. The revenue authority sought to bring the amount of the second mortgage into the taxpayer's accounts for tax purposes at face value in the year of sale without any allowance under s. 130(i) of the U.K. Act. The House of Lords allowed the taxpayer's appeal and in Lord Atkin's judgment the use of a reserve is alluded to as follows:¹⁷⁷

There are more methods than one of calculating the profit in such cases as the present, and it may be that more than one may have to be adopted. For my part I think that the most satisfactory course would be to put the debts at their face value on the one side and to open a suspense account on the other side, which no doubt would be calculated upon the ordinary risk of bad debts, and adjust it year by year in accordance with the actual payments made. It is said that this is forbidden by Rule 3(i) (now s. 130(i) of the U.K. Act)). On the other hand, if that Rule only applies, as I think it does, to debts that are correctly entered at their face value, its provisions would have no bearing on debts which could only be entered at their face value if some such corrective as a suspense account is necessary. Another method which is correct enough in theory is to value the debt. It would thus be treated as an asset received in part discharge of the price, and its value would be calculated according to the experience of the business. I see no reason why the valuation should not be made of each debt, as would appear to be the effect of Rule 3(i) 'to the extent that they are *respectively* estimated to be bad'. Valuation is certainly a rough method of adjusting profit, for there seems no means of subsequent correction by actual results, but at any rate it removes the anomalies that arise otherwise on a discontinuance of business.

Each case will depend on its own facts as to whether a debt is bad. As in Canada, where a payment is received on account of a debt which was deducted as bad in a prior year, the amount received will be brought into income in the year of receipt.¹⁷⁸ It is our submission that Lord Atkin's "suspense account" is synonymous with "reserve". Accordingly, to the extent permitted by Lord Atkin's judgment in *Absalom v. Talbot*, reserves for doubtful debts will be allowable in the United Kingdom. While the "suspense account" may strictly speaking not be a reserve, the effect is the same as the Canadian reserve treatment.

175. (1944) 26 T.C. 166 (H.L.).

176. *Id.*, at p. 193, per Lord Atkin.

177. *Id.*, at p. 193

178. *Bristow v. Dickinson(William) & Co. Ltd.* (1946) 27 T.C. 157 (C.A.).

C. Reserve for Deferral of Prepaid Income

1. The Reserve for Goods and Services: Canada: s. 20(1)(m) of the new Act

S. 20(1)(m) of the new Act states:

20.(1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto;

RESERVE IN RESPECT OF CERTAIN GOODS AND SERVICES

(m) subject to subsection (6), where amounts described in paragraph 12(1)(a) have been included in computing the taxpayer's income from a business for the year or a previous year, a reasonable amount as a reserve in respect of

- (i) goods that it is reasonably anticipated will have to be delivered after the end of the year,
- (ii) services that it is reasonably anticipated will have to be rendered after the end of the year,
- (iii) periods for which rent or other amounts for the possession or use of land or chattels have been paid in advance, or
- (iv) repayments under arrangements or understandings of the class described in subparagraph 12(1)(a)(ii) that it is reasonably anticipated will have to be made after the end of the year on the return or resale of the taxpayer of articles other than bottles;

This reserve complements s. 12(1)(a)¹⁷⁹ which deals with the inclusion of all amounts received by a taxpayer in the course of business. By virtue of s. 20(1)(m) (formerly s. 85B(1)(c) of the old Act), where amounts have been included in income by virtue of s. 12(1)(a), a taxpayer is permitted to deduct a reasonable amount as a reserve in respect of:

- (i) goods not yet delivered
- (ii) services not yet rendered
- (iii) rent received in advance
- (iv) returnable deposits on containers (other than bottles).

Under s. 12(1)(e), reserves deducted in the year under s. 20(1)(m) are included in the following year's income so that a fresh reserve is calculated annually. The reserve is in respect of goods to be delivered and services to be rendered to the extent that it is reasonably anticipated that the goods or services will have to be delivered or rendered in the future. Thus the full selling price and not merely the profit portion thereof, is put to reserve because the cost of such goods or services will be charged to the income statement in the year that the goods or services are actually delivered or performed. Thus s. 20(1)(m) acts as a check against the sweeping effect of s. 12(1)(a) since a taxpayer may have received amounts as payment for the supply of goods or services in future taxation years and he is permitted to deduct a

179. The provisions of s. 12(1)(a) of the new Act are discussed *supra*.

reasonable reserve for the entire selling price out of his receipts until the year of the delivery of the goods or the supply of services. Without the reserve vehicle, such prepaid amounts would be required to be brought into income in the year of receipt under the doctrine of beneficial receipt¹⁸⁰ unless the funds were received in trust or there were restrictions placed on the taxpayer's use or enjoyment of the funds until he completed his part of the trading bargain. Once again, through the use of reserves, we see the operation of the matching principle of deducting expenses from resulting revenues to provide true earnings in the proper accounting period, i.e. the reserves will be brought back into income by virtue of S. 12(1)(e) in the year when the goods are delivered or the services performed.

(a) Goods and Services After Year End (s. 20(1)(m)(i), (ii))

The above noted paragraphs of s. 20(1)(m) permit the deduction of a reasonable amount as a reserve for goods and services that it is reasonably anticipated will have to be delivered or rendered, as the case may be, after the end of the year. Amounts which do not represent "true income", i.e. amounts which the taxpayer does not have a legal right to and which is subject to restriction, contractual or otherwise, as to its disposition use or enjoyment, will be excluded from the taxpayer's profit calculation for the then current year. For example if a housepainter receives in one taxation year \$1,000 in advance to paint a home but he does not commence the project until the next taxation year, the amount will be included in his income in the year of receipt under s. 12(1)(a) but he will be allowed an equivalent deduction as a reserve under s. 20(1)(m)(ii). If he had half finished the project before year end, the reasonable reserve would have been \$500. Equally, amounts received in year 1 on account of goods to be delivered in year 2 will be removed from income under s. 20(1)(m)(i) until year 2, the year of delivery of the goods.

The provisions of s. 20(1)(m)(i) have permitted a taxpayer¹⁸¹ to deduct a reasonable amount as a reserve for unredeemed trading stamps to which a value of 3/20 of a cent each had been assigned and which were given to customers on the basis of 1½ % of the value of their purchases. The Minister asserted that no reserve should be available because the taxpayer did not increase its prices to cover the cost of the scheme nor did it allocate any of its revenue as between the stamps distributed or goods sold. However, Cattanach, J., sided with the taxpayer stating:¹⁸²

180. The doctrine of beneficial receipt is discussed *supra*.

181. *Dominion Stores Ltd. v. M.N.R.* (1966) C.T.C. 97 (E.C.).

182. *Id.*, at p. 103.

It does not follow that, because no specific amount is identifiable as being allocated to the cost of distributing and redeeming the stamps, the total amount is not attributable in part thereto.

Notwithstanding the lack of direct evidence on the point Cattanach, J., held that the taxpayer was entitled to the reserve by saying:¹⁸³

...a portion of each amount received by the appellant from its customers was received on account of goods to be delivered on presentation of the trading stamps or tapes for redemption. All amounts received by the appellant in respect of such goods were included in the appellant's income in the year of receipt whether or not the trading stamps or tapes were redeemed in that year. Such amounts, with respect to trading stamps which remained outstanding at the end of each taxation year, were on account of goods not delivered before the end of the year.

The taxpayer succeeded even though, from all appearances, it was not clearly within all four corners of the wording of the section affording relief. Once again a victory for the matching principle.¹⁸⁴

(b) *Articles of Food and Drink or Transportation: s.20(6)*

Where the reserve claimed under s. 20(1)(m)(i), (ii) is with regard to food or drink or transportation for which tickets have been sold prior to delivery of the food or drink or the provision of the transportation, s. 20(6) (formerly s. 85B(3) of the old Act) provides that the amount of the reserve that may be allowed cannot exceed the cash equivalent at the end of any taxation year of those unredeemed tickets which were issued and credited to income in that year. That is, a reserve may not be deducted for unredeemed tickets sold in a prior year. The permissible reserve only extends to revenues received for tickets sold by unredeemed in the same taxation year. The reserve can never be in excess of the undelivered or unredeemed balance of amounts included in the current year's sales. The reason for this restriction appears to be because there could be a large amount of unredeemed tickets in prior years which might never be used to obtain goods or services from the taxpayer. If the reserve included these amounts, there would be an artificial reduction of profit. The taxpayer would have had the use of the sale proceeds free of tax and this is inequitable in the view of the Minister.

(c) *Prepaid Rent: s. 20(1)(m)(iii)*

This paragraph permits a deduction of a reasonable amount as a reserve in respect of periods for which rent or other amounts for the possession or use of land or chattels have been received in advance. Even though the renting of real property may not constitute a business, subparagraph (iii) will still apply in these situations. The amount of reserve allowable is that proportion of prepaid rental received and included in income

183. *Id.*, at p. 104.

184. In the United Kingdom a dealer in trading stamps may deduct a reserve for his liability with regard to unredeemed trading stamps: see *Cowen v. I.R.C.* (1934) 19 T.C. 155.

under s. 12(1)(a) which relates to the period of tenancy after the end of the taxation year in question. For example if a yearly tenant pays rent of \$12,000 for a lease year running from July 1 to June 30 and if the landlord is on the calendar year, he includes \$6,000 in income in the first year and the balance in the following year.

(d) *Returnable Containers: s. 20(1)(m)(iv)*

Where an amount has been included in income by virtue of s. 12(1)(a)(ii), a reasonable amount as a reserve (based on past experience) may be deducted for the returnable containers (e.g. oil drums) because of the taxpayer's liability to redeem them at a fixed price. Bottles are excluded from the scope of subparagraph (iv). Bottles are excluded presumably because of the administrative difficulties that the Minister would face in ensuring that the provision was not being used by some taxpayers for improper tax avoidance. For example, if a reserve were allowed for bottles and if some of the bottles broke or remained in the possession of the taxpayer's customers, less bottles would be returned than the amount of the reserve and there would be an artificial reduction of profit.^{184a}

(e) *Prohibitions: s. 20(7)*

Section 20(7) contained the following prohibitions with regard to the operation of s.20(1)(m) reserves:

- (i) no reserves are available for guarantees, indemnities or warranties,¹⁸⁵
- (ii) a taxpayer who is on the cash method (a farmer) under s. 28(1) is not permitted the use of 2. 20(1)(m) reserves.
- (iii) insurance except insurance corporations may not compute a s. 20(1)(m) reserve but rather deduct policy reserves according to regulations (not yet prescribed).¹⁸⁶

These prohibitions parallel the prohibitions contained in s.18(1)(e)¹⁸⁷

The prohibition against reserves for guarantees, indemnities or warranties ties in with the general prohibition in s. 18(1)(e) preventing the deduction of reserves for contingent accounts. Guarantees, indemnities or warranties are by their very nature contingent and s. 20(7)(i) appears to have been enacted for greater certainty to ensure that such reserves may not be deducted. Furthermore, guarantees, indemnities or warranties would relate in most instances to amounts expended on account of capital, the deduction of which is prohibited under s. 18(1)(a) of the new Act.¹⁸⁸

184a. See Interpretation Bulletin IT-165 issued on June 7, 1974 with respect to Returnable Containers.

185. *Supra* at p. 40.

186. See our discussion of *Acadia Overseas Freighters (Halifax) Ltd. v. M.N.R.* (1962) 28 Tax ABC 331, *supra*.

187. The provisions of s. 18(1) (e) are discussed *supra*.

188. However, see our discussion of dispositions subject to warranty concerning the effectiveness of s. 42 as it relates to the deferred payment reserve under s. 40(1) (a) (iii) of the new Act, *infra*.

(f) *Interpretation Bulletin: IT-154*

On March 14, 1974, the Minister issued Information Bulletin IT-154 (herein called IT-154) with regard to reserves (other than land) under s. 20(1)(m) and s. 20(1)(n) of the new Act. IT-154 repeats much of what has already been stated; accordingly we do not propose to discuss its provisions.

2. *Deferral of Prepaid Income: The Experience in the United Kingdom*

The treatment of reserves for advance payments in the United Kingdom depends upon the facts of each particular case and upon the ordinary principles of commercial accounting for determining profit.¹⁸⁹ Reserves for the deferral of prepaid income should be allowed where the sum provided is "an essential charge against the receipts of the trade to enable a true profit from that source to be stated for the year in question."¹⁹⁰

D. *Reserve for Profit Content of Instalment Receivables*

1. *Canada: Purpose and Application: S.20(1)(n)*

20.(1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

RESERVE FOR AMOUNT NOT RECEIVABLE UNTIL LATER YEAR

(n) where an amount has been included in computing the taxpayer's income from the business for the year or for a previous year in respect of property sold in the course of the business and that amount or a part thereof is not receivable,

(i) where the property sold is property other than land, until a day that is
(A) more than 2 years after the day on which the property was sold, and

(B) after the end of the taxation year, or

(ii) where the property sold is land, until a day that is after the end of the taxation year,

a reasonable amount as a reserve in respect of such part of the amount so included in computing the income as may reasonably be regarded as a portion of profit from the sale;

Under the provisions of this paragraph, where there is a receivable which is payable over a long period of time after the then current year end, the profit from the sale may be "reasonably" apportioned and brought into income over the period in which the debt is receivable and presumably collected. S. 20(1)(n) permits the deduction of a "reasonable amount as a reserve in respect of such part of the amount so included in computing the income as may reasonably be regarded as a

189. See our earlier discussion of this subject, *supra*.

190. Per Lord Radcliffe in *Southern Railway of Peru v. Owen* (1957) A.C. 334 at p. 361; see also our earlier discussion of prepaid income in the United Kingdom, *supra* at p. 32; this case is discussed *supra*.

portion of the profit from the sale". The provision only relates to property sold and no reserve is allowable for the profit content of payments extending over a long period of time for services rendered in a prior year. The amount of the reserve allowable may reasonably be regarded as the amount of profit brought into income under s. 12(1)(b) but not yet in fact received in the current year.

The following requirements must be met in using the reserve under s. 20(1)(n):

- (i) the receivable on which the reserve is taken must have been included in the business income of the taxpayer arising from property sold in the course of business (presumably under s. 12(1)(b), but the section does not so specify)
- (ii) except in the case of sales of land, a portion of the amount must not be receivable until more than two years after the property is sold; and
- (iii) the amount is not receivable until after the end of the taxation year.

Once the above conditions have been met, the profit content of all amounts receivable after year end may be deducted as a reserve from the current year's income. Again paragraph (1)(n) complements s. 12(1)(e)(ii) so that amounts deducted as a reserve in one year are brought into income the next year and the whole process begins again.

However s. 20(1)(n) will not afford relief to a taxpayer who has sold or assigned conditional sales contracts on which the taxpayer is contingently liable as a guarantor. This was the decision in *Home Provisioners (Manitoba) Ltd. v. M.N.R.*¹⁹¹ The taxpayer asserted that the amounts received from the finance company were loans and not sale proceeds but Thurlow, J. did not agree. The learned judge reviewed the decision of *Re George Inglefield Limited*¹⁹² where Romer, L.J. set out the essential differences between a transaction for sale and a transaction of mortgage and charge. Thurlow, J., then reviewed the facts of the case against the criteria propounded by Romer, L.J. and stated:¹⁹³

I find nothing in the terms set out either in the assignment or the memorandum giving the appellant any right of redemption of the kind referred to by Romer, L.J., in the passage above quoted. No doubt, certain equities in respect of the property assigned would arise in favour of the appellant upon the appellant honouring its guarantee when called upon to do so, but in my opinion such equities are quite distinct from a right at any time to call for a return of property subject to a mortgage or charge upon payment of a loan. In my opinion, the appellant had no such right to repay the finance company and demand a return of the property assigned except upon being called upon to honour its guarantee. Accordingly, I find that the transactions were sales rather than loans.

191. (1958) C.T.C. 334 (E.C.).

192. (1933) 1 Ch. 1 at p. 27.

193. (1958) C.T.C. 334 at p. 342.

It follows from this finding that, since the appellant was not the owner of the unpaid purchasers' accounts totalling \$344,665.78, it is not entitled to a reserve under Section 85B(1)(d) (now s. 20(1)(n)) in respect of any portion of that amount.

Accordingly, it is necessary for a taxpayer to convince the Minister that it has mortgaged its accounts receivable in favour of a finance company (rather than assigned them) in order to have a reserve pursuant to s. 20(1)(n). However it appears that the taxpayer has had little success in this area.¹⁹⁴

2. *Merchandise Sales: Canada: S. 20(1)(n)(i)*

Where merchandise has been sold, the following is an example of the computation of a reasonable reserve with regard to the profit content of the unrealized portion of the sale price.

	<u>Account Receivable</u>	<u>Profit Content</u>
June 1/72 Sale Price	\$4,000	\$1,000
Cash down	<u>1,000</u>	250
Balance Due by 30 equal monthly instalment payments	3,000	750
Due in 1972 (6)	<u>600</u>	<u>150</u>
Dec. 31/73 Balance Receivable	2,400	
Reserve allowable		600
Instalments Due (12)	<u>1,200</u>	<u>300</u>
		1973
		Dec. 31/73 Bal-
Reserve Allowable		1,200ance Receivable
		300
1974 Instalments Due (12)	<u>1,200</u>	<u>300</u>
Dec. 31/74 Balance receivable	nil	
Reserve		nil

The above is computed in accordance with the formula set out and explained in paragraph 3 of Interpretation Bulletin-152 as follows:

$$\frac{\text{gross profit}}{\text{gross selling price}} \quad \text{X amount receivable — reserve}$$

3. *Lands Sales: Canada: s. 20 (1)(n)(ii)*

In *No. 703 v. M.N.R.*¹⁹⁵ the Tax Appeal Board determined the formula for computing a reserve for traders or dealers in real estate for

194. See the decision of *United Trailer Co. Ltd. v. M.N.R.* 61 D.T.C. 1162 (E.C.) where the taxpayer, in a situation similar to the *Home Provisioners* case, was denied both a doubtful debt reserve under s. 20(1) (1) and a deferred profit reserve under s. 20(1) (n).

195. (1960) 24 Tax ABC 129.

the profit portion of proceeds receivable arising from the sale of land. The issue to be determined in *No. 703 v. M.N.R.* was whether or not a mortgage which the taxpayer assumed when the land was purchased and which was later assumed by the taxpayer's purchase on the subsequent sale had to be included in the computation of the reserve for unrealized profit. Could it be said that the vendor taxpayer earned a profit by the purchaser's assuming payment of the mortgage? The taxpayer computed a reserve according to his "equity" in the transaction whereas the Minister viewed the profit and computed the reserve in relation to the total selling price including mortgages assumed.

	Total	Cash	Mortgage Assumed	Mortgage Given	Mortgage Assumed	Mortgage Given
Purchase Price	\$63,000	\$18,000	\$9,500	\$35,000		
Sale Price	<u>\$93,309</u>	<u>\$35,000</u>	\$9,500		\$35,500	<u>\$13,309</u>
Profit	\$30,309	\$17,000				\$13,309

The taxpayer's formula for the computation of the reserve was:

\$13,309 (amount receivable) X \$30,309 (profit — \$8,350.15
\$48,309 (total cash to be
paid to taxpayer)

The Minister's formula for the computation of the reserve was:

\$13,309 (amount receivable) X \$30,309 (profit — \$4,323.08
\$93,309 (total sale price)

Mr. Boisvert decided the taxpayer's method was more appropriate in the circumstances holding that the portion of the sum receivable that was not profit to the taxpayer (namely the mortgages assumed by the purchaser totalling \$45,000) could not be considered as a component part of the formula. After reviewing s. 20(1) (n) (formerly s. 85B(1) (d)) he stated:¹⁹⁶

It follows that in enacting the *Income Tax Act*, the legislator made it clear that he intended to tax the *taxable income* of every person residing in Canada, and that the taxable income of a taxpayer from a *business* be the *profit therefrom* for the year. Parliament sought to tax the *profits* derived from a business, and nothing else. Therefore, when determining a reserve under Section 85B, only the profit realized is to be taken into account. To construe the section otherwise would be erroneous, considering the wording of the sections (s. 2, and s. 9) quoted above. There cannot be any doubt that, in view of the words employed by the legislator, only the *profit* from the sale made by the appellant is the basis for the establishment of the reserve; in other words, the reserve must be passed on that portion of the sale price that is the profit derived from the sale. Well, the profit realized from the sale was \$30,309. Consequently, the reserve is to be a portion thereof, and not a portion of the total sale price of \$93,309.

¹⁹⁶ *Id.*, at p. 132.

If it were to be held that the Minister was right in setting up the reserve at \$4,323.08, this would result in the levying of tax on more than the actual profit realized by the appellant in the taxation year 1956. This cannot be done. The portion of the sum receivable that is not *profit* to the taxpayer may not be considered as a component part of the formula used in the determination of the reserve.

This method is currently followed by the Minister for assessing purposes¹⁹⁷ as indicated by the last paragraph of Interpretation Bulletin IT-152 (herein called IT-152).¹⁹⁸ However, where the taxpayer had clear title to the land sold but encumbered it to facilitate future sale, IT-152 indicates the Minister will use the method of computing the reserve which he argued was proper in *No. 703 v. M.N.R.* That is, in computing the reserve, the gross profit and the gross selling price will be used in the formula but the amount receivable will exclude the unpaid balance of the mortgages assumed by the purchaser which had been earlier placed thereon by the vendor.

For example:

Sale price	\$300,000
Profit	\$ 30,000
Cash Payment	\$ 50,000
*Mortgage Assumed	\$150,000
2nd Mortgage Back	\$100,000

Reserve is:

$$\frac{\$30,000}{\$300,000} \times \$100,000 = \$10,000$$

* This mortgage was not a component of the purchase price when the vendor originally purchased the property.

However the recent case of *Station Heights Subdivision Ltd. v. M.N.R.*¹⁹⁹ is extremely interesting because it indicates that the Tax Review Board will not necessarily agree with the Minister's "reasonable" computation of a reserve if the taxpayer's method of computing the

197. See also *M.N.R. v. Burns* (1958) C.T.C. 51 at p. 59 where second mortgages owing to a house builder were included in the taxpayer's income with a reserve for the unreceived profit content under s. 20(1) (n) (ii). Also, the taxpayer was not allowed to set up a reserve equal to the full amount of the profit until all costs of the taxpayer had been recovered; *Brown v. M.N.R.* 61 D.T.C. 1253 at p. 1258 real estate profits were allowed to be reported on the cash basis, consequently the same taxes resulted as if s. 20(1) (n) had been applied; *Felgor Investments Ltd. v. M.N.R.* 24 Tax ABC 327, where s. 20(1) (n) was held to apply rather than permitting a mortgage to be discounted under s. 76; *Fedak v. M.N.R.* 32 Tax ABC 311, amounts receivable are taxable when agreements for sale are executed not when title is transferred; *Chappel v. M.N.R.* (1963-4) 34 Tax ABC 374, no reserve under s. 20(1) (n) (ii) where sale of land and municipal beventures received as full payment on closing

198. Issued February 28, 1974, IT-152 sets out the formula for computing a reasonable reserve for that part of the profit on a sale that can be reasonably regarded as not then due. The general formula used to compute the reserve is:

$$\frac{\text{gross profit}}{\text{gross selling price}} \times \text{amount receivable} = \text{reserve}$$

199. (1973) C.T.C. 2004 (T.A.B.).

reserve is also reasonable. The case points up the wisdom of Thorson, P. in *Publishers Guild of Canada Ltd. v. M.N.R.*²⁰⁰.

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.

The *Station Heights* case indicates that the Tax Review Board will not necessarily follow the formula for computing a "reasonable" reserve as set out by the Minister in IT-152. Here the taxpayer brought back into income the previous year's reserve as required by s. 12(1) (e) with the result that it claimed less than the maximum allowable reserve under s. 20(1) (n) (ii) and in effect averaged its income. The Minister asserted that his formula of gross profit over gross selling price multiplied by the balance of the mortgage then receivable was the only formula which could be used to compute a reasonable amount of reserve. Mr. St. Onge concluded his decision by stating:²⁰¹

Subparagraph 85B(1) (d) (ii) (now s. 20(1) (n) (ii)) is included under Division H (now Division B) of Part 1 of the *Income Tax Act* which deals with special reserves, and where the property sold is land, the provision allows the taxpayer to set a reserve in those words:

'there may be deducted a reasonable amount as a reserve in respect of that part of the amount so included in computing the income that can reasonably be regarded as a *portion of the profit from the sale*'. (Italics mine). But the said provision does not provide the taxpayer with any formula for the calculation of what is called a 'reasonable amount' and does not stipulate any maximum or minimum. In this type of reserve, we are dealing with an actual deferment of income rather than the establishment of an actual reserve to provide for eventual doubtful debts or contingencies. The deferred amount, in the present case, is well secured by a mortgage and according to the evidence adduced, does not represent a sizeable risk inasmuch as the land has been originally purchased at a cost of \$100,000 and sold, ten years later, for \$875,116.50. Consequently, under the circumstances, the amount of \$6,854.18 fixed by the taxpayer might be as reasonable as the \$84,610.07 set by the Minister. The matter of reasonableness could be subjective as well as objective. In the present case, because the option

200. (1957) C.T.C. 1 at p. 17 (E.C.C.).

201. (1973) C.T.C. 2004 at p. 2007 (T.R.B.).

belongs to the taxpayer, due to the use of the verb 'may' the subjective value would be the one fixed by the taxpayer rather than that set by the Minister. Furthermore, because the taxpayer is in a better position to know the nature of the deferred income as well as the amount likely to be received by him as part of the profit in future years, it is reasonable to expect that the taxpayer is the person who should determine what is reasonable under the circumstances. It is well established in the juris-prudence that a taxpayer can arrange his affairs to pay the least amount of income tax as long as he complies with the Act and therefore the Board cannot understand why the Minister would object to a taxpayer increasing his taxable income in any one year by claiming a smaller reserve. The jurisprudence cited by counsel for the respondent is applicable to cases where it was obviously necessary to set a *maximum* reserve so that the taxpayer could not unduly reduce his income. In the present appeal, the appellant is not trying to reduce unduly his income but rather to average, by deferral, his profits in accordance with the section enacted for that very purpose. The mathematical formula used by the Minister in the cited cases is purely arbitrary and the amount set by the appellant could be as reasonable, if not more so, than that set by the Minister, when taking into account all of the evidence adduced: the well-secured loan, the substantial increase in land value, the possibility of prepayment of mortgages, and the appellant's business and experience in real estate.

The Minister cannot intervene in the present appeal because there is no evidence of any abuse on the part of the taxpayer, and should the latter not receive the amount to which it is entitled, it would be because it had not availed itself fully of the provisions of the Act. The Board, for the above reasons, is of the opinion that the amount claimed by the appellant is reasonable.

It appears that as a result of the *Station Heights* case, the method of computing the reserve is within the discretion of the taxpayer and the Minister must accept it as long as it is reasonable even if the Minister uses another method which results in a different "reasonable amount" as a reserve.

4. *Canada: Whether Reserve Must be Applied For*

In *Weinstein v. M.N.R.*²⁰² Mr. Fordham regarded as obiter dictum comments made by Mr. Weldon in an earlier decision²⁰³ to the effect that the Minister cannot on his own initiative allow a reserve.

Mr. Fordham stated his view as follows:²⁰⁴

Looking at some of the other sections in the Act dealing with reserves, I can discover nothing to suggest that 'may', where used with reference to the deducting of reserves, is exclusive as well as permissive. It seems to me that either the taxpayer or the Minister's assessor is at liberty to deduct the amount of a reserve in a proper case in order to arrive at the correct amount of taxable income remaining. Moreover, where the Minister has allowed a reserve on his own initiative, there would seem to be no good reason why he first *should notify the taxpayer concerned as though to ascertain his wishes in that regard.*

202. (1966) 41 Tax ABC 253; aff'd., (1968) CTC 357 (E.C.C.); the *Weinstein* decision is referred to *supra*.

203. *Earl W. Gardner v. M.N.R.* (1965) 39 Tax ABC 162 at p. 166.

204. (1966) 41 Tax ABC 253 at p. 256

Mr. Fordham's position was that:

It seems to be that the unilateral allowance of a reserve by the Minister in a proper case is simply a normal part of the assessing process and to be endorsed rather than frowned upon.²⁰⁵

However, the assessing practices of the Minister are even more perplexing in *Bronze Memorials Ltd. v. M.N.R.*²⁰⁶ This case involved the taxpayer's earlier appeal²⁰⁷ relating to the Minister's assessment of a \$138,150 real estate profit made in the 1958 taxation year as taxable and the Exchequer Court agreed with the Minister but directed that a reserve under s. 20(1) (n) (ii) be allowed in 1958 for the uncollected portion of the sale proceeds. The taxpayer then launched an appeal to the Supreme Court of Canada from that judgment relating to the issue of the capital gain. Then in the present case, the Minister reassessed the years 1959 to 1962 and brought into income the cash proceeds collected in each year. The taxpayer argued that it had not adopted the cash method of computing income and had not claimed any reserve under s. 20(1) (n) (ii). Gibson, J., held that there was no basis in fact or in law for any of the reassessments for the years 1959 to 1962. Additionally, Gibson, J., held that the Minister had no power to issue the reassessment since more than four years had elapsed from the date of the original assessments and accordingly the reassessments were statute barred under s. 152(4).

However the crux of the decision is contained in the following passage from the judgment of Gibson, J.:²⁰⁸

In my view, the Minister had no right to so re-assess on a cash or received basis, and predicted on the pleadings and the evidence in this case there is no power in this Court to refer these re-assessments back to the Minister for further re-assessment on a receivable or accrual basis to tie in with the way that the Minister may assess this gain in the taxation year 1958 of the appellant, in the event the appellant's said appeal to the Supreme Court of Canada is not successful. Also to do so in effect would be to allow an appeal to the Minister from his own re-assessments, on these appeals therefrom by the appellant taxpayer.

The dispute between *Bronze Memorials Ltd.* and the Minister arising from the reassessments for the years 1958-62 has been settled and both appeals to the Supreme Court of Canada have been discontinued, i.e. the taxpayer's appeal for 1958, and the Minister's appeal for 1959-62.

205. *Ibid.*, considerable written debate ensued from the *Gardner* and *Weinstein* cases; see particularly "The Last Word" (1965) 13 *Can. Tax Jo.* 143 concerning the use of the word "may" in s. 20(1) (n); (1966) 14 *Can. Tax Jo.* 358 concerning Mr. Fordham's decision in *Weinstein v. M.N.R.*; Stuart D. Thom: "Ne Sutor Supra Crepedam" (1965) 13 *Can. Tax Jo.* 479, an article concerning *Gardner v. M.N.R.* and (1968) 16 *Can. Tax Jo.* 359 for an analysis of the judgment of Gibson, J. in the Exchequer Court of Canada in *Weinstein v. M.N.R.*

206. (1969) C.T.C. 620 (E.C.).

207. (1967) C.T.C. 41 (E.C.).

208. (1969) C.T.C. 620 at p. 623 (E.C.).

The decision of Gibson, J., does not change the law as propounded by Mr. Fordham in the *Weinstein* case. Gibson, J., merely stated it was not proper for the Minister to put the taxpayer on the cash method on the basis of the facts before him but he did not expressly comment on the correctness of the earlier *Weinstein* decision. In conclusion, the Minister may grant an allowance of a reserve in a proper case as a normal part of assessing procedure but it was "improper" to do so in the *Bronze Memorials* decision.

5. *Canada: Certain Special Reserves Prohibited*

Under the provisions of s. 20(8) (formerly s. 85B(bb) of the old Act), no reserve under s. 20(1) (n) is allowable where a taxpayer in the taxation year or in the immediately following year becomes non-resident or exempt from tax under Part I.²⁰⁹ A taxpayer will not be able to avoid the provisions of s. 12(1) (e) (which returns previous reserves to income) by claiming a reserve in one year and then becoming non-resident or exempt from tax in the next taxation year. It is curious that this provision does not prevent a non-resident who carries on business in Canada from utilizing the provisions of s. 20(1) (n) but does prevent a resident taxpayer who becomes non-resident from using s. 20(1) (n) even if as a non-resident he continues to carry on business in Canada. Presumably, the resident taxpayer who becomes a non-resident but still carries on business in Canada could use s. 20(1) (n) in the third taxation year after ceasing to be a Canadian resident. Furthermore, there is no similar restriction on the use of s. 20(1) (m) when a taxpayer becomes a non-resident.

Deceased taxpayers are also covered by s. 20(8) since a dead taxpayer is not resident in Canada.

6. *Canada: The Reserve for Proceeds of Disposition Under S. 40(1) (a) (iii) of the new Act.*

(a) Purpose and Application

The following is an extract of the relevant provisions of s. 40:

40.(1) Except as otherwise expressly provided in this Part

(a) a taxpayer's gain for a taxation year from the disposition of any property is the amount, if any, by which

(i) if the property was disposed of in the year, the amount, if any, by which his proceeds of disposition exceeds the aggregate of the adjusted cost base to him of the property immediately before the disposition and any outlays and expenses to the extent that they were made or incurred by him for the purpose of making the disposition, or

²⁰⁹ S. 40(2) (a) which is the comparable provision relating to s. 40(1) (a) (iii), the reserve for calculating a gain on the disposition of capital property, is discussed *infra* at p. 165.

(ii) if the property was disposed of before the year, the amount, if any, claimed by him under subparagraph (iii) in computing his gain for the immediately preceding year from the disposition of the property,

exceeds

(iii) such amounts as he may claim, not exceeding a reasonable amount as a reserve in respect of such of the proceeds of disposition of the property that are not due to him until after the end of the year as may reasonably be regarded as a portion of the amount determined under sub-paragraph (i) in respect of the property;

Under s. 40(1) (a), a taxpayer's gain from the disposition of any property is the amount by which the proceeds of disposition exceed the aggregate of:

(a) the adjusted cost base to the taxpayer of the property immediately before the disposition,

(b) outlays or expenses made or incurred for the purpose of making the disposition,

(c) such amounts as the taxpayer may claim not exceeding a reasonable amount as a reserve in respect of the proceeds of disposition that are not due to him until after the end of the year as may reasonably be regarded as a portion of the gain after making the above deductions.

Under the provisions of s. 40(1) (a) (ii), where a taxpayer has disposed of property in a previous taxation year, the reserve claimed in the immediately preceding year is included in computing the taxpayer's gain for the then current year minus a reasonable amount, under s. 40(1) (a) (iii), as a reserve (herein called "the deferred payment reserve") in respect of the proceeds not "due" in the current year. The provisions of s. 40 relating to the deferred payment reserve operate in much the same manner as the reserves under s. 20(1) (n) of the new Act.²¹⁰ However, it must be emphasized that there is no deferred payment reserve for amounts which are due and payable but for some reason have not been paid.

The new Act does not prescribe a method for computing the deferred payment reserve but since the wording of s. 40(1) (a) (iii) is similar to s. 20(1) (1) (m), and (n) of the new Act (formerly S. 85B of the old Act), presumably the method adopted by the taxpayer in *No. 703 v. M.N.R.*²¹¹ and followed in IT-152 and IT-154 will be accepted by the Minister. To compute the portion of the capital gain not due until after the end of the year, one multiplies the ratio of the net gain over the total proceeds of disposition by that part of the proceeds which is not due until after the end of the year as follows:

210. The provisions of s. 20(1) (n) are discussed *supra* at p. 98.

211. *Supra* no. 195; see also our discussion of the decision in *No. 703 v. M.N.R.*, *supra* at p. 102.

net gain _____ X portion of — deferred proceeds due
 total proceeds of disposition payment reserve after year end

Example: Proceeds of disposition 400,000 adjusted cost base 100,000; expenses of disposition 10,000; balance not due at year end 300,000 (proceeds of disposition payable over 4 years with annual payments of 100,000).

The gain is computed as follows:

Year 1	Proceeds of disposition	400,000
	Less adjusted cost base	100,000
	expenses of disposition	10,000
	<u>Total Gain</u>	<u>290,000</u>
	Less reserve: $\frac{290,000}{400,000} \times 300,000$	217,500
	Gain	72,500
	Taxable Capital Gain	36,250
Year 2	Previous Year's reserve	217,500
	Less new reserve $\frac{290,000}{400,000} \times 200,000$	145,000
	Gain	72,500
	Taxable Capital Gain	36,250
Year 3	Previous year's reserve	145,000
	Less new reserve $\frac{290,000}{400,000} \times 100,000$	72,500
	Gain	72,500
	Taxable Capital Gain	36,250
Year 4	Previous year's reserve	72,500
	Gain	72,500
	Taxable Capital Gain	36,250

(No reserve is claimed in year 4 because no amount is due at the end of year 4)

The total amount of taxable capital gain is \$145,000 which is equal to the taxable capital gain that would have been realized in year 1 if all of the \$400,000 had been paid in that year and the entire capital gain had been realized in one year. By claiming a deferred payment reserve, payment of the tax on the \$145,000 is spread over four years.

(b) Doubtful and Bad Debts

There is no deduction allowable for a doubtful debt reserve for an amount owing in respect of the proceeds of disposition of capital property. S. 20(1)(1) only provides for the deduction of a reserve for doubtful debts in computing income from a business or property and is restricted to debts which have been included in computing income for the current year. A taxpayer who has realized a capital gain and who has difficulty in collecting unpaid proceeds of disposition must include

deferred payment reserves taken in prior years under s. 40(1) (a) (ii), even though no payments have been received and no deferred payment reserve is allowable for any amount which is due but unpaid.

However, under s. 50(1), where a debt arising from the disposition of a capital property becomes a "bad debt", the taxpayer is deemed to have disposed of the debt at the end of the year and to have reacquired it immediately thereafter at a cost equal to nil. Then under s. 40(2) (g) (ii), such taxpayer may claim a capital loss from the disposition of the debt but only where the debt arises as consideration for the disposition of capital property to a person with whom the taxpayer is dealing at arm's length. Further difficulty will be encountered in judging whether a debt has become bad. Moreover, once a bad debt has been deemed to be reacquired at a nil cost and the debtor subsequently makes payment on the debt, the taxpayer will again be taxable but this time on the full payment made. It would seem logical for the Minister to allow the capital loss arising from the writing down of the debt to a nil cost to be netted against the capital gain which arises by virtue of the first disposition. The difficulty is further compounded because the taxpayer may not have any subsequent capital gains to offset against the capital loss. There is a clear need for amendments to this provision as well as a new provision for the deductibility of a doubtful debt reserve for an amount owing in respect of a disposition of capital property which is due in the taxation year but which has doubtful collectability.

(c) *Non-resident Taxpayers*

As an anti-avoidance device, pursuant to s. 40(2)(a), where a resident taxpayer becomes a non-resident of Canada, he will not be permitted to claim the deferred payment reserve in the year prior to the year when he becomes a non-resident. Moreover, non-residents may not make use of the deferred payment reserve when disposing of any capital property in Canada.

(d) *Dispositions Subject to Warranty*

The deferred payment reserve will have important implications for the effectiveness of s. 42. This latter provision requires a taxpayer to include in computing proceeds of disposition any amount received or receivable by the taxpayer as consideration for any warranty, covenant or other obligation. Conversely, under s.42 any outlay or expense incurred by the taxpayer as a result of the obligation in the year of disposition or in any of the six immediately following taxation years will be deemed to be a loss incurred in the year from the disposition of capital property. Aside from the fact that 6 years is too brief a period of time, it is readily apparent that a taxpayer who disposes of capital property and pays all taxes on the taxable capital gain in the year of sale because all of the proceeds of disposition are payable before the end of the year and who

is called on to make good on his warranty, covenant, or indemnity²¹² more than one year after the sale will be worse off than a taxpayer in a similar situation using the deferred payment reserve because his proceeds of disposition are payable over a period of years. The latter will be able to offset his capital losses arising under s. 42 against any gain computed under s. 40(1)(a)(ii) but the former may not have any gains to offset the loss deemed to arise by virtue of s. 42.

(e) *Tax Planning and the Use of the Deferred Payment Reserve*

(i) *Deemed Realization of Gains by Trusts*

S. 104(4) contains provisions whereby all trusts are deemed to dispose and reacquire all their capital property every twenty-one years, thus realizing possible taxable capital gains. Through the provisions of s. 104(4)(b), every trust created before January 1, 1972 is deemed to dispose all of its capital property (other than eligible capital property, resource properties and life insurance policies) on January 1, 1993 and every twenty-one years thereafter. For capital property (other than depreciable property), a trust will be deemed to have disposed of such property for proceeds of disposition equal to fair market value and to reacquire such property at the same price. Depreciable property is deemed to be realized and reacquired at a price equal to undepreciated capital cost plus or minus one-half the difference between fair market value and undepreciated capital cost. By reason of s. 104(4)(b)(ii), trusts created after January 1, 1972 will be deemed to realize their capital property at the above values every twenty-one years. A spouse trust (as defined by s. 70(6)(b)) will not be deemed to realize its capital property at the above values until the death of the spouse and then every twenty-one years thereafter. (see s. 104(4)(a) and (b)(iii).)

Shortly before the time of deemed realization, it may be advantageous for trusts to dispose of their capital property to controlled corporations for proceeds of disposition equal to fair market value payable by way of a long term debenture or note. The trust would realize its capital gains before the twenty-one year deemed realization occurs but the trust would avail itself of the deferred payment reserve in respect of that part of the capital gain which is not due to the trust in each year of the currency of the note or debenture.

(ii) *Transfers of Property to a Trust*

By virtue of s. 54(c)(iii), any transfer of property to a trust (other than a transfer where there is no change in beneficial ownership) is deemed to

212. S. 20(7) (i), which prevents the deduction of a reserve for guarantees, indemnities or warranties is discussed *supra* at p. 95. S. 20(7) (i) only relates to income from business or property and has no application to capital gains arising from dispositions of capital property (s. 9(3)).

be a disposition of capital property. Subject to the transfer not being at arm's length,²¹³ where the transfer is a sale at fair market value, the vendor should be permitted to utilize the deferred payment reserve in respect of that part of the capital gain which is not due in the taxation year (in accordance with a long term note or debenture).

(iii) *Sales Before Death*

Under the provisions of s. 70(5), on the death of a taxpayer, all capital property (other than depreciable property) is deemed to be realized at fair market value and all depreciable property is deemed to be realized at undepreciated capital cost plus or minus one half the difference between fair market value and undepreciated capital cost. However, these deemed realizations may be deferred through the use of a spouse trust under s. 70(6). Alternatively, a taxpayer could sell capital property at fair market value, to his children for example, payable by a long term note or debenture and then claim a deferred payment reserve. At death a taxpayer is not permitted to claim such a reserve,²¹⁴ but any amounts owing to the taxpayer at the time of his death could be bequeathed to his spouse or a spouse trust and an election could be made under s. 72(2)(b) for the deferred payment reserve to be continued to be claimed during the currency of the debt. Accordingly, the liability for the tax on the taxable capital gain arising on the sale by the deceased taxpayer before his death could be minimized by spreading the tax liabilities over several years and presumably at the spouse's lower income tax rate thus achieving an element of averaging.²¹⁵

(iv) *Sales to Controlled Corporations*

A taxpayer could use the technique of selling capital property to a controlled corporation at fair market value payable, once again, by way of a long term note or debenture. The taxpayer would then claim a deferred payment reserve for any part of the taxable capital gain not payable in the year. Immediately thereafter, the controlled corporation would sell the underlying property to a third party at arm's length at fair market value resulting in no capital gain to the corporation because the sale by the corporation has taken place at its adjusted cost base i.e. fair market value. Once again, the liability for tax has been minimized through the averaging technique of spreading the tax liability over a period of years through the use of the deferred payment reserve.

213. The question of the use of the deferred payment reserve in non arm's length transactions is discussed *infra* at p. 122.

214. s. 72(1)(c).

215. See Warren Grover; "Income Taxes Payable at Death", *Estate Planning Seminar*, York University, November, 1972, at p. 31.

(v) *The Deferred Payment Reserve in Non-Arm's Length Transactions: S. 78 and S. 55.*

The new Act does not specify that the deferred payment reserve is not permissible in non arm's length dispositions. It is presumed that unless the contrary is specifically stated, a taxpayer should have the benefit of the provision. For example, s. 40(2)(g)(ii) and s. 50(i), which relate to claiming a capital loss for a bad debt arising from a disposition of capital property, specifically exclude non-arm's length dispositions from their combined operation. If Parliament had intended that s. 40(1)(a)(iii) should not operate in non-arm's length dispositions it should have so specifically stated. It is arguable that *Home Provisioners (Manitoba) Limited v. M.N.R.*²¹⁶ is authority for the proposition that in a non-arm's length disposition there can be no reasonable amount of a reserve under s. 40(1)(a)(iii). However, the *Home Provisioners* case does not provide such sweeping authority.

The deferred payment reserve claimed under s. 40(1)(a)(iii) must not exceed a "reasonable amount". In the *Home Provisioners* case Thurlow, J., held that the amount claimed by the taxpayer as a reserve under s. 85B(1)(d) (now s. 20(1)(n) of the new Act) was not a reasonable amount and that the amount allowed by the Minister was a reasonable amount.

Thurlow, J., stated that reasonableness is integral to the amount of reserve being claimed:²¹⁷

Now under Section 85B(1)(d) what may be allowed as a reserve is not necessarily the whole of the amount which is receivable more than two years after the date of sale, for it may not be reasonable to regard all of the amount as profit from the sale; nor is the reserve to be allowed necessarily equal to the whole of the portion of the amount that can reasonably be regarded as profit from the sale. The reserve that may be deducted under Section 85(b)(1)(d) is a reasonable amount in respect of that part of the amount so included in computing the income that can reasonably be regarded as a portion of the profit from the sale.

What is a "reasonable amount" in a non-arm's length situation? Even if the Minister and the courts do not allow the whole of the deferred payment reserve, at least part of it should be allowed and if so, the taxpayer will have succeeded in achieving some income averaging where the deferred payment reserve is claimed. Furthermore, the *Station Heights Subdivision*²¹⁸ case indicates that there can be two "reasonably" amounts and in that case the Tax Review Board sided with the taxpayer's "reasonable amount". Only time will tell how and to what extent the deferred payment reserve may be used in non-arm's length transactions.

216. (1958) C.T.C. 334; the *Home Provisioners* case is discussed *supra*.

217. *Id.*, at p. 343.

218. *Supra* n. 199.

Further evidence that the Minister will allow a reserve under s. 40(1)(a)(iii) in a non-arm's length disposition is found in IT-152 which does contain a paragraph relating to non-arm's length transactions. It is stated that in determining what is a reasonable reserve the Minister will consider the following factors in a non-arm's length transaction:

- (a) any disposition of the property by the purchaser,²¹⁹
- (b) whether the terms of payment are reasonable and are adhered to.

IT-152 then states that where there are reasonable terms of payment but they are not adhered to, the Minister will recompute an allowable reserve on the basis on which the payments had been made.

Further difficulties may be encountered through the Minister making an assessment under s. 78(1)²²⁰ which relates to unpaid amounts in non-arm's length transactions. Under s. 78(1), where two taxpayers are not dealing at arm's length at the time an outlay or expense is incurred and such amount is unpaid at the end of the second taxation year following the taxation year in which the outlay or expense is incurred, the unpaid amount is included in computing the taxpayer's income in the third year unless the two taxpayers (debtor and creditor) elect under s. 78(1)(b) to file an agreement with the Minister whereby the amount is deemed to be paid but loaned back from the creditor to the debtor.

However, s. 78(1) may not apply because the cost of acquiring capital property may not constitute "a deductible outlay or expense" within the meaning of s. 78(1). The word "expense" relates to computing income from a business and the cost of acquiring capital property certainly is not such an expense. In the opinion of one commentator:

It is less clear that the cost of such property is not 'a deductible outlay' for the purposes of the subsection. On its face, subsection 78(1) is not limited to the computation of income from a business, although certainly under the former Act the only application of section 18 (now s. 78(1)) was in the computation of income from a business. It may be argued that the computation of gain contemplated by section 40 does not involve a deduction of any amount as such. Rather the section provides that the gain shall be the difference between two amounts, the proceeds of disposition and the adjusted cost base of the property.²²¹

The Minister could use s. 55 to attack any non-arm's length transactions which use the deferred payment reserve to minimize taxable liability. S. 55 has no counterpart in the old Act. Through s. 55, where the results of one of more sales exchanges, declarations of trust, or other transactions of any kind whatever is that a taxpayer has disposed of property under

219. A disposition by the purchaser is material in our discussion of sales to controlled corporations which is discussed *supra* at p. 121.

220. S. 18(1) of the old Act.

221. T. E. J. McDonnell, "Capital Gains: Tax Planning for the Individual" (1972) 20 *Can. Tax J.* 381 at 387.

circumstances such that he may reasonably be considered to have artificially or unduly:

- (a) reduced the amount of a gain, or
- (b) created or increased a loss,

the taxpayer's gain or loss will be computed without taking into account such reduction, creation or increase. S. 55 is very broad but it is arguable that using the deferred payment reserve to defer receipt of payment of proceeds of disposition over a period of years does not in fact reduce the amount of the gain within the meaning of s. 55 but rather minimizes the effective rate of tax on the gain because the vendor may be at a lower average tax rate over later years or he may have increased deductions in later years such as capital losses. If the latter are bona fide, it could not be said that a taxpayer "may reasonably be considered to have artificially or unduly reduced the amount of his gain." On the other hand, it may not be prudent to speculate on the extent of the scope of s. 55 until the courts have interpreted the provision.

S. 55 will be used in situations where the Minister is of the view that there has been an artificial or undue creation of a loss from a disposition. By a perusal of the English decisions on the analogous s. 460(3) of the U.K. Act, s. 55 should not apply where the transactions in question have been entered into principally for valid business reasons. In *I.R.C. v. Brebner*²²² a controlling group in a corporation successfully fought off a take over bid by purchasing minority interests at a higher price with funds that were borrowed from a bank and subsequently repaid from the proceeds of a reduction of the capital of the company. The revenue authorities sought to cancel the tax advantage obtained under the provisions of s. 460(3) of the U.K. Act. The House of Lords found in favour of the taxpayer and in doing so Lord Upjohn stated:²²³

My Lords, I would conclude my judgment by saying only that, when the question of carrying out a genuine commercial transactions, as this was, is considered, the fact that there are two ways of carrying it out, - one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects if for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except on the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide on a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence.

Needless to say, any adviser who recommends a tax avoidance technique using s. 40(1)(a)(iii) in a non-arm's length transaction is likely to end up in conflict before the courts with the Minister.

222. (1967) 1 A.E.R. 779.

223. *Id.*, at p. 784.

7. *Reserves for Profit Content of Instalment Receivables in the United Kingdom.*

1 (a) *Income Receivables*

In the United Kingdom it is not entirely clear whether reserves as they are known in Canada may be used in calculating profits of a trader where he is collecting receivables over a long period of time for goods sold and delivered in an earlier financial period. As previously stated, "profit" will be determined according to the ordinary principles of commercial accountancy unless the U.K. Act forbids the use of a specific deduction or accounting technique. For example, if the application of the reserve technique as we know it under s. 20(1)(n) of the new Act, best reflected profit of a trader in a particular industry in the United Kingdom, he would be able to use such method. The following has been stated more than once previously but it still bears repeating.²²⁴

In calculating the taxable profit of a business on income tax principles ... services completely rendered or goods supplied, which are not to be paid for till a subsequent year, cannot, generally speaking, be dealt with by treating the taxpayer's outlay as pure loss in the year in which it was incurred and bringing in the remuneration as pure profit in the subsequent year in which it is paid, or is due to be paid. ... the net result of the transaction, setting expenses on the one side and a figure for remuneration on the other side, ought to appear (as it would appear in a proper system of accountancy) in the same year's profit and loss account, and that year will be the year when the service was rendered or the goods delivered ... This may involve, in some instances, an estimate of what the future remuneration will amount to (and in theory, though not usually in practice, a discounting of the amount to be paid in the future) ... If the accounts ... were made up before the amount of the commission was ascertained, a provisional estimate of what the amount would be might be inserted in the first place and could be corrected, when the precise figure was known, by additional assessment or by a return of any excess within six years of the original assessment.

Therefore once the trader has fulfilled his part of the bargain either by providing services or delivering goods, he must include either an exact or estimated amount owing to him in his current year's accounts. "Money must not be taken as being, so to speak, in hand until all the conditions to earn it have been fulfilled."²²⁵ However, *Absalom v. Talbot*²²⁶ indicates that where a debt is paid by instalments extending over a number of years the taxpayer should either be taxed on the present value of the debt having regard to the risk of it not being paid in full or if this is impractical each instalment should be brought into the profits for the year in which it is payable and taxed accordingly.

224. Per Lord Simon in *I.R.C. v. Gardner, Mountain and D'Ambrumenil Ltd.* (1947) 29 T.C. 69 at p. 93.

225. Per Lord Greene M. R., in *Johnson v. W. S. Try Ltd.* (1946) 27 T.C. 167 at p. 185 (C.a.).

226. (1944) A.C. 204; 26 T.C. 166 (H.L.); *Absalom v. Talbot* is discussed *supra* at p. 87.

The following words of Lord Atkin from his judgment in *Absalom v. Talbot*²²⁷ support the above proposition:

Now no one doubts that in ordinary commercial practice where goods are sold on terms of ordinary commercial credit, three or six months or even more, traders are in the habit of treating the debt so created as part of the profits of the year in which the debt is incurred. Thus, where the business accounts are made up at the end of the calendar year, a sale in December on credit terms which expire in March or April will be regarded as a profit made in December. And this commercial practice is treated by taxpayers and tax collectors alike as involving a just and accurate computation of profits. The obligations so incurred in ordinary trading are treated as firm obligations and as good as cash in hand, and no one is any the worse. If expectations are disappointed, an allowance for a bad debt can be claimed and will be granted. But when one leaves the realm or ordinary commercial credits and has to deal with credits extending over many years, the whole situation is changed. ... To my mind to treat money to be paid 20 years hence as producing a profit this year equal to money in fact paid this year is to produce a completely unreal conception of yearly profit, and I venture to think quite foreign to any commercial ideas on the subject. ... It seems to me ... unreasonable to treat the whole sum payable over 20 years as amounting to a profit of the whole face value made in the year of sale ... a sum payable without interest, either in a lump sum several years ahead or by instalments could never be equivalent to its face value in the year of origin.

Finally, Lord Atkin stated that as an alternative to setting up a "suspense account ... calculated upon the ordinary risk of bad debts,"²²⁸ it would be proper to tax "in each year the instalments actually paid or at any rate payable.... I can express no final opinion about this, for it has not been argued, but I should like to consider it an open point."²²⁹

Lord Atkin was in effect stating what has been repeated before. "It is established that there is no express statutory provision governing the computation of such profits, they are to be computed on principles of commercial accountancy, subject only to statutory modification."²³⁰

It can therefore be argued that under Lord Atkin's dicta in *Absalom v. Talbot*, a taxpayer could bring instalment payments received by him into income as they are received and the profit portion thereof would be taxed in accordance with the instalment method of accounting with the result that the profits would be taxed in the same fashion as a Canadian taxpayer who uses the reserve under s. 20(1)(n) of the new Act.

(b) Instalment Receivables and Capital Gains

Capital gains were first taxed in the United Kingdom under the Finance Act, 1965. The tax applies to all gains realized on the sale or other

227. *Id.*, at pp. 191-2

228. *Id.*, at p. 193.

229. *Ibid.*

230. Per Ungood Thomas, J., in *Coren Keighley* (1972) 1 W.L.R. 1556 at p. 1565 (Ch.).

disposition of property which has been held for more than twelve months. The basic rate is 30%. A corporation includes its gains in its profits which are then subject to corporate tax.

Until April 10, 1972, the U.K. Act contained what amounted to a provision quite similar in effect to s. 40(1)(a)(iii) of the new Act whereby, if the consideration was payable by instalments over a period exceeding eighteen months beginning not later than the time the disposition was made, the amount of the taxable gain could be accrued proportionately throughout the payment period. Paragraph 14 of Schedule 6 of the Finance Act, 1965 stated:

If the consideration or part of the consideration, taken into account in the computation under this Schedule is payable by instalments over a period beginning not earlier than the time when the disposal is made, being a period exceeding 18 months, the chargeable gain (or allowable loss) accruing on the disposal shall be regarded for all the purposes of this Part of this Act as accruing in proportionate parts in the year of assessment in which the disposal is made and in each of the subsequent years of assessment down to and including the year of assessment in which the last instalment is payable.

Effective April 11, 1972 paragraph 14 was amended as follows:

14.-(1). If the consideration, or part of the consideration, taken into account in the computation under this Schedule is payable by instalments over a period beginning not earlier than the time when the disposal is made, being a period exceeding eighteen months, then, if the person making the disposal satisfies the Board that he would otherwise suffer undue hardship, the tax on a chargeable gain accruing on the disposal may, at his option, be paid by such instalments as the Board may allow over a period not exceeding eight years and ending not later than the time at which the last of the firstmentioned instalments is payable.

As a result of its amended form, paragraph 14 of the U.K. Act now is remarkably different in its impact as compared with s. 453 of the Code and s. 40(1)(a)(iii) of the new Act. However before discussing the ramifications of paragraph 14 of Schedule 6 of the U.K. Act it is necessary to point out the somewhat startling recent decision in *Coren v. Keighley (Inspector of Taxes)*.²³¹ Here the taxpayer sold a property for £3,750 on terms which provided for a downpayment of £1500 and the balance of £2,250 by the taxpayer as vendor taking back a mortgage for £2,250 payable over 10 years with interest at 9¼ %. Ungoed-Thomas, J., held that it was a sale for a consideration of £3,750 and not a sale by instalments and that paragraph 14 (as it read before the amendment noted above) did not apply. The judgment of Ungoed-Thomas, J., is based on his finding that the transactions of sale and loan by way of mortgage were severable since the taxpayer as vendor acknowledged

231. (1972) 1 W.L.R. 1556 (Ch.); at the date of writing there appears to be no reported appeal from the judgment of Ungoed-Thomas, J.

receipt of the full purchase price of L3,750 and treated the mortgage of L2,250 as a loan or advance. This is the most startling decision since most sales of real property in Canada involving the vendor taking back a mortgage from the purchaser are technically structured in this manner. In Canada, the transferor will acknowledge receipt of the full sale price in the transfer of land. If this case is followed in Canada it will have disastrous repercussions on the usefulness of s. 40(1)(a)(iii) of the new Act. Alternatively, it will be necessary for the transferor not to acknowledge payment in full in the transfer of land.

Now let us return to our discussion of paragraph 15 of Schedule 6 (as amended)²³² of the U.K. Act. Before the amendment of April, 1972, (as with s. 40(1)(a)(iii) of the new Act) there could be substantial deferment of capital gains tax liability if the sale consideration was payable over a long period of time (for example, twenty or thirty years) even though the property was actually transferred contemporaneously with the execution of the contract. Effective April 11, 1972, these provisions must be terminated and the capital gains tax will be payable at the time the contract is made unless the vendor can satisfy the Board of Inland Revenue that he will suffer undue hardship. In such event, the capital gains tax may be paid by instalments over a period not exceeding eight years but in no event not longer than the time when the instalments terminate under the sale agreement. For transactions entered into prior to April 11, 1972, the whole of the capital gains tax becomes due and payable unless the taxpayer can show he suffers undue hardship, in which event the Board of Inland Revenue may allow payment of the tax by instalments on such terms as they may allow.²³³ Of course the danger for the taxpayer in such a provision is what is "undue hardship"? Will the revenue authority look at just the cash resources of the taxpayer generated by the sale or will it look to the other resources of the taxpayer?

The answers to the above questions may be found in the following statement of the Chief Secretary to the Treasury during debate in Committee stage on the amendments:²³⁴

In considering whether undue hardship would arise, the Revenue would look primarily to the question whether the vendor or disponent could reasonably be expected to pay the tax on the full amount immediately, in the light of the resources made available by the particular transaction involved. Regard would not normally be paid to the other resources of the taxpayer if it could be shown

232. An extract of paragraph 14 of Schedule 6 may be found *supra* at p. 132 substantially the same amendment was made to s. 81 of the U.K. Act concerning the taxation of lease premiums payable by instalments.

233. The length of time of payment need not be limited to the 8 year rule: see s. 116(3) and para. 5 of Sch. 13 of F.A., 1972.

234. Standing Committee E. June 22, 1972, Col 1358:

that the instalment arrangement was in the circumstances, and apart from any tax considerations, a normal commercial arrangement and reflected a genuine deferment of the enjoyment of the considerations.

The apparent reason given for the amendment was that "the instalments provisions in the 1965 capital gains tax provisions had been grossly abused and Ministers, after considering various alternative anti-avoidance measures, had decided that the best course was to abolish them and allow a spread-over up to eight years where otherwise undue hardship would be caused as in other estate duty and capital gains tax provisions."²³⁵

If s. 40(1)(a)(iii) of the new Act is similarly abused in the future, the "handwriting is on the wall" as to how the provision will be amended to prevent and curtail such abuse.

IV. CONCLUSION

Both jurisdictions, ie. Canada and the United Kingdom, have different approaches to the use of reserves in their tax collecting mechanisms. The determination of the ever elusive concept of profit is different in each jurisdiction but the same tools are used. It is only the extent of the statutory direction to use the specific tools that differs. By way of conclusion, these different approaches shall be examined as they relate to the use of reserves.

A. *The Concept of Profit*

Each of the jurisdictions attempts to comply with the matching principle.²³⁶ However, there are still wide differences between financial accounting and tax accounting in both jurisdictions.²³⁷ Both the U.K. Act and the new Act are silent on the subjects of the accounting methods to be used to ascertain profit except to the extent that s. 12(1)(b) of the new Act implicitly requires the use of the accrual method of accounting. The U.K. Act and the new Act do not expressly state that profit shall be determined in accordance with recognized accounting principles or practices. (By contrast, s. 446 of the U.S. Internal Revenue Code and the Regulations require a method of accounting which clearly reflects income of the taxpayer with the Regulations²³⁸ expressly requiring the consistent application of generally accepted accounting principles in order to clearly reflect income.) On the other hand, the application of accounting principles to ascertain profit is strongly

235. Summary of Submission of Allied Accountancy Body to the Chancellor of the Exchequer - Finance Bill, 1972; Volume 89, *Taxation*, p. 369.

236. The matching principle is discussed *supra* at p. 14.

237. The conflict between financial accounting and tax accounting is discussed *supra* at p. 21.

238. Regulation 1.455-1(2).

entrenched in the jurisprudence of Canada²³⁹ and the United Kingdom.²⁴⁰ The approach in Canada and the United Kingdom is preferred over that of the United States because the courts can be more flexible and easily adaptable to changing conditions and needs in today's modern industrial complex. The legislature and the executive branches of government are often unable to deal effectively with the real issues facing a taxpayer. We have one reservation in this area, and that is in agreement with Chairman Carter,²⁴¹ the new Act should contain a provision expressly directing the application of recognized accounting principles for the determination of profit.

B. Reserves

1. General

The new Act contains far more provisions permitting the use of reserves in a great many situations as compared with the U.K. Act. The new Act's glaring defect, however is s. 18(1)(e).²⁴² The following are general comments with regard to each of the four reserves dealt with in this thesis.

2. Reserve for Estimated Expenses and Contingent Liabilities

Reserves for contingent liabilities per se will not be allowed in either of the two jurisdictions. However in the United Kingdom, reserves for contingent liabilities will be allowed where they constitute an essential charge against the year's receipts.²⁴³

Canada is the only jurisdiction (when compared with the U.K. Act and the U.S. Internal Revenue Code) which by statute forbids the use of reserves for contingent liabilities.²⁴⁴ The result of such a blanket prohibition is either gross distortions of the matching principle²⁴⁵ or judicial decisions which go to extreme lengths to afford relief to a taxpayer notwithstanding the provisions of the new Act.²⁴⁶ The law in the United Kingdom is preferred over that of the other two jurisdictions since the courts in England, without being encumbered by any statutory obstacles, are permitted to apply fairly flexible standards to particular

239. The profit concept is discussed *supra* at p. 5; see also *Dominion Taxicab Association v. M.N.R.* 54 D.T.C. 1020 at p. 1021 (S.C.C.).

240. *Supra* at p. 8 for a discussion of the reliance in the United Kingdom on "Ordinary Commercial Principles for Computing Profit."

241. Mr. Carter's views on the subject are set out *supra* at p. 6.

242. S. 18(1)(e) is discussed *supra* at p. 47.

243. *Supra* at p. 54 for a discussion of *Southern Railway of Peru v. Owen* (1957) A.C. 334 at p. 361.

244. S. 18(1)(e).

245. *J. L. Guay Ltee v. M.N.R.* 71 D.T.C. 5423 (F.C.T.D.) discussed *supra* at p. 48.

246. See particularly *Atlantic Engine Rebuilders Ltd. v. M.N.R.* (1967) C.T.C. 230 (S.C.C.) discussed *supra*.

situations since they are able to use reserves for contingent liabilities provided the ascertainment of "true profit" results on the facts of each particular case. Pragmatism in the United Kingdom is definitely preferred over the rigidity found in the taxing statute and jurisprudence of Canada.

3. *Reserves for Doubtful and Bad Debts*

Apart from the problems that an investor faces in both jurisdictions in attempting to deduct the total amount of his losses from ordinary income, this reserve appears to answer the needs of modern business conditions and practices. Although the U.K. Act does not provide specifically for a reserve for doubtful debts, a taxpayer in the United Kingdom seeking to determine "true profit" may be afforded relief by the courts, depending upon the facts of each case.

4. *Reserves for Deferral of Prepaid Income*

It is clear that s. 20(1) (m) of the new Act is all embracing and its application is beneficial to Canadian taxpayers since it essentially permits the matching principle to operate to its optimum potential. While the U.K. Act does not provide specifically for such a reserve, the jurisprudence clearly provides for the matching principle to operate through reserves (by whatever name) being used in accordance with proper principles of commercial accounting.

5. *Reserve for Profit Content of Instalment Receivables*

S. 20(1)(n) of the new Act again permits the matching principle to operate to the fullest extent possible. There are no time limits on the period in which payments may be received, and the manner in which the reserve is calculated does not appear to be unfair to the taxpayer. In the capital gains area, the United Kingdom has introduced the "undue hardship"²⁴⁷ test without much outcry from taxpayers and their advisors. If s. 40(1)(a)(iii) of the new Act proves to be a provision which is abused by the Canadian taxpayer, the road taken by the authorities in the United Kingdom clearly indicates how the provisions relating to the deferred payment reserve in Canada might be amended.

C. *Canada: The Need For Reform*

It is difficult to disagree with the logic behind Chairman Carter's personal recommendations that our statute should direct that profit be ascertained in accordance with recognized accounting practices. Once this provision was part of the new Act, all the provisions relating to reserves could be repealed and the taxpayer would be put to the reasonable test in much the same manner as reserves are used in the

247. The "Undue hardship test" in the United Kingdom is discussed *supra* at p. 134.

United Kingdom. All reasonable charges that are allowed by a system of accounting would be deductible in computing business income. So long as s. 67, which prevents unreasonable deductions, is part of the new Act, abuse by the taxpayer would be prevented and the requirements of government revenue would be protected. The ordinary businessman wishes to know what his "true profit" is and there does not appear to be any logical argument why the revenue authority should not tax this "true profit". Any other treatment amounts to confiscation and a gross distortion of and lip service to the matching principle. If rules relating to reserves remain part of our taxing statute, the unnecessary technicalities in the statute become more and more entrenched. Rules relating to reserves add to the statute's technicality by ubiquitously surfacing in some of its most complex provisions such as amalgamations of corporations,²⁴⁸ winding up of wholly owned Canadian corporations²⁴⁹ tax equity,²⁵⁰ and therefore 1971 capital surplus on hand,²⁵¹ paid up capital deficiency²⁵² and paid up capital limit.²⁵³

With regard to the deferred payment reserve of s. 40(1)(a)(iii) there is a clear need for a reserve for doubtful debt provision similar in effect to s. 20(1)(1). Additionally the Minister should issue some clarification concerning the extent to which s. 40(1)(a)(iii) may be used in non arm's length transactions.

It is clear that in the area of reserves, the Canadian tax reform process has only begun and one should optimistically watch each new Budget for greater advances.

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248. S. 87(2) (g) (i); s. 87(2) (h), (i), (j), (m).

249. S. 88(e) refers to paid up capital limit which is defined in s. 89 (1) (e) as paid up capital minus paid up capital deficiency. Reserves affect the computation of paid up capital deficiency under s. 89(1) (d) since reserves form a part of tax equity (pursuant to s. 89 (1) (h) (ix)) which must be deducted from paid up capital deficiency under s. 89 (1) (d) (v). This directly affects the computation of paid up capital limit under s. 89 (1) (e).

250. S. 89(1) (h) (ix).

251. S. 80(1) (1).

252. 89(1) (d).

253. S. 89(1) (e).

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