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

AND

ATLANTIC ENGINE REBUILDERS LIMITED ..... RESPONDENT.

1966
*Dec. 9
1967
May 23

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Whether unredeemed refundable deposits received from customers part of business income—Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(a), 85B.

The respondent company was in the business of rebuilding automobile engines for sale to car dealers. The company required the car dealers, on purchasing a rebuilt engine, to supply it with another rebuildable engine as well as paying the invoice price. A dealer who did not supply a rebuildable engine was required to pay a cash deposit, about three times the market value of the used engine. This deposit was refundable when the dealer supplied a rebuildable engine, which happened 96 per cent of the time. The unredeemed deposits held by the respondent company at the end of 1958 were added by the Minister to the respondent's declared income for that year. The Exchequer Court allowed the respondent's appeal, and the Minister appealed to this Court.

Held (Abbott and Judson JJ. *dissenting*): The appeal by the Minister should be dismissed.

Per Cartwright, Martland and Ritchie JJ.: In stating what its profit was for the year in question, the respondent could not truthfully have included these unredeemed deposits. It knew that it might not be able to retain any part of that sum and that the probabilities were that 96 per cent of it would be returned to the depositors in the near future. The circumstance that the company became the legal owner of the moneys deposited and that they did not constitute a trust fund in its hands was irrelevant. There was no basis, having regard to the realities of the situation, on which these deposits could properly be treated as ordinary trading receipts of the respondent which it was entitled to include in calculating its profits for the year. There was nothing in the *Income Tax Act* requiring these deposits to be treated as profits of the respondent.

Per Abbott and Judson JJ., *dissenting*: The deposits were of an income nature arising in the ordinary course of the respondent's trading transactions. There was no liability to refund until the rebuildable engine was actually delivered. The probability that the taxpayer would be required to refund the greater portion of the deposits does not permit their deduction. They would be deductible in the year in which they were refunded. Furthermore the amount, shown as a liability, was an amount transferred or credited to a reserve within the provisions of s. 12(1)(*e*) of the *Income Tax Act*.

*PRESENT: Cartwright, Abbott, Martland, Judson and Ritchie JJ.

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Revenu—Impôt sur le revenu—Dépôts reçus de clients remboursables mais non rachetés font-ils partie du revenu de l'entreprise—Loi de l'Impôt sur le Revenu, S.R.C. 1952, c. 148, arts. 12(1)(a), 85B.

Le commerce de la compagnie intimée consistait dans la reconstruction de moteurs d'automobiles et leur vente à des commerçants d'automobiles. La compagnie exigeait que les commerçants fournissent, lorsqu'ils achetaient un moteur reconstruit, un autre moteur apte à être reconstruit en plus de payer le prix de la facture. Un commerçant qui ne pouvait pas fournir un moteur apte à être reconstruit était obligé de payer un dépôt en argent, représentant à peu près trois fois la valeur marchande d'un moteur usagé. Ce dépôt était remboursable lorsque le commerçant fournissait un moteur apte à être reconstruit, ce qui se présentait dans 96 pour cent des cas. Le Ministre a ajouté au revenu de la compagnie pour l'année 1958 le montant des dépôts non rachetés qu'elle avait en mains à la fin de cette année. La Cour de l'Échiquier a maintenu l'appel de la compagnie et le Ministre en appela devant cette Cour.

Arrêt: L'appel du Ministre doit être rejeté, les Juges Abbott et Judson étant dissidents.

Les Juges Cartwright, Martland et Ritchie: En déclarant quel était son profit pour l'année en question, la compagnie intimée ne pouvait pas véridiquement inclure ces dépôts non rachetés. Elle savait qu'elle pourrait ne pas être en mesure de retenir aucune partie de cette somme et que les probabilités étaient que 96 pour cent de cette somme serait remis aux déposants. Le fait que la compagnie était devenue le propriétaire légal des argents déposés et que ces argents ne constituaient pas un fonds en fiducie entre ses mains n'avait aucune pertinence. En face de la réalité de la situation, il n'y avait aucune base sur laquelle ces dépôts pouvaient être considérés comme étant des reçus provenant du commerce ordinaire de l'intimée et qu'elle avait droit d'inclure dans le calcul de son profit pour l'année. Aucune disposition de la *Loi de l'Impôt sur le Revenu* exige que ces dépôts soient traités comme étant des profits entre les mains de l'intimée.

Les Juges Abbott et Judson, *dissidents*: Les dépôts étaient de la nature d'un revenu survenant dans le cours ordinaire des transactions commerciales de l'intimée. Il n'y a aucune obligation de les retourner tant qu'un moteur apte à être reconstruit ne soit actuellement délivré. La probabilité que le contribuable serait obligé de retourner la majeure portion de ces dépôts ne permet pas leur déduction. Ils étaient déductibles dans l'année où ils avaient été retournés. De plus, le montant, tel qu'entré comme étant un passif, était un montant transféré ou crédité à une réserve dans le sens de dispositions de l'art. 12(1)(*e*) de la *Loi de l'Impôt sur le Revenu.*

APPEL d'un jugement du Juge Thurlow de la Cour de l'Échiquier du Canada[1], en matière d'impôt sur le revenu. Appel rejeté, les Juges Abbott et Judson étant dissidents.

[1] [1965] 1 Ex. C.R. 647, [1964] C.T.C. 268, 64 D.T.C. 5178.

APPEAL from a judgment of Thurlow J. of the Exchequer Court of Canada[1], in an income tax matter. Appeal dismissed, Abbott and Judson JJ. dissenting.

G. W. Ainslie, for the appellant.

George B. Cooper, for the respondent.

The judgment of Cartwright, Martland and Ritchie JJ. was delivered by

CARTWRIGHT J.:—This is an appeal from a judgment[1] of Thurlow J. pronounced on August 17, 1964, allowing the appeal of the respondent from a re-assessment of income tax for the year 1958 in respect of a sum of $38,213, representing the balance of amounts known in the respondent's business as "core deposits", which the appellant in making the re-assessments included in the computation of the respondent's income.

The relevant facts are fully set out in the reasons of Thurlow J. and are sufficiently summarized in those of my brother Judson; it is unnecessary to repeat them.

I have reached the conclusion that the appeal fails.

Section 4 of the *Income Tax Act* provides that, subject to the other provisions of Part I of the Act, income for a taxation year from a business is the profit therefrom for the year.

In *Sun Insurance Office v. Clark*[2], a case in which the question for decision was the amount of the profits arising from the appellant's business, Earl Loreburn L.C. spoke at page 454 of "the only rule of law that I know of, namely, that the true gains are to be ascertained as nearly as it can be done".

In *Dominion Taxicab Association v. Minister of National Revenue*[3], it was said in the judgment of the majority of the Court:

> It is well settled that in considering whether a particular transaction brings a party within the terms of the *Income Tax Act* its substance rather than its form is to be regarded.

The question of substance in this case appears to me to be whether in stating what its profit was for the year the

[1] [1965] 1 Ex. C.R. 647, [1964] C.T.C. 268, 64 D.T.C. 5178.
[2] [1912] A.C. 443.
[3] [1954] S.C.R. 82 at 85, 2 D.L.R. 273.

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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 per cent 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.

The grounds upon which Thurlow J. based his decision appear to me to be supported by the reasoning of the majority in this Court in *Dominion Taxicab Association v. Minister of National Revenue, supra,* at p. 85, where it is stated that as each deposit was received by the Association and became a part of its assets there arose a corresponding contingent liability equal in amount. This was one of the grounds on which it was held that the deposits formed no part of the profits of the Association. Since that decision there has been no substantial change in the wording of the sections of the *Income Tax Act* on which the appellant relies.

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.

The result brought about by the judgment of Thurlow J. is that in the year in question the respondent will be taxed on its true profit for that year. If in the following year, as seems probable, as to a small portion of the said sum of $38,213, the respondent ceases to be under liability to

return it to the depositor or depositors, such portion will form part of the profit in that year and once again the respondent will be taxed on its true profit. I do not think that such a result should be disturbed.

I would dismiss the appeal with costs.

The judgment of Abbott and Judson JJ. was delivered by

JUDSON J. (*dissenting*):—The Minister, in assessing the respondent's income for its 1958 taxation year, included in income the sum of $38,213 shown on its balance sheet as a current liability entitled "Customers' Deposits". The Exchequer Court[1] allowed an appeal from this assessment and the Minister appeals now to this Court.

The company was in the business of rebuilding Ford engines. It sold these to Ford dealers, but in order to stay in business, it needed a regular supply of rebuildable engines. Therefore, when it sold an engine to a dealer, it required that dealer to supply it with another rebuildable engine of the same model. If the dealer did not supply the rebuildable engine, he had to pay a deposit to be held by the company until he did supply such an engine. When he did, he got his deposit back. It is these unredeemed deposits held by the company to the amount of $38,213 which the Minister has assessed for income. The amount of the deposit was usually about three times the market value of the old used engine. It was deliberately set at this high figure in order to ensure that an old engine would be delivered as soon as possible.

Other details of the arrangement between the company and its customers were that the engine on a visual inspection had to be rebuildable. If parts of the engine were missing or if there were defects which were visual or apparent on inspection, the deposit was not refunded in full but was reduced. If the engine on a visual inspection was not rebuildable, the dealer only got the scrap value of the engine as a credit.

The company did not keep these deposits separate from other monies received by it from its sale of rebuilt engines. There is no question here of any trust attaching to the deposit monies. It was argued before the Tax Appeal Board

[1] [1965] 1 Ex. C.R. 647, [1964] C.T.C. 268, 64 D.T.C. 5178.

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in another case that there was such a trust. This was rejected and no appeal was ever taken from this decision. *Western Engine Works Limited v. Minister of National Revenue*[1]. In my opinion, this case was correctly decided.

The learned trial judge in setting aside the assessment held that the company was entitled to a deduction in respect of its liability to refund the deposits, that this liability was not a contingent liability, and that the amount necessary to provide for their retirement was not a reserve, contingent amount, or sinking fund within the prohibition of s. 12(1)(*e*) of the *Income Tax Act*. The liability, he said, was not one that arose on delivery of the engine but existed from the time of receipt of the deposit. It became due and payable when the engine was actually delivered.

The evidence seems to show that in most cases only a short time elapsed between the payment of the deposit and its redemption by the delivery of a rebuildable engine. It also shows that about 96 per cent of the deposits were redeemed.

The judgment of the Exchequer Court is obviously founded upon the finding that the deposits were of an income nature arising in the ordinary course of the company's trading transactions. With this, I agree.

In this Court, the Crown has two points in its appeal based on ss. 12(1)(*a*) and 12(1)(*e*) of the Act,

(1) that the amounts necessary to provide for the retirement of these liabilities which at the end of the year had "not become due or recoverable by the dealer" were neither outlays or expenses made or incurred during the year (s. 12(1)(*a*)), and

(2) that such amounts would be in respect of a reserve or contingent account and, as such, prohibited by s. 12(1)(*e*).

Sections 12(1)(*a*) and 12(1)(*e*) read:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
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> * * *
>
> (*e*) an amount transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by this Part.

[1] (1959), 13 D.T.C. 472.

The Minister's position is that unless there is an express provision in the Act, the taxpayer is prohibited by these paragraphs from making these deductions. He says there are no such other provisions.

It is obvious that there was no outlay or expense made until the deposit was refunded. But the judgment under appeal holds that the outlay or expense was incurred when the deposit was made because the liability to refund was immediate and not contingent. In this I think there is error. There was no liability to refund until the rebuildable engine was actually delivered. 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. And even then, as I have pointed out above, there were several potential adjustments to be made depending on the state of the rebuildable engine as disclosed by a visual inspection.

The probability, in this case 96 per cent, that the taxpayer would be required to refund the greater portion of the deposits does not permit their deduction. They are deductible in the year in which they are made.

I also think that the company fails under s. 12(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 make an express provision here.

The main argument of the taxpayer in this case was directed to the nature of the receipt. He argued that the consideration for the sale of a rebuilt engine is the catalogue price plus the delivery of a rebuildable engine of the same model, and that the deposit is a refundable deposit which at the time of its receipt is not the absolute property of the respondent. I cannot accept this submission. No one else had any property interest in the deposit except the taxpayer. It became part of his funds. It was not a trust. Its receipt merely gave rise to an obligation to repay when something further was done by the person who made the deposit. There was no immediate liability to repay. These deposits are chargeable against income for the year when they are refunded.

I do not think that s. 85B requires any consideration for the determination of this appeal.

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Nor do I think that *Dominion Taxicab Association v. Minister of National Revenue*[1] governs this case. The word "deposit" is one of highly variable meaning. Its mere use in a contract determines nothing without an analysis of the rights and obligations created. In the *Taxicab* case it was the price of membership in the Association. It was transferable and interest bearing under certain conditions. The conclusion in this Court was that it did not become the absolute property of the Association. Rand J. held that it was a contribution to the capital of the Association and not an income receipt. On both grounds the present case is distinguishable.

The appeal should be allowed with costs and the assessment of the Minister for the 1958 taxation year restored.

Appeal dismissed with costs, ABBOTT *and* JUDSON JJ. *dissenting.*

Solicitor for the appellant: E. A. Driedger, Ottawa.

Solicitors for the respondent: Friel & Cooper, Moncton.

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[1] [1954] S.C.R. 82, 2 D.L.R. 273.