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Timing and Recognition of Income

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Abstract

This paper reviews selected developments concerning the timing and recognition of income since Brian Arnold's 1983 book on the topic. In particular, the author examines the "analytical framework" for resolving business profit-measurement issues under section 9, designed by the Supreme Court in the *Canderel* decision, and shows the similarities between the Supreme Court's approach to the issues and that of Arnold in 1983.

The author argues that the framework has internal inconsistencies and does not reconcile prior case law, leaving difficulties for the future. The author also synthesizes and summarizes many of the basic case law principles governing the determination of profit under section 9.

Keywords Accounting principles; income; profits; realization; timing.

In 1983, the Canadian Tax Foundation published Tax Paper no. 71, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, by Brian J. Arnold.[1] It has been influential. It is perhaps the most comprehensive treatment in Canadian tax literature of the timing aspects of various sources of income and deductions for purposes of the Income Tax Act.[2]

Nearly 20 years later, there have been a number of significant developments in the law respecting timing and recognition of income for tax purposes, particularly through a series of Supreme Court decisions during the 1990s. It would seem timely to attempt at least a partial survey of developments to update the analysis from 1983.

For practical reasons, the objectives of this paper will be more modest than the comprehensive treatment Arnold gave the subject. In the first part of the paper, I will examine the principles involved in computing business profit, with particular focus on the "analytical framework" for determining profit for income tax

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purposes proposed by the Supreme Court of Canada in *Canderel*.[3] In the second part of the paper, I will look at the *Friesen*[4] decision with respect to recognition of inventory losses. The third part will survey a number of selected timing and recognition issues that have arisen through legislative amendment and case law since the publication of Arnold's monograph. Throughout, I will attempt to steer the same course as Arnold—discussing the principles rather than the detailed rules.

The Computation of Business Profit

Introduction

Arnold began his paper with a basic outline of the concept of profit in Canadian income tax law:

> Section 9 of the Canadian Income Tax Act provides quite simply that "a taxpayer's income for a taxation year from a business or property is his profit therefrom for the year." Two important aspects of the measurement of business income emerge from this simple provision. First, income is defined as "profit"; and second, such profit is computed for each taxation year.[5]

In defining income as "profit," section 9 invites inquiry into the substantive issues surrounding the recognition of revenues and expenditures. As the profit must be "for the year," section 9 invites further inquiry into the relevant factors that determine when revenues and expenditures arise and enter into the computation of profit for a given taxation period.

These two problems of inquiry have occupied revenue authorities, taxpayers, professionals, and the courts from the earliest days of income taxation, and remain, for compliance reasons, of yearly concern to taxpayers. A substantial body of jurisprudence and literature has built up over the years concerning recognition and timing. Running through the commentary, including Arnold's work, is a desire for definition, predictability, and consistency in the principles governing the computation of profit, and an apparent concern that the jurisprudence does not always satisfy in these respects. In particular, questions repeatedly arise concerning the role and relevance of generally accepted accounting principles (GAAP), and the linkages between accounting and judicial concepts for determining profit.

The Supreme Court of Canada attempted to address these issues in the 1990s. In *Symes v. The Queen et al.*,[6] Iacobucci J explained what he considered to be the general principles governing the computation of profit for income tax purposes. Subsequently, in *Canderel*, he reviewed and attempted to clarify these principles further, out of an apparent concern that some of what he said in *Symes* may have been misinterpreted by the Federal Court of Appeal.[7] He did this by analyzing what he considered to be the principles of profit computation, and their rationale, in the context of the jurisprudence. He then summarized these into six principles, which he intended as an "analytical framework" to guide lower courts, revenue

authorities, and taxpayers in resolving profit measurement issues, particularly where the case involves competing accounting solutions to the problem. These principles are as follows:

> (1) The determination of profit is a question of law.
>
> (2) The profit of a business for a taxation year is to be determined by setting against the revenues from the business for that year the expenses incurred in earning said income: *M.N.R. v. Irwin*, *supra*, *Associated Investors*, *supra*.
>
> (3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.
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> (4) In ascertaining profit, the taxpayer is free to adopt any method which is not inconsistent with
>
> (a) the provisions of the *Income Tax Act*;
>
> (b) established case law principles or rules of law; and
>
> (c) well-accepted business principles.
>
> (5) Well-accepted business principles, which include but are not limited to the formal codification found in G.A.A.P., are not rules of law but interpretive aids. To the extent that they may influence the calculation of income, they will do so only on a case-by-case basis, depending on the facts of the taxpayer's financial situation.
>
> (6) On reassessment, once the taxpayer has shown that he has provided an accurate picture of income for the year, which is consistent with the Act, the case law, and well-accepted business principles, the onus shifts to the Minister to show either that the figure provided does *not* represent an accurate picture, or that another method of computation would provide a *more* accurate picture.[8]

Iacobucci J also applied these principles to dispose of the appeals in *Toronto College Park Limited v. The Queen*[9] and *Ikea Limited v. The Queen*,[10] both of which were heard on the same day as *Canderel*. The court's summary of principles is already being referred to and applied in subsequent cases.[11]

Parallels Between Arnold's and Iacobucci J's Analyses

Curiously, Iacobucci J's analysis of the issues and the solutions or approaches he preferred appear largely to parallel Arnold's 1983 analysis. One is easily left wondering if this is evidence of the influence of Arnold's work.

Both Iacobucci J and Arnold observed that the determination of profit is a question of law for tax purposes and referred to similar policy reasons for preferring a legal test over one based solely on GAAP. Arnold was one of the earliest commentators to observe that the determination of profit was subject not just to overriding statutory provisions, but to overriding judicial principles as well. While courts traditionally said that profit was to be determined according to ordinary commercial principles, subject to the statute, Iacobucci J specifically

confirmed that determination of profit based on ordinary commercial and business principles is subject to established case law principles—perhaps the first time the Supreme Court has done so in such terms.

Both Arnold and Iacobucci J examined the interplay between the judicial and accounting concepts of profit. Both were of the view that "ordinary commercial principles," the judicial determinant of profit, include GAAP. Iacobucci J distilled the determinant of profit for tax purposes into a concept that he called "well accepted principles of business or accounting practice."

Each acknowledged, though, that this determinant is not necessarily one and the same with GAAP. While business or commercial principles often have their roots in the methodology of financial accounting, and while GAAP can often be determinative of profit for tax purposes, there are instances where the determination of GAAP according to accounting principles would be inappropriate for tax purposes. The problem, as Arnold saw it in 1983, was that the courts had not adequately articulated the nature of the relationship between accounting principles and income tax law or the criteria to be used to decide when it is inappropriate to apply an accounting principle or to choose between two competing accounting methods. Iacobucci J's analytical framework in *Canderel* attempts to address these specific concerns.

Arnold was particularly concerned about the test used by the courts to choose between competing methods of accounting—the "more accurate" or "truer picture" test. He was critical of this approach because, in his view, there is no one true picture of profit in modern enterprises. Business income is the result of many judgments, characterizations, and allocations, such that any determination of profit under a system of accounting is only a reasonable approximation of the actual profit. This view is supported in accounting theory and by the frequent availability of more than one methodology of accounting to express or measure the profit of the same business, depending upon the accountant's (or management's) view of the business, and the factors to which they give most weight in trying to arrive at an appropriate or accurate picture of profit for financial reporting purposes.

In these circumstances, Arnold suggested that courts should not assume the responsibility for deciding which accounting method is the best or more accurate without setting out clear criteria governing the choice. He suggested that taxpayers should be free to choose among the various accepted accounting methods available (where more than one is available) to describe the results of the taxpayer's business and that the minister should not be permitted to adopt a method he prefers and then impose on the taxpayer the onus of showing that the taxpayer's method is superior. Accordingly, Arnold concluded that if the method the taxpayer uses is based on ordinary commercial principles and accounting practice and is in accord with the statute and with judicial principles, it should be accepted, even though there may be other, equally acceptable accounting approaches that produce a different result.

Arnold's criticism of the "more accurate" or "truer picture" approach is somewhat surprising. The criteria the courts used for determining whether an accounting method is appropriate for tax purposes recognized implicitly that, in most situations, there is no one true way of expressing profit. They simply approached the matter, though, on the basis of a factual norm against which accounting methods could be tested for acceptability for tax purposes. More on this later.

The approach Iacobucci J adopted in the *Canderel* analytical framework was effectively that suggested by Arnold in 1983. The parties in *Canderel* appear to have viewed the issue of the timing of deductibility of lease inducement payments as, in part, a contest between competing accounting methods. The Supreme Court appears to have developed the analytical framework for the purpose of clarifying the role of accounting principles in determining profit and how the choice between competing accounting methods is to be made in determining profit for tax purposes.

While Iacobucci J reaffirmed the "more accurate picture" principle, he did not explain its application or emphasize the criteria the courts traditionally used to apply it. According to Iacobucci J's framework, a taxpayer is free to choose a method of accounting that (1) is in accordance with well-accepted business and accounting principles so as to produce an accurate picture of income under these principles, (2) is consistent with the express provisions of the statute, and (3) is also consistent with case law principles. Once the taxpayer establishes these things, the burden then shifts to the minister to show that another accounting method shows a more accurate picture. If the minister is unable to discharge this burden, the taxpayer's chosen method of accounting will prevail with the court. This was, in essence, Arnold's 1983 prescription.

Arnold also identified two subsidiary issues that he considered unclear in 1983. The first was whether there is a legal requirement for conformity between financial statement profit and profit for income tax purposes, and the second was whether profit for income tax purposes must be computed on a consistent basis from year to year. Iacobucci J addressed both in *Canderel*. He clarified that there is no legal requirement of consistency in either respect. Profit is a question of law, not of financial reporting, and must be determined discretely for each year, recognizing any material changes in the facts of the business carried on.

The Canderel Framework: Does It Work?

Does the *Canderel* analytical framework provide clear guidance to resolve timing and recognition problems? On close analysis, the framework has some deficiencies that, if not resolved, may cause problems in future cases. These deficiencies relate principally to the role of case law principles in determining profit for tax purposes. The determination of profit can often depend more on a proper understanding and application of the judicial principles, whereas the main focus of the *Canderel* framework is on the role of GAAP and the freedom of a taxpayer to choose among available accounting solutions.

Before examining the deficiencies, it is useful to look at the first two principles in Iacobucci J's analytical framework, which underlie all issues of profit measurement.

Question of Law

Iacobucci J's first principle defines the nature of the inquiry:

> The starting proposition, of course, must be that the determination of profit under s. 9(1) is a question of law, not of fact. Its legal determinants are two in number: first, any express provision of the *Income Tax Act* which dictates some specific treatment to be given to particular types of expenditures or receipts, including the general limitation expressed in s. 18(1)(a), and second, established rules of law resulting from judicial interpretation over the years of these various provisions.[12]

In Canadian income tax law, all questions of profit determination are informed by the principle that profit is a question of law and not fact, to be ascertained based on the statute and judicial decisions interpreting them. This was a specific policy decision.

Subsection 9(1) has its antecedent in subsection 4(1) of the 1948 Income Tax Act,[13] the language of which was carried through into the 1952 and 1985 Acts substantively unchanged. The 1948 Act was enacted to replace the Income War Tax Act[14] and modernize Canadian taxation law. As Arnold noted,[15] the first draft of the 1948 revision proposed determining income for a taxation year from a business or property "in accordance with generally accepted accounting principles." Following much comment against this proposal, it was decided to substitute the wording "income for a taxation year from a business or property is the profit therefrom for the year." A significant factor in this decision was the view of the accounting profession at that time that GAAP were not sufficiently certain to be susceptible of precise definition.[16] The 1966 Carter report revisited the issue, but decided against adopting GAAP on the recommendation of the accounting profession.[17]

There are a number of reasons that have been given over the years for not adopting GAAP as the determinant of profit for tax purposes. For example:

- GAAP are fluid and evolutionary by their very nature, changing over time to reflect the changing business environment and the needs of both business and users of financial statements, which may not be sufficiently certain for tax purposes.
- GAAP, while having the benefits of general acceptance, permit significant elements of judgment in their application, as well as discretion in the use of appropriate principles or practices.
- Taxation based on GAAP might negatively influence the development of GAAP, contrary to the best interests of users of financial statements and conservatism in accounting.[18]

There is also a view that the objectives of income determination for tax purposes and for financial reporting purposes are different and not always compatible.[19] Taxation concerns the raising of public revenues in discrete annual periods on a basis that is reasonably fair and equitable as between the government and taxpayers and as between differently situated taxpayers. Taxation demands greater factual precision than GAAP in measuring income, in view of their different objectives. Tax needs to be computed whether or not the enterprise will continue or fail. The wherewithal to pay is relevant to tax policy. GAAP, on the other hand, aim to give the users of financial statements timely information on the financial position of the business. They strive for annual consistency and conservatism. In many cases they allow for the evening out of profit over time, and permit the allocation of profits and losses to various reporting periods based on professional judgment to ensure that the financial position is not overstated. As a tax policy matter, therefore, accounting policy may not achieve appropriate results.

Parliament's decisions to use the term "profit" and to leave its definition to the courts have made for a fundamentally different judicial approach to income determination than would have prevailed if the original 1948 proposal had been enacted. The decision not to employ GAAP as the income determinant established the primacy of the tax policy objections to its use for income tax purposes. The selection of the word "profit" as a substitute for GAAP allowed the content and meaning of business income to be decided by judges.

Not defining the word "profit" in the statute was a deliberate legislative choice, reflecting the practical impossibility of finding a definition suitable for all possible circumstances.[20] All of this means that Parliament intended in 1948 that "profit" is to be defined through judicial interpretation and experience, not by the accounting profession.

Therefore, in controversies, it is the job of the judge to receive, evaluate, and make findings as to the relevant facts concerning the income-earning process of the business in question and the results of that process. The judge has to decide, from the evidence, what relevant principles of business and accounting practice might assist the court to understand the income-earning process and its results. The judge determines the applicable legal principles and decides what the profit should be. Expert accounting evidence can be relevant and provide helpful guidance to the court, but ultimately the judge has to understand the facts concerning the accounting method or principle, the rationale for its use, and the consequences for accounting purposes in the particular circumstances of the case. The judge then has to assess whether the accounting practice conforms with the tax law principles that are applicable in light of the facts and decide whether to accept or reject the accounting approach:

> As the trial judge rightly noted, the determination of profit under s. 9(1) is a question of law. *Neonex International Ltd. v. The Queen*. . . . Perhaps for this reason, and as *Neonex* itself impliedly suggests, courts have been reluctant to posit a s. 9(1) test based upon "generally accepted accounting principles" (G.A.A.P.). . . . Any reference to G.A.A.P. connotes a degree of control

> by professional accountants which is inconsistent with a *legal* test for "profit" under s. 9(1). Further, whereas an accountant questioning the propriety of a deduction may be motivated by a desire to present an appropriately conservative picture of current profitability, the Act is motivated by a different purpose: the raising of public revenues. For these reasons, it is more appropriate in considering the s. 9(1) business test to speak of "well accepted principles of business (or accounting) practice" or "well accepted principles of commercial trading."[21]

Put another way, the court, not the accounting expert, decides the correct accounting for income tax purposes based on the actual facts of the taxpayer's income-earning process, rather than on the basis of accounting theory or practices that do not need to track the actual facts to achieve an appropriate result for financial reporting purposes. However imperfect this is, it is the necessary consequence of the policy decision to make income determination a question of law.

The Definition of Profit

The second of Iacobucci J's principles sets out the basic definition of the term "profit" for Canadian income tax purposes as articulated by the courts:

> What, then, is the true nature of "profit" for tax purposes? While the concept has been variously expressed, perhaps the clearest and most concise articulation of the term is to be found in the oft-quoted decision of this Court in *M.N.R. v. Irwin* . . . where profit in a year was taken to consist of "the difference between the receipts from the trade or business *during such year* . . . and the expenditure laid out to earn those receipt[s]". . . . This definition was echoed by Jackett, P. in *Associated Investors* . . . where he stated . . .
>
> > Ordinary commercial principles dictate, according to the decisions, that the annual profit from a business must be ascertained by setting against the revenues from the business for the year, the expenses incurred in earning such revenues.[22]

The Supreme Court of Canada in *Irwin*[23] considered this definition a "long-settled" concept. It drew on the Privy Council's decision in *Anaconda American Brass*,[24] which traced this principle to the 1888 English case, *Russell v. Aberdeen Town and County Bank*[25] and the 1925 Scottish case *Whimster & Co. v. the Commissioners of Inland Revenue*.[26] Jackett P's remarks in *Associated Investors of Canada Ltd. v. MNR*[27] are based on this same authority. Thus, from 1888 to 1998, the classic definition of profit has been repeatedly accepted and applied. It counts among the most enduring principles Canadian tax law knows.

The principle that profit consists of the surplus of revenue for a year over the expenditure to earn that revenue has two aspects: first, the netting of revenues and expenses, and, second, the matching of revenues to the expenses incurred to earn them for a taxation year. The first aspect rarely requires comment—the courts defined the concept of "profit" as they perceived business people understood it,

and that clearly means a netting of expenses against revenues. To determine the revenues and expenses, the facts of the business must be looked at to identify the income-earning process and its results. Judicial experience has produced more precise principles to resolve revenue and expense identification issues in specific cases.

The timing aspect of the definition of profit is no less important. The expenditure is to be set against the revenues it was incurred to earn. Accordingly, the time at which the expenditure is incurred is not determinative; it is the timing of the revenues that dictates the timing of the expense deduction. Thus, the cases recognized early on that the profit or loss from the sale of goods or the performance of financial services consists of the gross profit or loss determined by netting against revenues in the year in which the sale occurs or the service is rendered the costs incurred to make the sale or render the service, even if those costs were incurred in a prior year.[28] The cases also recognized that some expenses were incurred in the running of the business as a whole and could not be said to be productive of or to relate to one specific or identifiable stream of revenue (running expenses). The courts held that the taxation year to which such expenses best relate is the year in which they are incurred.[29]

This timing aspect of the definition of profit has not always been well understood. In one early case decided by the Exchequer Court under the Income War Tax Act, *Consolidated Textiles Limited v. Minister of National Revenue*,[30] Thorson P held that expenses were deductible only in the year they were incurred, based on paragraph 6(a), the predecessor to paragraph 18(1)(a) of the present statute. The same issue subsequently came before him in *Rossmor Auto Supply*,[31] decided under the 1948 Act. That Act had not carried forward the more restrictive language of the Income War Tax Act that the *Consolidated Textiles* decision had been based on, but adopted in paragraph 12(1)(a) the language now found in paragraph 18(1)(a). As a result, there was a strong school of thought that expenses were only deductible in the year they were incurred, or not at all, as an overriding statutory requirement.

The Crown attempted to make this argument in two later cases, *Associated Investors* and *Tower Investment*.[32] In the former, the taxpayer had made short-term advances to a salesperson on account of commissions to be earned, and set up a short-term receivable in its accounts. Approximately two years later, the taxpayer concluded that the salesman was not going to be able to earn sufficient commissions to offset the receivable and that it was uncollectible. The taxpayer successfully established the expense to be a current one, but the Crown attempted to argue that the advances were only deductible in the year they were advanced. Jackett P, in his now-famous footnote, rejected Thorson P's interpretation of former paragraph 12(1)(a) (now paragraph 18(1)(a)) in *Rossmor*. He noted that there were many examples under general principles of expenses that are deductible in a period subsequent to the year they are incurred (such as the cost of inventory sales).[33]

In *Tower Investment*, the taxpayer developed an apartment complex as its sole business asset. It spent considerable sums over the first three years of its ownership on an advertising campaign to promote the complex and increase rentals.

Most of the advertising expenses were deducted in its financial statements in a year after they were incurred, and the taxpayer adopted the same method of reporting the expenses for income tax purposes. The minister reassessed on the basis that the expenses were deductible in the year they were incurred or not at all. The minister's submissions were that, under general principles of profit computation, the "matching principle" was not authorized, and that the statute required expenditures to be deducted only in the year incurred under former paragraph 12(1)(a). The Exchequer Court disagreed and held that the taxpayer was entitled, under general principles, to amortize the expenses as it had. The advertising expenses were clearly productive of rental revenues in the periods in which the deductions were claimed, and paragraph 12(1)(a) did not limit this, based on Jackett P's footnote in *Associated Investors*.

Subsequent cases such as *Canadian Glassine*,[34] *Oxford Shopping Centres*,[35] and *Tobias*[36] collectively reaffirmed that the *Rossmor* approach of requiring all expenses to be deducted in the year incurred or not at all was not the law of Canada.

Since those cases, the timing issue that has principally plagued the court is whether the concept of matching expenses and revenues under tax law is the same as it is under accounting principles. On this point, the Crown has attempted in recent years to advance an argument diametrically opposed to its argument in *Associated Investors* and *Tower Investments*. In cases such as *Oxford Shopping Centres*, *Cummings*,[37] *Metropolitan Properties*,[38] *Canderel*, and *Toronto College Park*, the Crown has argued that specific expenses may not be deducted for income tax purposes in the year they are incurred if they must be amortized over a period of years under GAAP. The taxpayers have argued that, based on the *Naval Colliery*,[39] *Vallambrosa Rubber*,[40] and *Associated Investors* cases, an expense that is not productive of, attributable to, or related to a specific item of revenue is an expense of the running of the business as a whole and is therefore deductible in the year in which it is incurred. By reason of *Tower Investments* and the dissent of Desjardins J in *Canadian Glassine*,[41] taxpayers have also taken the view that the option is open to them to amortize a running expense, if to do so is appropriate under accounting principles and on the facts.

Generally, the matching concept under GAAP is broader than that inherent in the definition of profit for tax purposes. In the case of expenditures, accounting principles will often require the amortization of an expense over a period of years if, on the accountant's view of the business, there are a number of financial periods that will derive economic benefits from the expenditure. This matching of the expense to the various periods that benefit ensures that profits will be flattened out over time, rather than understated in the year of the expense and overstated in subsequent periods. Judgment must be exercised in determining the periods that benefit; considerations of consistency and conservatism play a role in these judgments.

For tax law purposes, though, income must be determined on an annual basis, even if to do so would distort profit, viewed from an accounting perspective.

There is no general tax law requirement of consistency from period to period. In fact, the annual accounting requirement is against consistency, where the facts change. The minister's argument that the matching of the expense to a number of years if so required by GAAP has been at odds with this fundamental tax policy. Courts have also been reluctant to adopt the broader accounting approach to matching where it conflicts with the tax policy that favours precision and factual objectivity over estimates and subjective judgment. The courts will not accept any judgment that an expense economically benefits a number of years. The judgment must be based on the actual facts of the taxpayer's income-earning process, and the expense must relate factually to the earning of specific revenues in identifiable periods to be required to be carried forward and deducted in a year following the year it is incurred. Otherwise, based on case law principles, the expense can be deducted in the year it is incurred, even if, for accounting purposes, it is amortized.

Much of the difficulty in this area has arisen over the years because of attempts to reconcile two basically incompatible views: that the determination of profit is a question of law for the courts, to be determined on the basis of the statute and case law principles, and that the determination of profit is essentially an accounting exercise that judges are ill suited to undertake except with the guidance of accountants. Commentators such as Arnold have criticized the jurisprudence as not having adequately defined the proper relationship between accounting principles and tax law and not having articulated clear criteria for determining when a court should reject an accounting method or choose between two competing accounting methods. They have questioned whether courts should exercise that role, advocating for freedom for taxpayers to choose between accounting methods that are acceptable under GAAP rather than having the court make the choice. The underlying critique is that courts are not the proper forum to decide questions that are essentially matters of accounting.

Yet the very policy choice Parliament made—that profit be a question of law, not of GAAP—places courts in the role of making value choices concerning different approaches to profit measurement. In response, the courts developed principles through judicial experience to assist them in this task, and the early judges do not seem to have been hesitant to assume their role. In recent years, though, the courts—and the Supreme Court in *Canderel* is a case in point—appear to have accepted the criticism and attempted to enhance the role of GAAP in determining profit and to be less open to getting involved in deciding between two competing accounting approaches to profit measurement.

This has practical consequences. It has created an unresolved conflict in the jurisprudence between the traditional judicial approach to profit determination and that of more recent years. This conflict materializes very clearly in the *Canderel* analytical framework. What is more, the modern approach does not seem to recognize that the conflict exists. Yet, without resolution, this conflict will continue to create problems, and therefore litigation, in profit-measurement cases and make the framework deficient as a practical tool for resolving problems. This conflict

and the specific deficiencies in the framework it gives rise to are discussed in detail in the next section.

Deficiencies in the Canderel Framework

The *Canderel* framework is informed, as a whole, by the first two principles that we have just discussed—namely, that the determination of profit is a question of law and that profit is defined as the surplus of revenues over the expenditures incurred to earn them. That any exercise of profit measurement must be informed by these two principles is incontrovertible based on judicial precedents long predating *Canderel*.

Neglecting the Hierarchy of Principles

The first difficulty the framework poses, though, is that the six principles, and in particular the first two, are not a complete and properly weighted synthesis of the law. One of the challenges in ascertaining the criteria used by courts to resolve profit-measurement problems involves understanding the case law in its proper and complete context. Thus, for example, as will be seen later in this paper, the first principle of the *Canderel* framework can be considered a "foundation" principle—that is, a root principle that is a direct judicial interpretation of the words of the statute. The second is a secondary, or derivative, principle—that is, a principle that was derived from applying the more fundamental root or foundation principle that profit for tax purposes is to have its ordinary commercial meaning as understood in business.[42]

This natural hierarchy of foundation and derivative principles of profit measurement is evident from a proper analysis of the jurisprudence, and yet does not appear to have been considered in the formulation of the *Canderel* analytical framework. The framework appears to be a confused jumble of foundation and derivative principles. There are many foundation principles (we have identified nine, which are discussed later in the paper) that are not mentioned in the *Canderel* framework. Yet the derivative principles are difficult to understand and apply in their proper context without a clear appreciation of the foundation principles from which they derive. For example, the "accurate picture" principle, to which Iacobucci J assigns great weight as the goal of the profit-determination process, is a derivative, not a foundation, principle. It has limited practical utility for resolving specific problems unless it is applied in the context of the root principles from which it arose because, outside of that context, it simply begs the question of what an "accurate picture" of profit is intended to mean. Stated in the *Canderel* framework, the "accurate picture" principle does not tell taxpayers how to get to an accurate picture, although it intimates that they ought to know when they have arrived.

Neglecting the Proper Role of Case Law Principles

The next and equally important difficulty the *Canderel* framework poses relates to the role of case law principles in the determination of profit. According to the framework, the taxpayer is "free" to adopt any method of profit computation that is not inconsistent with

- the express provisions of the statute,
- established case law principles or rules of law, and
- well-accepted business principles.

For these purposes, the framework asserts that well-accepted business principles include but are not limited to GAAP, and that they are not rules of law, but "interpretive aids." As such, they may influence the calculation of income, but only on a case-by-case basis, depending on the facts of the taxpayer's financial situation.

There are two aspects to this problem. First, the framework creates confusion as to the line to be drawn between business principles and case law principles and the precedential weight of each. Many case law principles arose from business and commercial principles, and hardened into rules of law through judicial experience. Yet Iacobucci J says that business principles are "interpretive aids" and not binding. This leaves open the question as to which case law will be thought to establish a principle with which a particular accounting method must be consistent if it is to be acceptable for tax purposes, and which case law will simply be viewed as non-binding examples of the use of interpretive aids. Second, framing the principles as a freedom of choice for taxpayers is profoundly misleading and apt to give rise to unnecessary uncertainty and controversies. Many of the decided case law principles dictate a particular measurement solution for a given type of transaction. Others establish clear criteria by which the choice of acceptable accounting methods is to be made. Only in very rare cases is the taxpayer actually free to choose an accounting method if the taxpayer is faithful to the existing case law principles, properly understood.

These are important difficulties that show the inherent conflict in *Canderel* between the traditional judicial approach to profit determination (where case law principles override accounting principles from time to time) and the *Canderel* approach, which tends to suggest a lesser role for the court in choosing between competing accounting methods. Each will be discussed in more detail.

Rules of Law or Interpretive Aids?

Iacobucci J wrote that business principles (such as the concepts of "running expenses" and "matching") are not binding rules of law but "interpretive aids." Yet most of the case law principles governing profit measurement arose from the application of ordinary commercial, business, or accounting practices in particular cases. How is the distinction between case law principles and business law

principles to be drawn? The Supreme Court's reasoning is open to two different interpretations, with somewhat confusing results.

First, the internal logic of the *Canderel* framework says that methods of profit computation must be consistent with established case law principles or rules of law. They must also be consistent with well-accepted business principles, which influence the calculation on a case-by-case basis depending on the facts. These latter principles aid in interpreting the meaning of "profit" in the circumstances of the case and in getting to the "accurate picture" of profit. But they are not rules of law—that is, they are not determinative of profit.

If it is true that the business and accounting principles remain interpretive aids and do not "harden" with experience into rules of law, then, logically, the only "rules of law" referred to in *Canderel* to which a given accounting method must conform to be acceptable for tax purposes are the foundation or "root" principles—those arising directly out of the interpretation of the word "profit" (such as: "profit" is to have its ordinary commercial meaning, and revenues cannot be included in profit unless they have achieved the "quality of income"). Other case law decisions in which an ordinary commercial, business, or accounting principle has been applied (that is, "derivative principles," such as the rules concerning the deduction of running expenses or matching) will not have the force of law—they aid only in interpretation in new cases that come before the court. On this view of the matter, the court would have to assess the facts in each case and determine profit on a case-by-case basis. Evidence would have to be adduced in each case of the well-accepted business principles sought to be invoked and why they produce an accurate picture of income, regardless of how similar the facts may be to earlier cases or earlier decisions on point. Decisions to accept and apply a given business or accounting principle in a particular case would, on this view, have no precedential value for future cases, however similar the facts.[43]

The alternative logic is that case law principles include the body of judicial decisions accepting and adopting a particular business principle in particular cases. While each case would turn on its particular facts, profit measurement in other cases involving similar or analogous facts would apply earlier precedents. As new cases with different facts arise, well-accepted business and accounting principles would assist the court to ascertain the true profit on the facts of the case. Through judicial experience and the principle of stare decisis, well-accepted business principles held to be applicable in common fact patterns would "harden into" rules of law and become binding on future courts in similar cases.[44] Case law principles of this nature (derivative principles) would still be subordinate to principles arising from the direct interpretation of the word "profit" in the Act (foundation principles), including the admonition that case law principles based on well-accepted business principles would not have universal application.

Either of these two views of the distinction between case law principles and business principles has logical consistency. It is not evident from Iacobucci J's reasons for judgment which approach he had in mind in designing the analytical

framework. For example, he insists that the concepts of "matching" and "running expenses" are merely interpretive aids:

> [T]he competing concepts of running expenses and matching which appear to be at play in this appeal fall into the category of well-accepted business principles, no more, no less. They are simply important interpretive aids which may assist, but are not determinative, in the illumination of an accurate picture of the taxpayer's income.[45]

Yet a review of *Naval Colliery*, *Vallambrosa*, *Associated Investors*, *Oxford Shopping Centres*, and other cases reveals two clear case law principles that inform each of these decisions—namely, that it is implicit in the concept of profit (being the surplus of revenue over the expenditures incurred to earn them) that expenses are to be deducted against the revenues to which, on the facts, they causally relate. If, on the facts, they are not referable to the earning of specific revenues in any given period, they should be brought into the calculation of the profit of the year in which they are incurred. The labels "matching" and "running expense" are simply short-form labels for these case law principles.

Moreover, Iacobucci J includes the case law definition of "profit" as his second principle and calls it a "rule of law" arising from the interpretation of statutory rules:

> Of course, this is distinct from the *interpretation* of such rules, such as, for example, the elucidation of the otherwise undefined concept of "profit" which is well within the jurisdiction of the courts. Such interpretive jurisprudence will fall within the category of "rules of law" which, as a matter of course, will predominate over well-accepted business principles. . . . The simple application by a court of one or another well-accepted business principle to a particular case or cases, moreover, will not ordinarily amount to the elevation of that principle to the status of a "rule of law."[46]

Yet this definition is itself derived from an ordinary commercial or business principle.[47] It was adopted for tax purposes based on the foundation principle that the term "profit" carries its ordinary commercial sense as businessmen understand it.[48] Judicial precedent has clearly "hardened" it into a rule of law.[49] The concept of determining to which period an item of expense relates by reference to the revenues derived from it (running expenses versus matching principle) is simply a more detailed elaboration of this rule of law, based on ordinary commercial or business principles. On what principled basis can the Supreme Court consider one to be a rule of law and the other a mere "interpretive aid" without determinative authority?

In the end, it appears that Iacobucci J is not certain which view he takes of the delineation between the role of case law and business law principles. The manner in which he applied his analytical framework is a study in contrasts. On the one hand, he followed the analysis laboriously and faithfully, not wanting to

treat as determinative ordinary commercial principles on which other cases (such as *Cummings*) were decided, and reviewing the parties' detailed positions based on GAAP. He concluded that the taxpayer had freedom to choose his method and that the minister had not discharged his onus to show a more accurate method. Then, in a volte-face, he proceeded to hold that the expenses in question were running expenses on the authority of *Oxford Shopping Centres*, and so were deductible in the year incurred:

> Indeed, in my view, the fact that in the instant case, Brulé, J. found that the TIPs were properly attributable to a number of different expenses makes inevitable the conclusion that they constituted running expenses. As I have already noted, I do not see how, under these circumstances, it is possible with any accuracy to amortize the payments over the term of the lease, in the absence of an established formula acceptable for tax purposes, which was not advanced by the Minister. It follows, then, that the TIPs were not referable to any particular items of income, i.e., they cannot be correlated directly, or at least not principally, with the rents generated by the leases which they induced. They therefore qualify as running expenses to which the matching principle does not apply: see *Oxford Shopping Centres*, *supra*.[50]

This last passage contradicts the view that the "running expense" concept is merely an interpretive aid rather than a case law principle. It is probably the true ratio of the case. This unsatisfactory approach leaves significant doubt as to the real practical utility of the analytical framework as it relates to the application of the appropriate case law principles that have been derived from business principles.

The simplicity of the ultimate resolution of *Canderel* contrasts with the complexity of the route taken to get there. In the final analysis, it is questionable whether the analytical framework was necessary to the result. An analytical framework should solve practical problems. *Canderel's* framework probably will make cases more difficult to resolve where the interplay between case law and business principles needs to be properly understood and applied.

Freedom of Choice of Accounting Method

As mentioned above, the *Canderel* framework is clear that a method of determining profit must be consistent with the statute, with case law principles, and with business principles to be acceptable. If there is more than one method that meets those tests, the taxpayer is free to choose among them, and the burden shifts to the minister to show that a more accurate method exists. This appears to give a greater role to accounting principles in determining profit, and a more neutral role to the court with regard to the choice of accounting methods.

Many case law principles, particularly foundation principles, dictate a particular profit result for a given type of transaction. The case law also establishes

criteria for determining when an accounting method is or is not acceptable for tax purposes. These cases and the tax policies they are based on leave little actual freedom of choice. Even the controversy in *Canderel* was resolvable on the basis of past case law principles, without the need to resort to a "freedom of choice" approach. The *Canderel* framework raises very practical questions as to which case law principles should be considered relevant in a given case, whether those principles dictate a particular result in the circumstances, and, if so, in what circumstances a taxpayer's freedom to choose between accounting methods is actually available.

To understand the scope of the problem with the *Canderel* framework and its "freedom of choice," it is necessary to go back to the foundation cases that established the "accurate picture" principle as it is understood for tax purposes. These cases not only show that principle in its proper context, but also establish a clear set of criteria for determining whether an accounting method is acceptable for tax purposes. Curiously, these criteria seem to have been overlooked by Arnold in 1983.

The leading case is *MNR v. Anaconda American Brass Ltd.*[51] Most think of *Anaconda* as the case that held that the last in, first out (LIFO) method of valuing inventory is unacceptable for tax purposes in Canada.[52] There, the taxpayer changed from reporting profit for tax purposes based on the first in, first out (FIFO) method to the LIFO method at a time of high inflation, thus reducing its taxes. The minister argued that the taxpayer had to continue to use the FIFO method. The Crown persuaded the Privy Council that, on the facts, the FIFO method produced a truer picture of profit than the LIFO method. The reason was that, on the facts, the profit resulting from the use of the FIFO method was closer to the actual profit of the business based on the factual turnover of materials in and out of inventory. The LIFO method resulted in historic inventory costs being carried forward indefinitely, even though the materials created through those costs had long since gone into inventory and been sold.

This case has been criticized as applying an unsophisticated approach to the determination of inventory cost of sales.[53] From the perspective of accounting theory, this may well be a valid criticism. But it overlooks the different analysis that judges bring to bear for tax law purposes in responding to a question of law as opposed to a question of accounting. The tax policy that motivated the *Anaconda* decision differed from the policy objectives of the accounting methods considered in that case.

The Privy Council arrived at its decision by applying the same definition of profit that has been applied for over 100 years in UK and Canadian courts and that Iacobucci J reaffirmed in *Canderel*—that is, that the profit of a business is the surplus by which the revenues from the business exceed the expenditure to earn them. Implicit in this definition, the Privy Council said in *Anaconda*, is that no assumptions of fact need be made for determining profit unless the facts cannot be ascertained, and then only to the extent that they cannot be ascertained. In

other words, where it is not possible to base the computation of profit on precise facts because the precise facts cannot be known, it is permissible to make reasonable estimates, assumptions, and other judgments to complete the facts that are known. In such a case, though, the only rule of law is that the true gains are to be ascertained as nearly as can be. This was the rule set out by the House of Lords in the *Sun Insurance Office*[54] case more than 40 years before *Anaconda*.

The *Anaconda* decision reflects the fundamental policy that the determination of profit is a question of law. Questions of law are decided on the basis of the facts. In the case of taxation, the only fair way to make sure that the same legal rules apply to everybody, where businesses are so different from one another, is to determine profit on the basis of the actual facts of the businesses themselves. It also reflects the policy that taxation should be based as much as possible on objective facts and less on professional judgments and estimates that are based on theories the purposes and goals of which relate not to raising tax revenue, but to portraying adequately an enterprise's financial position for the users of its financial statements.

To understand this in its proper context, one needs to reflect on what the old judges meant when they said that profit is to be determined in accordance with "ordinary commercial principles." This expression is really just another way of referring to the income-earning process of the business. Profit was to be determined by ascertaining the income-earning process of the business and identifying properly through the facts the results of that income-earning process. These results would be the profit for the year.

In fairly simple and straightforward businesses, all of the facts can usually be known. Take, for example, the case of a trader with relatively few transactions and with readily available and precise information concerning the revenues and costs incurred in the course of the income-earning process. *Friedberg*[55] is a case in point. There, the taxpayer engaged in commodity futures spread trading in the futures markets. Long and short futures positions were entered into as a hedge against each other in the course of the taxpayer's trading to control risk. Trades were entered into on open markets and settled daily through the exchange clearing house. The price for the commodity when a futures contract was entered into was well known and reflected in the brokerage account statements. The price for the commodity when the position was closed out (by entering into a contra contract for the same quantity of the same commodity deliverable in the same month) was also precisely known and reflected in the statements. Obviously, in these circumstances, there was no need for any estimate or assumption to determine profit or loss. Profit or loss was simply the difference between the aggregate price for the commodity stipulated in a futures contract when it was entered into, and the aggregate price for the commodity stipulated in a contra contract when it was entered into, to set off and close out the first contract, recognized on a realization basis.

A different approach is needed for more complex businesses. There, all of the facts typically will not be known and reasonable estimates, assumptions, or other

judgments need to be applied to ascertain profit. These are typically provided by accounting principles, practices, and methods. However, it would not be appropriate for tax purposes to disregard the known facts about the business. Accounting methods that do so provide too much room for subjective judgment and taxpayer discretion in determining profit and the amount of tax to be attributable to a particular taxation year. This would be contrary to the tax law policy that the public revenues not be based on too much individual taxpayer discretion without Parliament expressly allowing it.

Accordingly, in those cases where a system of accounting is needed to describe the results of the income-earning process in a way that involves assumptions or judgments to complete the facts that are known, and there is a dispute whether one or more methods, each of which is acceptable for accounting purposes, is acceptable for tax purposes, the method to be used for tax purposes is the one that most closely reflects the known facts and uses assumptions, judgments, or other rules of thumb that come closest to describing what the facts concerning the results of the income-earning process would be for the year if all of the facts were known.

Cases in point are *Publishers Guild*[56] and *West Kootenay*.[57] In each of these cases, the taxpayers' businesses were complex. They could not know all of the facts concerning the results of their income-earning process, so they applied a reasonable accounting system acceptable under GAAP. However, in each case, GAAP allowed for more than one acceptable method in the circumstances. In *Publishers Guild*, the minister argued in favour of the accrual method while the taxpayer argued in favour of the instalment method as the method that best ascertained profit on the known facts of the business. In *West Kootenay*, the minister argued in favour of the earned method of accrual while the taxpayer argued in favour of the billed method of accrual. In each case, the facts of the businesses were explored in detail by the courts. The instalment method in *Publishers Guild* and the earned method in *West Kootenay* were found on the facts to better describe the taxpayers' respective profits. In other words, given that estimates or judgments were necessary in the circumstances, these two methods each came as close as possible in their respective circumstances to describing the actual results of the taxpayers' income-earning processes. They were therefore the "more accurate" or "truer picture" of profit, and therefore the acceptable method for tax purposes.[58]

If the *Anaconda* criteria for choosing whether an accounting method is acceptable for tax purposes are still applicable, the method presenting the truest description of the factual results of the income-earning process must be selected for tax purposes. In principle, then, applying the *Canderel* framework according to its terms, the *only* case in which a taxpayer would be free as a practical matter to choose between different accounting methods is where it is impossible to tell on the basis of the known facts which of two accounting methods (each involving the exercise of equally reasonable judgments or assumptions) gets closer to reflecting the actual profit that would be determined if all the facts were known. This

would be a rare case indeed, and does not appear to have come before the courts to date. Even in *Canderel*, where the court purported to apply the freedom-of-choice approach to resolve the case, the court actually accepted the method that, based on the facts, most closely reflected the known facts and involved no element of judgment or estimate.

This raises an important question. If the freedom-of-choice of method is not real for taxpayers except in rare cases, why was it given such prominence in the *Canderel* framework? Why were the *Anaconda* criteria and their importance not expressed or explained by Iacobucci J even though the framework purports to invoke the "more accurate picture" principle, and requires any method of accounting to be consistent with case law principles and rules of law to be acceptable?

Is it a case of the law evolving away from the older jurisprudence? It is difficult to say at this stage. There is no evidence in *Canderel* of a policy reason for doing so. *Canderel* cites *Anaconda, Publishers Guild, West Kootenay*, and other cases and relies upon them—particularly as authority for the basic definition of profit. *Anaconda* has never been overruled, but rather has been followed by the Supreme Court in other recent cases, such as *Symes*[59] and *Friesen*.[60]

All that has been missing has been an articulation and appreciation of the underlying ratio of *Anaconda*—that no assumptions or estimates of fact need be made in determining profit unless the facts cannot be ascertained, and then only to the extent that they cannot be ascertained. Had this been articulated, the "accurate picture" principle could have been understood in its proper context. *Canderel* would be more clearly understood as a case of the court preferring the deduction of lease inducements in the year incurred because they best related to that year on the facts, in contrast to a method of amortization that admittedly assigned the deductions to particular taxation years somewhat arbitrarily (that is, involving subjective judgments) for reasons of accounting conservatism.

In summary, the *Canderel* framework as a whole has important deficiencies, and an internal, unresolved conflict. It fails to recognize the hierarchy of foundation and derivative case law principles. It does not explain and apply the accurate-picture principle in its proper case law context. It lacks logical consistency with regard to the distinction between case law principles and business principles, and it declares a freedom of choice in choosing a method of determining profit that is expressly subject to case law principles which, when properly applied, mandate the choice in all but rare cases. The intellectual approach that underlies the framework seems disconnected from the case law precedents it purports to derive from. It is reasonable to predict in the circumstances that future profit-measurement controversies will arise as a consequence of the *Canderel* framework.

Case Law Principles

As we have seen, an understanding of the case law principles relating to profit measurement is integral to resolving practical problems using the *Canderel* framework. Arnold's 1983 paper identified some of these principles, but did not identify

many or try to organize them in a coherent hierarchy. While it would be an enormous and controversial task to try to identify and evaluate them all, some discussion would be useful to better understand how the *Canderel* framework will apply in practice.

From an analysis of the decided cases, it is evident that the courts have applied two distinct types of rules to the task of profit measurement. The first can be described as the foundation principles. These are the basic principles for interpreting section 9 and the word "profit," which inform and govern the development and application of all other rules. The second type may be described as derivative principles that consist essentially in more detailed elaborations of the foundation principles, derived from judicial experience in evaluating the income-earning process and business principles in particular cases.

Foundation Principles

While the following list does not purport to be exhaustive, some foundation principles can be discerned from the decided cases:

1) The determination of profit for tax purposes is a question of law for the court.[61]
2) Profit for tax purposes is to be determined in accordance with well-accepted principles of business (or accounting) practice, subject to the provisions of the statute and overriding case law principles.[62]
3) "Profit" for tax purposes has its ordinary commercial meaning as understood in business.[63]
4) Profit for tax purposes is to be determined in discrete periods consisting of each taxation year.[64]
5) "Profit" is to be determined from the facts.[65]
6) In determining profit for tax purposes, no assumption or estimate is permitted unless the facts cannot be ascertained, and then only to the extent that they cannot be ascertained.[66]
7) To be recognized for tax purposes, an item of income must have attained the "quality of income."[67]
8) The true profit for the taxation year is to be ascertained as nearly as it can be on the facts of the income-earning process—that is, the goal is to obtain an accurate picture of profit for the business in question.[68]
9) There can be no general determinant of profit for tax purposes that applies to every type of activity. Each case must be determined on the basis of its own facts.[69]

Derivative Principles

Attempting to identify and synthesize derivative principles of profit measurement is an even more hazardous undertaking than identifying foundation principles. The list below is subject to debate and makes no claim to be exhaustive.

From an analysis of the case law, derivative principles of profit measurement appear to fall into two broad categories: first, the basic definition of profit; second, the various, more detailed rules that help determine profit in specific circumstances. It is important to note that derivative principles are subordinate to and limited by express statutory provisions and foundation principles. Accordingly, none is universal in application and their appropriateness, scope, and application will depend on the particular facts.

First Category

1) Definition: profit for a taxation year consists of the surplus of the revenues in respect of that year over the expenditures incurred to earn the revenues.[70]

Second Category

2) Profits and losses are recognized when realized, subject to certain exceptions recognized in the cases.[71]
3) The use of the cash method is generally inappropriate for determining profit from a business except where permitted by the statute.[72]
4) Revenues are generally realized when they are earned, (that is, when they become receivable, whether or not they are received immediately or in the future,)[73] and they are ascertained or ascertainable.[74]
5) Revenues that are received are included in income in the year in respect of which the right of the taxpayer to the amount is absolute and under no restriction as to its disposition, use, or enjoyment.[75]
6) It is appropriate in trading and service businesses to determine gross profit by deducting from revenues from sales made or services rendered the cost of those sales, recognized in the taxation year in which the goods are delivered or the services are rendered.[76]
7) The inventory method of accounting for cost of sales is permissible in respect of businesses engaged in trading and manufacturing, including valuing closing inventory at the lower of cost and market, as an exception to the realization principle.[77]
8) Taxpayers may not deduct anticipated losses or expenditures.[78]
9) Taxpayers may, but cannot be required to, recognize anticipated gains.[79]
10) Expenses are recognized when incurred—that is, when the taxpayer has an immediate and not contingent obligation to pay an amount, even if payment is not immediate.[80]
11) Expenses are deductible in computing the profits of the taxation year to which they properly relate. This involves an inquiry into the specific facts to determine whether there is a causal link between a cost and specific revenues or benefits. If there is a direct link between costs and revenues, the costs are deductible in the taxation year in which the revenues are earned. If the expenditure is not referable to specific revenues or benefits arising in respect of a taxation year, and is part of the expenditure more

generally incurred in running the business on an ongoing basis, it is deductible in the year in which it is incurred. If it is inconclusive on the facts as to which period the expense relates, the taxpayer is free to adopt an accepted accounting method of recognizing the expense unless the minister can demonstrate that another method provides a more accurate picture of income.[81]

12) Where there is a dispute between two methods of accounting, the method to be preferred is the one that is most appropriate to the facts of the business, is consistent with well-accepted business and accounting principles, is not inconsistent with the statute or case law principles, and provides the most accurate picture of income by best describing, based on the known facts, the results of the income-earning process.[82]
13) Courts should not readily accept for tax purposes methods of accounting that depart too far from or ignore the actual facts, use assumptions or estimates that are insufficiently precise in light of the known facts, or admit too much subjective judgment in the determination of profit.[83]
14) The foundation and derivative case law principles relevant to the measurement of profit override the application of accounting principles where the two are in conflict.[84]
15) The deductibility of expenses incurred in a year is not dependent on the production of profit in that year or at all.[85]
16) Where the value of an asset or liability affects the annual profit or loss from a business, it is appropriate to take into account the amount of gain or loss in that value[86] and to do so in the year in which the businessman recognizes the gain or loss to arise, or, if the asset or liability cannot be valued, when the gain or loss is realized.[87]

There are many more derivative principles that can be discerned from a careful reading of the cases. Many are of less broad application than the foregoing, being primarily relevant to particular types of businesses or categories of revenue or expense. Many have been overridden by specific statutory amendments. The decisions are not always consistent, and a close appreciation of the different facts of the cases is often needed to reconcile them or to synthesize a principle. It is even useful to reflect on the underlying financial interests of the taxpayer and the minister in the various cases to understand the apparent differences in approach the courts have used to resolve computation issues.

Inventory Accounting and Its Role in the Computation of Income

The most significant development in the area of inventory accounting since the publication of Arnold's paper is the Supreme Court of Canada's decision in *Friesen v. The Queen*.[88] To properly analyze *Friesen* and its relevance to the computation of income under section 9, it is important to understand the legislative framework and the existing body of jurisprudence at the time of the decision.

Subsection 248(1) currently defines "inventory" to mean "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method and, with respect to a farming business, includes all of the livestock held in the course of carrying on the business."[89]

At the time of the Supreme Court's decision in *Friesen*, subsection 10(1) provided that "for the purpose of computing income from a business, inventory shall be valued at its cost to the taxpayer or its fair market value, whichever is lower, or in such other manner as may be permitted by regulation." Regulations in effect at that time, read in conjunction with subsection 10(1), provided three alternative methods of inventory valuation for the purpose of computing a taxpayer's income from a business: (1) all inventory may be valued at fair market value; (2) all inventory may be valued at cost; or (3) all inventory may be valued at the lower of cost and fair market value.

This statutory scheme for inventory allowed a modified lower of cost and market method to be used in computing income for businesses engaged in the sale of inventory. It was a statutory recognition of principles already recognized in case law prior to the 1948 Act.[90] Prior to the enactment of section 10 and the relevant regulations, the courts had held that in determining profit from a trading or manufacturing business, the gross profit or loss was to be determined by deducting the cost of sales from revenues in the year of sale. The courts also permitted the use of the lower of cost and market method in valuing closing inventory for the purpose of determining cost of sales.[91] It was an exception to the general rule that anticipated losses were not to be recognized for tax purposes. There was no apparent policy or legislative rationale for permitting the writedown of inventory for tax purposes; it may have been a practical consequence of the fact that early businesses operating under manual accounting systems would not have maintained records of closing inventory except in accordance with the lower of cost and market method.

The accounting rationale behind the use of inventory accounting was the inability or impracticality of tracking precisely the cost of each item of inventory. Because the cost of sales could not be precisely determined in a business with many transactions, estimates, assumptions, and deductive reasoning would be used to determine the cost of goods sold in the year.

Thus, the cost of sales was ascertained by aggregating opening inventory with the costs of additions and subtracting closing inventory valued at the lower of cost and market. In trading businesses with relatively few items of inventory (where there is certainty with respect to the aggregate cost of goods sold) no estimate was considered necessary, and gross profit was determined by deducting the precise cost of a good sold from the revenue generated by its sale.[92] This was consistent with the Privy Council's reasoning in *Anaconda American Brass*, where it held that "no assumption need be made unless the facts cannot be ascertained and then only to the extent to which they cannot be ascertained."[93] For such businesses,

there was no need to use the inventory method to get at the cost of a sale, and consequently that method was not relevant to the computation of profit.

This did not change with the enactment of section 10 of the Act. This was addressed, in obiter, by the Supreme Court of Canada in *Irwin:*

> The law is clear therefore that for income tax purposes gross profit, in the case of a business which consists of acquiring property and reselling it, is the excess of sale price over cost, subject only to any modification effected by the "cost or market whichever is lower" rule. . . .
>
> This appeal has raised the question whether the inventory provisions of the Act and the Regulations have effected a change in that settled concept of profit. I doubt whether the combined effect of s. 14 of the Act [now section 10] and Regulation 1800 of the Income Tax Regulations, to which I shall refer in a moment, has made any such change, and *I am also doubtful whether, in any event, the inventory provisions referred to, are applicable in the circumstances of a case such as this where the actual cost and sale price of each particular piece of property are well established.*[94]

Therefore, the jurisprudence based primarily on *Irwin* and *Anaconda* can be summarized as follows:

1) profit (or loss) from a stock-in-trade business for a taxation year is the excess (or deficit) of revenues from the sale of the goods less the cost of goods sold;
2) where revenues and cost of goods sold can be determined with certainty (as in the case of a business with relatively few items in inventory, such as an adventure in the nature of trade), profit can be determined without resort to assumptions or estimates;
3) where the aggregate cost of goods sold cannot be determined with certainty—for example, due to the volume of items in trade—an estimate or assumption is required;
4) where an estimate or assumption is required, cost of goods sold is determined by using the inventory method—namely, by adding items purchased in the year at an estimated cost to opening inventory and deducting from the sum the closing inventory valued at cost or market, whichever is lower; and
5) the lower of cost and market method is not relevant to businesses where no estimate of cost of goods sold is necessary because the precise cost of each item sold is known.

Until the late 1980s, both the courts and Revenue Canada considered that subsection 10(1) inventory writedowns did not apply to property held as an adventure in the nature of trade.[95] Then the Tax Court of Canada started a contrary trend in *Bailey v. MNR.*[96] The question before the court was whether a particular property found to be the subject of an adventure or concern in the nature of trade could be considered inventory. In coming to its decision, the court held that the

definition of inventory in subsection 248(1) was not helpful. The court relied on the Exchequer Court's decision in *Associated Investors*, which held that one may look to relevant commercial principles in computing income under section 9 of the Act. The court then reviewed various accounting texts to determine whether property held in an adventure in the nature of trade could be inventory. On the basis of the accounting definitions, the court concluded that such property could be inventory, and the taxpayer was therefore entitled to value the property at the lower of cost and fair market value.

With respect, the comments of Jackett P in *Associated Investors* were of a general nature and did not assist the resolution of the problem before the court in *Bailey*.[97] The court erred in failing to consider the definition of inventory in subsection 248(1), the *Anaconda* case, the obiter of the Supreme Court in *Irwin*, and Jackett P's reasons in the *Oryx Realty* case,[98] as adopted by the Supreme Court in the *Shofar* case.[99]

The taxpayer in *Bailey* was dealing with a single property held as an adventure in the nature of trade. For the taxation years in question, the property had not been disposed of. The taxpayer had no need to make an estimate of cost of sales, which would have brought into play the lower of cost and market method. Therefore, according to cases such as *Anaconda*, *Whimster*,[100] and *Edward Collins*,[101] a deduction in respect of a decline in the value of the property in the years in question did not give a true picture of profit and represented an unwarranted anticipation of unrealized losses. The cost of the property should, on the authorities, only have been deducted against sales in the year of disposition.

In *Weatherhead v. MNR*,[102] the Tax Court of Canada considered the same issue. The court held that the particular properties were being held as adventures in the nature of trade, and, relying on *Bailey*, determined that the taxpayer was entitled to value the properties at the lower of cost and fair market value and to create a deductible expense, notwithstanding that the properties had not been disposed of. Similar decisions were reached in *Van Dongen* and *Skerrett*.[103]

The Federal Court Trial Division's decision in *Friesen*[104] was the next case on this issue. The taxpayer, along with a group of other people, acquired a parcel of raw land for the purposes of resale at a profit. For his 1983 and 1984 taxation years, the taxpayer sought to deduct, as business losses, reductions in the value of the land. In determining whether or not the raw land was inventory within the meaning of the Act, the court rejected the reasoning in *Bailey*, *Van Dongen*, and *Weatherhead*. The court held that subsection 10(1) should not be interpreted as suggested by these cases because "[i]t is a well-established principle that any provision in the *Income Tax Act* must be read in light of the Act as a whole,"[105] and that when applying ordinary commercial and accounting principles to determine tax profits, "[t]he applicable method of accounting should be one which best reflects the taxpayer's true income position."[106] After reviewing the formula generally used by trading businesses to determine the aggregate amount of cost of goods sold, the court concluded that "[t]he valuation of inventory can therefore

affect the business's gross profit. It is only to this extent that the inventory value becomes relevant. It is not by itself deductible from the taxpayer's income."[107] The court concluded:

> The computation of profit in the case of a business with relatively few transactions is somewhat different than that of the continuous trading business. The "cost of sales" formula is not generally applied in these circumstances since it does not reflect the true picture of this business' income position.
>
> For example, when there is but one item in inventory, profit or loss cannot be ascertained until the disposition of that particular item since, before disposition, there would be no revenues upon which to set off costs.
>
> Subsection 10(1) clearly states that only property described as "inventory" can be written down. According to subsection 248(1), "inventory" includes property whose cost or value is relevant in computing a taxpayer's income. In a business of few transactions, the value of its inventory is not relevant in computing income until disposition. As a result, in a year when the property is not sold, it would not be included in the computation of income for tax purposes and, therefore, subsection 10(1) would not apply.[108]

The Trial Division held that applying subsection 10(1) to an adventure in the nature of trade would lead to an absurdity, because the Act does not tax unrealized profits and it follows that it should not recognize unrealized losses.[109] The Federal Court of Appeal upheld the Trial Division judgment.[110]

The Supreme Court of Canada[111] was split as to whether the property was inventory in 1983 and 1984, and whether the taxpayer could use the lower of cost and market rules in subsection 10(1) to create a deduction in the absence of a disposition.

Writing in dissent, Iacobucci J (Gonthier J concurring) emphasized that inventory accounting was necessary when all the facts could not be known, specifically the aggregate amount of the cost of goods sold. Subsection 10(1) should therefore apply only to "dealers in stock-in-trade," not to "adventurers" such as the taxpayer, for whom "the actual cost and sale price of each particular piece of property are well established."[112] Iacobucci J held that the property may have been inventory to the taxpayer in the year in which it was sold, because its cost was relevant in determining his business income for that year, but that it could not be inventory for any previous year.[113]

The majority decision, written by Major J (Sopinka and L'Heureux-Dubé JJ concurring) concluded that subsection 10(1) "is a mandatory provision requiring a taxpayer who computes income from a business to value the inventory at the lower of cost or market value."[114] Once the majority decided that the taxpayer's activity constituted a business because it was an adventure in the nature of trade, they turned to whether the property would also constitute inventory.[115]

The majority held that the property would be inventory, since its cost or value would be relevant in computing the taxpayer's business income in a taxation year—namely, the year of disposition. If the property was inventory for the year

of disposition, they concluded, it necessarily had to be inventory throughout the time that it was held by the taxpayer.[116]

Iacobucci J argued that the object and purpose of section 10(1) was to provide a limited exception to the realization principle for stock-in-traders. Major J disagreed, invoking a rule of statutory interpretation:

> Therefore, the object and purpose of a provision need only be resorted to when the statutory language admits of some doubt or ambiguity. In this case, there is no doubt or ambiguity in the statutory language of s. 10(1) which clearly applies to the inventory of a business including an adventure in the nature of trade.[117]

With respect, this is a novel construction of subsection 10(1). The provisions of subsection 10(1) have always had a special or technical purpose. The definition of inventory has a special or technical and not an ordinary meaning. These provisions were drafted with the jurisprudence in existence in 1948 in mind and were not intended to supplant it. They were intended to supplement and not to override the provisions of section 9.

The meaning of "inventory" as property, the cost or value of which is relevant in computing income, clearly extends only to property included in a closing inventory required to be valued for the purpose of computing cost of sales. If the cost of sales is precisely known, estimates based on valuing inventory at the lower of cost and market are not needed to compute profit. Accordingly, no "cost" or "value" is relevant in computing income in such cases.

The Privy Council in *Anaconda* disapproved inventory accounting methods that ignore the actual facts of the business. In *Friesen*, the majority ignored the facts. The taxpayer knew what he had paid for his property. When it sold, he knew what revenue he realized. The difference was his profit or loss in the year of sale. Any writedown in value in a year prior to the sale was an inappropriate anticipation of loss contrary to the realization principle and authorities dating back to the *Naval Colliery*, *Edward Collins*, and *Whimster* cases. The Supreme Court seems to have lost sight of first principles of tax law in *Friesen*.

Within three months of the Supreme Court's decision in *Friesen*, the Department of Finance introduced legislation that purported to overturn *Friesen* and reinstate Revenue Canada's administrative position. Subsection 10(1) was amended to apply only to valuations of inventory for the "purpose of computing a taxpayer's income for a taxation year from a business that is not an adventure or concern in the nature of trade." For property that is used in an adventure in the nature of trade, new subsection 10(1.01) requires that "an inventory shall be valued at the cost at which the taxpayer acquired the property."

The amended legislation sidesteps the fundamental error in the *Friesen* decision. Assumptions or estimates, such as the accounting assumptions and estimates resulting from an application of subsection 10(1), are not required and will not result in the truest picture of income where all of the facts can be accurately

determined. The amended legislation determines the method of inventory accounting to be used based on whether a taxpayer is carrying on a business or engaging in an adventure in the nature of trade. Where a taxpayer's activity involves only infrequent transactions (or transactions where all of the information regarding cost of goods sold is known) but is organized in such way that the taxpayer, in fact, does carry on a business,[118] on the basis of the analysis in *Friesen*, subsection 10(1) still appears to allow inventory writedowns in the absence of dispositions.[119]

Selected Timing and Recognition Issues

This section reviews developments since 1983 for a number of selected timing and recognition issues connected with specific statutory provisions.

Tenant Inducement Payments

Paragraph 12(1)(x) was introduced by the 1985 federal budget as a legislative response to the decisions in several cases which held that certain payments or reimbursements were received as non-taxable capital receipts rather than as income payments and were not income to the taxpayer.[120] Paragraph 12(1)(x) requires a taxpayer to include in income any amount received by the taxpayer in the year in the course of earning income from a business or property as, inter alia, an inducement, refund, reimbursement, or contribution in respect of the cost of property or as an outlay or expense.

In *Ikea Limited v. The Queen*,[121] the Supreme Court of Canada dealt with a tenant inducement payment received by Ikea prior to the enactment of paragraph 12(1)(x).[122] The taxpayer had sought to characterize the payment as a capital receipt for tax purposes and had not included any amount in respect of the payment in its income in the year of receipt. In its financial statements, the taxpayer treated the payment as a capital asset to be amortized over the period of the lease. The minister disagreed and included the entire amount of the payment in the taxpayer's income for the year.[123]

The court was first required to decide whether the payment was on account of income or capital. Although at trial the uncontested evidence was that the taxpayer's method of accounting for the payment was entirely consistent with GAAP, the trial judge found that GAAP, although potentially useful in indicating the underlying commercial and economic reality of the transaction, was of "marginal assistance" in tax cases.

On this issue, the Supreme Court held that the payment was either a reduction of rent or consideration paid to the taxpayer for moving onto the leased premises, paying rent, and carrying on business thereon. The payment, therefore, was income and not a capital receipt. The court approved of the trial judge's finding that the payment, while it did not arise out of the sale of the taxpayer's goods, was

"inextricably bound up with the economics of the operation" and an "integral element of the day-to-day costs of running the business."

The next issue concerned the timing of the recognition of the income—should the taxpayer have been required to include the entire payment amount in the year it was received, or should the "matching principle" be applied to effectively amortize the recognition over the course of the lease? Here the Supreme Court relied on the principles for determination of income discussed in the first part of this paper and found that the income should be included in the year in which it was received. In so doing, the Supreme Court made the following comments on the realization principle:

> The combined effect of these passages is to confirm what in the law of income tax has become known as the "realization principle," given that an amount may have the quality of income even though it is not actually received by the taxpayer, but only realized in accordance with the accrual method of accounting. The ultimate effect of this principle is clear: amounts received or realized by a taxpayer, free of conditions or restrictions upon their use, are taxable in the year received, subject to any contrary provision of the Act or other rule of law. The T.I.P. received by Ikea in the present case fits this description perfectly. The tenant inducement agreement made it clear that the sole condition precedent to receipt of the payment was the assumption of Ikea's obligations under the lease agreement, and further stipulated that the payment was to be made within seven days of Ikea's commencing business in the premises, pursuant to the lease. Thus, Ikea's right to the payment became absolute at that time. There were no further strings attached such as to postpone actual realization or receipt into a subsequent taxation year, and the payment was received in full by Ikea in 1986. Therefore, I conclude that the entire amount was taxable in that year.[124]

The court also noted that the correct approach to the determination of profit for tax purposes was to find a method of computation that is consistent with the case law and business principles and that gives an accurate picture of the taxpayer's income for the year. Since the payment had been received by the taxpayer with no strings attached, the court noted that "it would constitute a serious distortion of the taxpayer's taxation picture to ignore the fact that this entire amount was freely available to it as of the 1986 taxation year."[125] As a final observation, the court held that the "accurate picture" principle must apply even if this could "lead to asymmetry in some future case, where a T.I.P. might be amortizable by the payer over the term of the lease but should be properly included in income immediately by the payee."[126]

Timing of Inclusion of Unbilled Amounts

Chapter 4 of Arnold's book, particularly in connection with the interpretation of paragraph 12(1)(b),[127] may now be supplemented by the decisions of the Federal Court of Appeal in *West Kootenay*[128] and *Maritime Telegraph*.[129]

The taxpayer in *West Kootenay* was a distributor of hydroelectric power. As of the end of its last two fiscal periods, the taxpayer had delivered electricity to certain customers but was neither permitted by law nor physically able to bill those customers. It was able, however, to estimate reasonably accurately the sale price for the delivered but unbilled electricity. Although the taxpayer had in prior years used the accrual method for recognizing its income for tax purposes, it switched to a "billed" basis for the years in question and therefore did not recognize the estimated revenue that was unbilled at the end of the fiscal year. It was the taxpayer's contention that the unbilled revenues were not includible in its income under paragraph 12(1)(b) as an "amount receivable."

The Federal Court of Appeal, relying on the interpretation of the meaning of "receivable" set out in *MNR v. Colford Contracting Co. Ltd.*,[130] concluded that the taxpayer had a "clearly legal, though not necessarily immediate, right to receive" the unbilled but earned revenues. In finding that paragraph 12(1)(b) applied, the court stated:

> I can have no doubt that the appellant was absolutely entitled to payment for any electricity delivered, and in an amount reasonably estimated. Suppose, for example, that a customer's residence was destroyed by fire at midnight on December 31. The appellant would surely have a legal right as of the due date to reimbursement for the electricity supplied since the previous billing, viz, through December 31, and a Court would be prepared to fix the amount of entitlement, probably using something like the appellant's prorated method.[131]

West Kootenay reconfirms that an amount is includible in income under paragraph 12(1)(b) when the taxpayer has a legal right to enforce payment and the taxpayer would be entitled to enforce payment of the amount shortly thereafter.[132]

In *Maritime Telegraph*, the taxpayer provided telephone and telecommunication services (as opposed to the taxpayer in *West Kootenay*, who provided electricity, a "good"). Like the taxpayer in *West Kootenay*, it switched to the "billed" method to report its income for tax purposes and used the accrual or "earned" method for financial statement reporting.[133] It was able to produce highly accurate estimates of its unbilled earnings based on records of telephone calls made up to the end of the fiscal period. The trial judge in *Maritime Telegraph* found that the earned method presented a truer picture of the taxpayer's income and should have been used by it for tax purposes as well.

In contrast to *West Kootenay*, where paragraph 12(1)(b) was applied, and section 9 was not needed, in *Maritime Telegraph* the Federal Court of Appeal found it unnecessary to resort to the recently amended paragraph 12(1)(b) and found that the taxpayer's estimated revenues were income under the general provisions of subsection 9(1). Consequently, *Maritime Telegraph* holds that earned but unbilled services at the end of a fiscal year may be includible in income in that year, provided that they are sufficiently ascertainable and notwithstanding that they were billed without undue delay in the following year.[134] The case also

clarified that amounts includible in income by the taxpayer did not escape inclusion by reason of the amendment to paragraph 12(1)(b) relating to the billed method.

Dispositions

Subsumed under the heading "Shares" in chapter 4 of Arnold's book, the concept of a disposition of property is obviously fundamental to determining the proper timing of an income inclusion. Although there have been few significant court decisions or changes to the Act since 1983 in the area of dispositions,[135] the CCRA has been actively issuing rulings on topics ranging from the revision of land boundary lines to conversions of gold certificates into gold bullion.[136]

Deemed Disposition on Emigration

Under former subsection 48(1) (in force at the time of Arnold's book and later renumbered as subsection 128.4(4)), a taxpayer who ceased to be resident in Canada was deemed to have disposed of his capital property, other than taxable Canadian property and certain other property, immediately before ceasing to be resident, for proceeds of disposition equal to the fair market value of the property at the time of emigration. Gains on taxable Canadian property were calculated as of the date of actual disposition and subject to the collection mechanism under section 116.

In his discussion of Canada's departure tax regime, Arnold identified several problems that undermined the propriety of the emigration rules then in force: the taxpayer may not have the necessary funds to pay the tax; his interest in the property may not have terminated; he may never actually realize a gain on the property; determinations of fair market value are often a matter of dispute between the taxpayer and Revenue Canada; and there is a substantial risk of double taxation since the taxpayer's new country of residence may tax the entire gain arising on the ultimate disposition of the property.

A significant statutory overhaul of the taxpayer emigration rules came into force in 2001.[137] The impetus for the new rules was an apparent concern for loss of revenues.[138] For instance, if before emigration a taxpayer reorganized his affairs in a transaction that was tax-deferred for Canadian purposes but fully taxable in the new country of residence, Canada's network of tax treaties would generally prevent Canada from taxing gains arising after the taxpayer had been non-resident for a certain period of time (5 or 10 years). If the taxpayer were to emigrate from Canada and reside in the new country of residence for the requisite amount of time before disposing of the property, tax would be payable in the new country of residence and Canada would receive no tax.

The definition of "taxable Canadian property" is no longer relevant for the purposes of the emigration rules.[139] The categories of property exempt from taxation on emigration have been narrowed to include only those which Canada would in any event retain the right to tax through its treaty network. Specifically,

the list of excluded properties includes real property situated in Canada; Canadian resource property; timber resource property; property (capital property, eligible capital property, and inventory) used in a business carried on through a permanent establishment in Canada; excluded rights (pensions, RRSPs, RRIFs, etc.); where the taxpayer has been resident in Canada for five years or less, any property owned at the time of arrival or any inherited property; a trust interest acquired for no consideration; life insurance policies (other than segregated fund policies); and employee stock options. The removal of taxable Canadian property from paragraph 128.1(4)(b) means that shares of private corporations, shares of public corporations held in significant blocks, mutual funds, and foreign real property will be subject to the emigration rules. Virtually all types of property are now deemed to be disposed of at fair market value immediately prior to emigration.

To reduce the impact of this accelerated tax liability, an individual may elect to defer payment of tax on the deemed disposition of any property until the property is actually disposed of, provided that adequate security is given to the minister. However, no security is required from individual taxpayers (other than trusts) for the first $25,000 of tax. If security is given, interest on the amount owing does not start to accrue until the amount becomes unsecured. The CCRA has indicated that it will not initiate any collection action in respect of amounts that are secured, or, if they have become unsecured, before notifying the taxpayer and allowing 90 days in which to improve the security.[140] The CCRA has also indicated that it is prepared to accept private company shares as security where the gain in question arose on the shares themselves and the value of the shares can be ensured.[141]

The ability of a taxpayer to defer payment of tax by granting security goes some way toward alleviating the Arnold's concern that taxpayers have an ability to pay their departure tax. As well, a measure of fairness is provided by new subsection 128.1(7), which enables individual taxpayers to carry back post-departure losses against deemed gains from the date of emigration (subject to new stop-loss rules in subsection 40(3.7)), and by new subsection 128.1(6), which allows individuals who return to Canada within five years to unwind the deemed disposition on emigration. However, potential economic double taxation remains a concern. The minister has stated that Canada will be pursuing changes to its bilateral tax treaties to ensure that other countries will not tax emigrants' pre-departure gains a second time. As an interim measure pending treaty changes, new subsection 126(2.21) provides a limited tax credit for post-departure foreign tax arising in the year of departure from Canada.

Matchable Expenditures

The "matchable expenditure" rules in section 18.1 were enacted to counter transactions whereby taxpayers achieved tax-shelter benefits by providing upfront financing of the business expenses of another taxpayer in exchange for a right to receive future income from that taxpayer's business.[142] The Department of Finance

criticized such transactions on the basis that they provided businesses with financing that was partially subsidized by the government, that they were off-balance sheet in nature, and that they provided investors valuable tax-deferral benefit without which they would not have assumed the immediate expenditures.[143] It was thought that matching the expenditure to the revenues was the more appropriate approach; thus, this section reflects the accounting concept of matching in modified form.

The key to section 18.1 is the concept of a "matchable expenditure," which is defined as an expenditure made by a taxpayer (including a partnership) that would otherwise be deductible in computing the taxpayer's income[144] to (1) acquire a "right to receive production"; (2) to fulfill a covenant or obligation arising in circumstances in which it is reasonable to conclude that a relationship exists between the covenant or obligation and a right to receive production; or (3) to preserve or protect a right to receive production. A "right to receive production" generally means a right under which a taxpayer is entitled to receive an amount all or a portion of which is computed by reference to use of property, production, revenue, profit, cash flow, commodity price, cost or value of property, or any other similar criterion, or by reference to dividends paid or payable to shareholders of any class of shares where the amount is in respect of another taxpayer's activity, property, or business, except income interests in trusts, Canadian resource property, and foreign resource property.[145]

Where a taxpayer has made a matchable expenditure, the rules in section 18.1 generally restrict its deductibility by prorating it over the greater of 5 years and the economic life of the related right to receive future income, to a maximum of 20 years. However, to ensure that expenditures are properly matched to revenues, the deduction in any given year may not be greater than the revenues earned in respect of the right in that year. If the right to receive income has a term of less than 5 years, the deduction is prorated as if it had a 5-year term, and the balance of the expenditure is generally deductible when the term expires. If the rate of return on the taxpayer's right to receive production is "reasonably certain," no amount of the matchable expenditure is deductible; instead, the right is deemed to be a prescribed debt obligation for the purposes of subsection 12(9) and regulation 7000.[146]

The rules in section 18.1 will not apply to a matchable expenditure if the expenditure can reasonably be considered to have been paid to another taxpayer, or to a person with whom that taxpayer does not deal at arm's length, to acquire the right to receive production from the other taxpayer, and either (1) the expenditure cannot reasonably be considered to relate to a tax shelter or tax-shelter investment (as defined in subsection 143.2(1)) and none of the main purposes for making the expenditure is that the taxpayer or non-arm's-length person obtain a "tax benefit";[147] or (2) the amount included in the taxpayer's income in respect of the right to receive production to which the matchable expenditure relates exceeds 80 percent of the expenditure.[148]

The Mark-to-Market Rules

The "mark-to-market rules" in sections 142.2 to 142.6 of the Act were introduced in 1995 to provide certainty with respect to the tax treatment of securities held by financial institutions. The Department of Finance sought by these rules to rectify what it perceived as uncertainty as to whether particular profits and losses of financial institutions were on account of income or capital, the extent to which a financial institution's profits and losses on securities were to be recognized while a security is held, and the possibility for financial institutions to reduce taxable income by disposing of securities that have decreased in value while retaining those that have appreciated.[149] This is accomplished by requiring financial institutions (which is defined to include, inter alia, banks, trust companies, credit unions, insurance corporations, investment dealers, and trusts or partnerships if more than 50 percent of their fair market value is held by one or more financial institutions) to mark to market certain property[150] on an annual basis in order to realize unrealized gains and losses.[151] Such deemed gains and losses must be included in computing the taxpayer's income for the year, as must gains and losses from actual dispositions.[152] Subject to limited exceptions, there is no capital gain or capital loss treatment on the disposition of mark-to-market property by a financial institution.

Additionally, where a financial institution holds a specified debt obligation that is not a mark-to-market property (as is the case where the specified debt obligation is held by a financial institution other than an investment dealer), the income recognition rules in section 142.3 and regulation 9101 will require the economic return of the debt obligation to be included in computing the income of the financial institution on an accrual basis. As well, on a disposition of a specified debt obligation that is not a mark-to-market property, any gain or loss is treated as being on account of income under section 142.4. Only a portion of the income or loss is required to be recognized immediately; the amount not then included may be amortized over the remaining period to the maturity date of the debt obligation.

Appendix: Development of the "Accurate Picture" Principle

Four cases demonstrate the development of the "accurate picture" principle in Canadian tax law. They are *Sun Insurance Office v. Clark*,[153] *MNR v. Anaconda American Brass Ltd.*,[154] *MNR v. Publishers Guild of Canada Ltd.*,[155] and *West Kootenay Power and Light Company Limited v. The Queen*.[156] Each involved the question whether one system of accounting or another better described the results of the taxpayer's income-earning process at an aggregate level. None dealt with a specific item of expense, such as in *Canderel*.

Sun Insurance is one of the earliest "accurate picture" cases. In that case, the taxpayer was a fire insurance company. In calculating its profits from its insurance

business, it included annual premium income and deducted an estimated reserve relating to future periods in respect of which the premiums had been prepaid.

The court looked at the facts of the business and found that gain or loss from insurance contracts could not be ascertained as a fact until after the taxation period because many of the premiums covered periods extending into the future. Because tax had to be determined on an annual basis, it would be necessary to resort to estimates. No one way of estimating was imposed by law—whether one way of estimating or another was to be preferred was a question of fact, with fairness between the government and the taxpayer to guide. Earl Loreburn LC said:

> Thus it appears that you cannot base the assessment of income tax upon the actual facts of the business done and the actual pecuniary results of it in the case of fire insurance companies who take single premiums to cover risks for a year or for more years. This is such a company, and I believe nearly all companies are in the same position.
>
> If that be so, it follows that in assessing such fire insurance companies you must proceed wholly or part by estimate.
>
> An estimate being necessary and the arriving at it by in some way using averages being a natural and probably inevitable expedient, the law, as it seems to me, cannot lay down any one way of doing this. It is a question of fact and of figures whether what is proposed in each case is fair both to the Crown and to the subject.[157]

The court noted that it would be very difficult to analyze each insurance contract separately to determine which ones had expired and which ones remained in part unexpired and subject to a degree of risk. In light of the thousands or even hundreds of thousands of contracts entered into annually, it was considered that there was no evidence that such an exercise would be a reasonable way of ascertaining profit.

The court then reviewed three possible methods of estimating the proper premium reserve. It held that each method was not a rule of law, but a good working rule generally. Only one was held on the evidence to be the fair way by which "the truth can be approximately attained."[158]

Earl Loreburn LC said: "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 it can be done*."[159]

Explicit in the court's reasoning was the ordinary requirement that the profit be ascertained precisely from an examination of the facts pertaining to the business and its relevant transactions, based on evidence. Where, however, the evidence is that the assessment of tax cannot be based on the actual facts and the actual profit, it is permissible to resort to reasonable estimates. Where there is a competition between methods for estimating the profit, there is no one method that is necessarily right. However, the method to apply is the one that gets the closest to the true gains based on the facts and is fair as between the government and the taxpayer.

In the *Anaconda American Brass* case, the taxpayer carried on a business of purchasing metals and manufacturing them into intermediate products for sale. The company always maintained a stock of metals on hand, which it used in a constant flow of production. It had relatively stable outflows of products, to which it tried to match its raw materials purchases. Materials turned over approximately four times per year.

It was common ground in the case that to ascertain its profits for income tax purposes the taxpayer had to use the inventory method for computing gross profit from sales. Due to the volume of transactions and the absorption of metals in manufacturing, it was impossible and undesirable for the taxpayer to try to determine cost of sales by specific identification of material costs. Rather, the taxpayer used an accounting method to estimate the opening inventory for each year, the cost of additions in each year, and the cost or value of closing inventory to enable it to ascribe a cost of sales, so estimated, to revenues in each period.

Prior to 1936, the taxpayer used the FIFO assumption to calculate costs for both financial statement and income tax purposes. In 1936, it changed its assumption for financial reporting only to the LIFO assumption. It was the view of the taxpayer's accounting experts that LIFO, which ascribed the most recent costs to additions of inventory and the oldest costs to closing inventory, was the most appropriate method for the taxpayer's business and presented the truer picture of its profit in the circumstances of its business. The accounting evidence was that neither method related to the actual physical flow of inventory in the manufacturing process. Both LIFO and FIFO attempt to estimate the flow of costs into inventory so as to achieve a proper matching of costs and revenues according to the business. The evidence further showed that the taxpayer turned over most of its inventory annually so that there clearly was no link between the LIFO method of accounting and actual inventory use.

The taxpayer continued to use the FIFO method in determining its gross profit for income tax purposes. While metals were subject to price controls during the war, there was little practical difference between the results produced using either the LIFO or the FIFO assumption. Following the war, prices for metals rose rapidly. For its 1946 and 1947 taxation years, the taxpayer changed to the LIFO assumption in determining its gross profit for tax purposes. By ascribing the higher current material costs to the cost of sales and the lower prior-year costs to inventory on hand, the LIFO method produced a substantially lower profit for those years than the FIFO method.

The minister reassessed, applying the FIFO assumption. On appeal, the Exchequer Court held that the LIFO method was in accordance with accepted accountancy practice and most nearly accurately reflected the taxpayer's income position for financial reporting purposes. That being the case, it was to be accepted, since the statute did not otherwise prohibit it. A majority of the Supreme Court of Canada agreed with the Exchequer Court. The minority disagreed:

> Even though the Lifo assumption is recognized as a proper accounting method for corporate purposes, the authorities noted above show that that

> is not sufficient and, therefore, the view of the learned President of the Exchequer Court that the question to be determined was whether Lifo was an acceptable accounting method for the company is, in my opinion, incorrect. The Lifo method does not determine the company's profits for 1947 more accurately than the Fifo method which latter, for the reasons given, is more in accordance with the known facts. The following statement by Lord Loreburn in *Sun Insurance Office v. Clark* . . . may, I think, be repeated with advantage:—
>
> > A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, viz.: that the true gains are to be ascertained as nearly as it can be done.[160]

On further appeal, the Privy Council approved the opinion of the minority decision of the Supreme Court. The court cited two principles from *Whimster*: first, that profits are the difference between the receipts of the business and the expenditure laid out to earn them, and, second, that the account of profit and loss to be made up for ascertaining that difference must be framed consistently with ordinary commercial principles of commercial accounting "so far as applicable and in conformity with the rules of the *Income Tax Act*."[161]

Lord Simonds drew from these principles that commercial accounting will not be in conformity with tax law if it disregards physical facts even where they can be wholly or partly ascertained. The *actual* inventory is to be valued for tax purposes, so far as it can be ascertained, this being the only acceptable way to account for the expenditure referred to and the revenues realized for each particular taxation year. The Privy Council held that assumptions are inappropriate for tax purposes unless the facts cannot be ascertained, and then only to the extent that the facts cannot be ascertained:

> Seventy years ago Lord Herschell said in *Russell v. Town & County Bank* (13 A.C. 418 at p. 424):
>
> > 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.
>
> This is only one of many judicial observations in which it is implicit that *no assumption need be made unless the facts cannot be ascertained and then only to the extent to which they cannot be ascertained.* There is no room for theories as to flow of costs: nor is it legitimate to regard the closing inventory as an unabsorbed residue of cost rather than as a concrete stock of metals awaiting the day of process. It is in their Lordships' opinion the failure to observe, or, perhaps it should be said, the deliberate disregard of, facts which can be ascertained and must have their proper weight ascribed to them, which vitiates the application of the L.I.F.O. method to the present case. It is the same consideration which makes it clear that the evidence of expert witnesses, that the L.I.F.O. method is a generally acceptable, and in this case the most appropriate, method of accountancy, is not conclusive of the question that the Court has to decide. That may be found as a fact by the Exchequer Court and affirmed by the Supreme Court. The question remains

> whether it conforms to the prescription of the *Income Tax Act*. As already indicated, in their Lordships' opinion it does not.[162]

The decision in this case drew the link between the principle in *Sun Insurance* (that the true gains are to be ascertained as nearly as can be) to the fundamental principle in *Russell v. Aberdeen Town and County Bank*[163] (that profit is the surplus of revenue over expenditures incurred to earn the revenue). The profit is to be ascertained on the basis of the actual facts. *No* method of accounting meets the necessary test if it is not based upon actual facts, or on assumed facts that reflect as nearly as can be the true facts. Accordingly, the more "accurate picture" of profit under one accounting practice, if derived from assumptions or estimates that depart more from physical, ascertainable facts than another, will be less acceptable than another method that comes closer to those facts. The result is that the "more accurate picture" of profit for income tax purposes is not necessarily the same as the "more accurate picture" of profit under GAAP.

A year following the Privy Council decision in *Anaconda*, the Exchequer Court rendered its decision in *Publishers Guild*. There, the taxpayer sold book and magazine subscriptions door-to-door on an instalment plan basis. The taxpayer would obtain orders and an initial payment from customers. It would purchase the books and magazines from its parent and deliver them to customers, who would pay the balance of the subscription price due, typically over a defined period. The accounts receivable and the security for a customer's promise to pay were of dubious value. Defaults were high, and the taxpayer had to maintain a very active collection activity to collect instalments.

Due to the high level of uncertainty surrounding receipt of payments, the taxpayer chose, for the years under appeal, to account for profit on the instalment basis, in which the gross profit component of instalments was not treated as realized until payment was received. The minister reassessed, applying the normal accrual method of accounting for sales of goods, in which all of the sales profit is recognized in the year of sale, with potential allowance for doubtful or bad debts in accordance with the Act.

Each of the two systems required the application of assumptions and professional judgments. The taxpayer tendered expert accounting evidence concerning the two methods. The minister adduced no accounting evidence. The taxpayer's accounting experts were of the opinion that the instalment method was an accepted method, was appropriate to the taxpayer's business, and resulted in an accurate computation of profit. In their opinion, it was a more accurate method than the accrual method.

Faced with a dispute between two accounting methods and no express statutory rule, Thorson P had this to say about the role of accounting evidence, the legal test of profit, the role of the court, and the approach to be taken to resolve the dispute:

> At this stage it would, I think, be appropriate to make some remarks of a general nature regarding the role of accountancy experts in income tax cases. The accountancy profession is not a static one and the system of accounting

> which accountants should apply to the accounts of the businesses in which they are called upon to act are not immutable. A system of accounting that would be appropriate to one kind of business is not necessarily appropriate to a different kind. Only an arbitrary minded person would contend that there is only one system of accounting of universal applicability. No reasonable person would do so. But while accountants devise changes in systems of accounting to meet the changing conditions in the business world and new ways of conducting business their guiding principle must always be the same. Accounting is really the recording in figures, instead of words, of the financial implications of the transactions of the business to which it is applied. The accountant is thus the narrator of the transactions, his narrative being in the form of figures instead of words. His narrative should be such as to disclose to persons understanding his language of figures the true position of his client's business at any given time or for any given period. The accountant cannot fulfil the duty thus required of him unless he has carefully considered the manner in which his client carries on his business and has applied to it the system of accounting that is appropriate to it and most nearly accurately reflects its financial position, including its income position, at the time or for the period required.
>
> But the Court must not abdicate to accountants the function of determining the income tax liability of a taxpayer. That must be decided by the Court in conformity with the governing income tax law. It is an established principle of such law in this Court that there is a statutory presumption of validity in favour of an income tax assessment until it is shown to be erroneous and that the onus of doing so lies on the taxpayer attacking it. But while the Court must be mindful of this principle it must in its effort to apply the law objectively keep a watchful eye on arbitrary assumptions on the part of the tax authority such as, for example, that it is within its competence to permit or refuse any particular system of accounting and that its decision in the matter is conclusive. I cannot express too strongly the opinion of this Court that, in the absence of statutory provision to the contrary, the validity of any particular system of accounting does not depend on whether the Department of National Revenue permits or refuses its use. What the Court is concerned with is the ascertainment of the taxpayer's income tax liability. Thus the prime consideration, where there is a dispute about a system of accounting, is, in the first place, whether it is appropriate to the business to which it is applied and tells the truth about the taxpayer's income position and, if that condition is satisfied, whether there is any prohibition in the governing income tax law against its use. If the law does not prohibit the use of a particular system of accounting then the opinion of accountancy experts that it is an accepted system and is appropriate to the taxpayer's business and most nearly accurately reflects his income position should prevail with the Court if the reasons for the opinion commend themselves to it.[164]

In the absence of evidence in chief from the minister, the court proceeded to review the evidence concerning the business of the taxpayer and the instalment and accrual methods in light of "a realistic view of the facts."[165] The court

examined each of the reasons given for preferring the instalment method over the accrual method and, relating them to the facts, found that it was in agreement with those reasons. Accordingly, the court was satisfied that, based on the actual facts of the business, the instalment method did provide a more accurate picture of profit than the accrual method in the circumstances. It can be concluded that without any express statutory prohibition against the instalment method, and the method having passed the judicial test of ascertaining the true profit as near as possible in light of the actual facts, the taxpayer had attained the most accurate picture of profit.

Publishers Guild provides perhaps the best description of the relationship between tax law and accounting. The main difference between Thorson P's approach to the issue and the *Canderel* framework is that Thorson P considered it the proper role of the court to review the reasons given by accounting experts for their opinion that an accounting system is appropriate and shows a true picture. The system would be acceptable if the court finds the reasons persuasive; that is to say, that the accounting system most closely reveals, on the known facts, the profits that would be revealed if all the facts concerning the income-earning process could be known. In *Canderel*, the framework emphasizes the taxpayer's freedom of choice and de-emphasizes the role of the court in assessing the reasons motivating an accounting opinion that a particular method produces a true picture of income for financial reporting issues.

The three foregoing cases trace the origins of the "accurate picture" principle in Canadian tax law. The Federal Court of Appeal decision in *West Kootenay* placed it in a more modern context and is cited in *Canderel* by Iacobucci J as authority for the principle.[166]

In *West Kootenay*, the taxpayer generated and distributed hydroelectric power. Under applicable regulations, it billed customers on a two-month billing cycle. At the year-end, the taxpayer had delivered some electricity to consumers that, for practical reasons, could not be billed. As a result, estimates of unbilled revenue were made.

For financial statement purposes, the taxpayer applied GAAP and accrued unbilled revenues as of the year-end in its computation of income. The evidence was that GAAP would also permit the accrual in income of only those revenues for which bills were issued in the fiscal period, and this was the method the taxpayer used for tax purposes in the years in issue. Until then, the taxpayer had included estimates of unbilled revenues in income for tax purposes, but changed its treatment in 1983 and 1984 on advice that its prior practice was incorrect. Billings included revenues accrued for electricity delivered during the billing cycle, based on meter readings in most cases and on estimates in cases where meters could not be read. Billing all customers at December 31 would have interrupted a normal billing cycle, the applicable rates for which could not be established under regulation until the end of the billing cycle.

The minister assessed the taxpayer to include in income the estimates of unbilled revenues that the taxpayer had accrued for financial reporting purposes.

The Federal Court of Appeal rejected the trial judge's view that income for tax purposes had to conform to the taxpayer's financial reporting in the circumstances:

> In my view, it would be undesirable to establish an absolute requirement that there must always be conformity between financial statements and tax returns, and I am satisfied that the cases do not do so. The approved principle is that whichever method presents the "truer picture" of a taxpayer's revenue, which more fairly and accurately portrays income, and which "matches" revenue and expenditure, if one method does, is the one that must be followed.
>
> The result often will not be different from what it would be using a consistency principle, but the "truer picture" or "matching approach" is not absolute in its effect, and requires a close look at the facts of a taxpayer's situation.[167]

The court found that the accrual method presented the truer picture because it more accurately and fairly matched revenue and expenditure, even though an estimate was used. The court then concluded that the unbilled revenue was "receivable" within the meaning of paragraph 12(1)(b), and that it was unnecessary to consider the application of subsection 9(1) apart from paragraph 12(1)(b) or of subsection 12(2).[168]

In the result, the Federal Court of Appeal decided that there was no rule requiring conformity between income for financial reporting purposes and income for tax purposes. Rather, the approved principle was the "truer picture" principle, which, depending on the facts, might or might not require "matching." On the evidence, the court found that the accrual method presented the truer picture for accounting purposes, but did not actually decide whether it was the truer picture for tax purposes because, as noted above, it found the unbilled revenues receivable under paragraph 12(1)(b). For this reason, the case gives little direct guidance as to how to ascertain the "true" or "truer" picture for tax purposes, having been decided under an express statutory provision. However, the same analysis was expressly adopted in applying section 9 in the subsequent similar case of *Maritime Telegraph*.[169]

Notes

1 B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983).

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

3 *Canderel Limited* v. *The Queen*, 98 DTC 6100 (SCC).

4 *Friesen* v. *The Queen*, 95 DTC 5551 (SCC).

5 Supra note 1, at 1.

6 94 DTC 6001 (SCC).

7 Supra note 3, at 6105.

8 Ibid., at 6110 (emphasis in original).

9 98 DTC 6088 (SCC).

10 98 DTC 6092 (SCC).

11 *Rainbow Pipeline Company, Ltd. v. The Queen*, 99 DTC 1081 (TCC), and *Fédération des Caisses Populaires Desjardins c. La Reine*, 2001 DTC 5173 (FCA).

12 *Canderel*, supra note 3, at 6106.

13 SC 1947-48, c. 52.

14 RSC 1927, c. 97.

15 Supra note 1, at 20.

16 See Gwyneth McGregor, *Business Deductions Under the Income Tax*, Canadian Tax Paper no. 13 (Toronto: Canadian Tax Foundation, 1958).

17 See the excerpt quoted by Arnold, supra note 1, at 20-21.

18 Ibid., at 20-21; and Glen E. Cronkwright, "The Dilemma of Conformity: Tax and Financial Reporting—A Perspective from the Private Sector," in *Current Developments in Measuring Business Income for Tax Purposes*, 1981 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1982), 22-40.

19 W.R. Jackett, "Computation of Business Profits for Tax Purposes," in the 1981 Corporate Management Tax Conference, supra note 18, 285-94, at 285-86.

20 Former Chief Justice Jackett, one of the framers of the 1948 Act, later put it this way (ibid., at 285-86):

> The word "profit" or "bénéfice" is used in income tax legislation as an ordinary word in the English or French language of which there is no special statutory definition at least in our Income Tax Act. I might add that I think that it is very important that there should be *no* such definition because there is an infinite variety of situations to which the word "profit" or "bénéfice" may have to be applied and it is, in my view, beyond the wit of any legislative draughtsman to frame a definition that would make sense with regard to all of them. I might further add that, where there is a perfectly good word such as profit that is sufficiently flexible to be applied to all situations, in my view, it is bad legislative policy, to give it a rigid meaning, by statutory definition, that may well produce bizarre results in unforeseen cases.

Mr. Justice Iacobucci, in *Canderel*, supra note 3, at 6105, agrees:

> Significantly, "profit" is not defined in s. 9(1) or anywhere else in the Act. It seems to me that this approach was a deliberate legislative choice, particularly given that the Act contains exhaustive definitions of numerous other concepts and terms with which it deals. This choice reflects the reality that no single definition can adequately apply to the millions of different taxpayers bound by the Act.

21 Supra note 3, at 6105-6, quoting *Symes*, supra note 6, at 6009.

22 *Canderel*, supra note 3, at 6105 (emphasis in original).

23 *MNR v. Irwin*, 64 DTC 5227, at 5228 (SCC).

24 *MNR v. Anaconda American Brass Ltd.*, 55 DTC 1220, at 1224 (PC), per Viscount Simonds. See also *Roenisch v. Minister of National Revenue* (1930), 1 DTC 199, at 200 (Ex. Ct.); *Montreal L H & P v. Minister of National Revenue* (1941), 2 DTC 506, at 510 (Ex. Ct.), aff'd. (1942), 2 DTC 535 (SCC).

25 (1888), 2 TC 321, at 327 (HL), per Lord Herschell.

26 (1925), 12 TC 813, at 823 (Ct. Sess.), per Lord President Clyde.

27 67 DTC 5096 (Ex. Ct.).

28 See *Whimster*, supra note 26; *Sun Insurance Office v. Clark*, [1912] AC 443 (HL); and *Commissioners of Inland Revenue v. Gardner Mountain & D'Ambrumenil, Ltd.* (1947), 29 TC 69 (HL).

29 See in particular the famous footnote of Jackett P in *Associated Investors*, supra note 27, quoted infra note 33.

30 (1947), 3 DTC 958 (Ex. Ct.).

31 *Rossmor Auto Supply Ltd. v. MNR*, 62 DTC 1080 (Ex. Ct.).

32 *MNR v. Tower Investment Inc.*, 72 DTC 6161 (FCTD).

33 Supra note 27, at 5098:

> A submission was also made that section 12(1)(a) of the *Income Tax Act*, which reads as follows,
>
> "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,"
>
> must be interpreted as prohibiting the deduction in the computation of profit from a business for a year of any outlay or expense not made or incurred in that year. In support of this submission, reliance was placed on *Rossmor Auto Supply Ltd. v. M.N.R.*, (1962) C.T.C. 123, per Thorson P. at page 126, where he said, "As I view Section 12(1)(a), the outlay or expense that may be deducted in computing the taxpayer's income for the year is limited to an outlay or expense that was *made or incurred* by the taxpayer *in the year* for which the taxpayer is assessed" (the italics are mine). If this view were a necessary part of the reasoning upon which the decision in that case was based, I should feel constrained to follow it although, in my view, it is not based on a principle that is applicable in all circumstances. In that case, however, the loan was clearly not made in the course of the appellant's business and the President so held. In my view, while certain types of expense must be deducted in the year when made or incurred, or not at all, (e.g., repairs as in *Naval Colliery Co. Ltd. v. C.I.R.*, (1928) 12 T.C. 1017, or weeding as in *Vallambrosa Rubber Co., Ltd. v. Farmer*, (1910) 5 T.C. 529), there are many types of expenditure that are deductible in computing profit for the year "in respect of" which they were paid or payable. (Compare sections 11(1)(c) and 14 of the Act.) This is, for example, the effect of the ordinary method of computing gross trading profit (proceeds of sales in the year less the amount by which opening inventories plus cost of purchases in the year exceeds closing inventories) the effect of which (leaving aside the possibility of market being less than cost) is that the cost of the goods sold in the year is deducted from the proceeds of the sale of those goods even though the goods were acquired and paid for in an earlier year. This is, of course, the only sound basis for computing the profits from the sales made in the year. Compare *I.R.C. v. Gardner Mountain & D'Ambrumenil, Ltd.*, (1947) 29 T.C. per Viscount Simon at page 93: "In calculating the taxable profit of a business . . . 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 . . . the net result of the transaction,

setting expenses on the one side and a figure for remuneration on the other side, ought to appear . . . 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." (Applied in this Court in *Ken Steeves Sales Ltd. v. Minister of National Revenue*, (1955) Ex. C.R. 108, per Cameron J. at page 119.) The situation is different in the case of "running expenses." See *Naval Colliery Co. Ltd. v. C.I.R.*, *supra*, per Rowlatt J. at page 1027: ". . . and expenditure incurred in repairs, the running expenses of a business and so on, cannot be allocated directly to corresponding items of receipts, and it cannot be restricted in its allowance in some way corresponding, or in an endeavour to make it correspond, to the actual receipts during the particular year. If running repairs are made, if lubricants are bought, of course no enquiry is instituted as to whether those repairs were partly owing to wear and tear that earned profits in the preceding year or whether they will not help to make profits in the following year and so on. The way it is looked at, and must be looked at, is this, that that sort of expenditure is expenditure incurred on the running of the business as a whole in each year, and the income is the income of the business as a whole for the year, without trying to trace items of expenditure as earning particular items of profit." See also *Riedle Brewery Ltd. v. Minister of National Revenue*, (1939) S.C.R. 253. With regard to the flexibility of method permitted under the *Income Tax Act* for computing profit, see Cameron J. in the *Ken Steeves* case, *supra*, at pages 113-4.

34 *MNR v. Canadian Glassine Co. Ltd.*, 76 DTC 6083 (FCA).

35 *The Queen v. Oxford Shopping Centres Ltd.*, 81 DTC 5065 (FCA), aff'g. 79 DTC 5458 (FCTD).

36 *Tobias v. The Queen*, 78 DTC 6028 (FCTD).

37 *Cummings v. The Queen*, 81 DTC 5207 (FCA).

38 *The Queen v. Metropolitan Properties Co. Limited*, 85 DTC 5128 (FCTD).

39 *The Naval Colliery Co., Ltd. v. The Commissioners of Inland Revenue* (1928), 12 TC 1017 (HL).

40 *Vallambrosa Rubber Co., Ltd. v. Farmer* (1910), 5 TC 529 (Ct. Sess.).

41 The dissent in *Canadian Glassine*, supra note 34, appears to be the only direct authority for the proposition that a running expense can be amortized over a period of years if to do so is appropriate under GAAP. This authority is not that strong, as the majority in that case found the expense non-deductible as a capital outlay, and there was no detailed argumentation by the minister concerning amortization of the expense. The CCRA's administrative policy now favours amortization of expenses if this is in conformity with financial statement reporting, so there is little prospect for dispute on the issue. As a matter of principle, though, the requirement that tax liability be determined discretely for each year suggests that an expenditure or portion of an expenditure that cannot be factually related to revenue earned in a given year ought not be deductible as an expense in that year for tax purposes, under the general definition of "profit" for the purposes of section 9.

42 Foundation and derivative principles are discussed in greater detail below under the heading "Case Law Principles."

43 This view of the distinction between case law principles and business principles as interpretive aids only would be consistent with the inductive approach to jurisprudence prevalent in systems of civil law.

44 This view would be consistent with the deductive approach to jurisprudence prevalent in common law systems. Is Iacobucci J trying to steer an area of federal statute law on a careful course between civil and common law approaches?

45 Supra note 3, at 6108.

46 Ibid., at 6107 (emphasis in original).

47 As affirmed by Jackett P in *Associated Investors*, supra note 27, and relied upon by Iacobucci J in *Canderel*, supra note 3. See the extract from *Canderel* cited in the text at note 22.

48 See *Gresham Life Assurance Society v. Styles* (1892), 3 TC 185, at 188 (HL), per Halsbury LC; *The Bank of Nova Scotia v. The Queen*, 80 DTC 6009, at 6011 (FCTD); and Jackett, supra note 19, at 286. Even though this rule has persisted for over 100 years, it is not a rule of universal application. It means different things to cash basis taxpayers than to accrual basis taxpayers. If business people were to develop a new concept of profit and apply it generally (such as, "profit is the change in net assets over a time period"), the existing definition might cease to have currency.

49 The courts have recognized the elevation of ordinary commercial principles into rules of law: see *Oryx Realty Corporation v. MNR*, 74 DTC 6352, at 6354 (FCA):

> In the ordinary trading business, however, the practice, which has hardened into a rule of law, is that profit for a year must be computed by deducting from the aggregate "proceeds" of all sales the "cost of sales" computed by adding a value placed on inventory at the beginning of the year to the cost of acquisitions in the year and deducting a value placed on inventory at the end of the year [footnotes omitted].

This passage was expressly adopted by the Supreme Court of Canada in *MNR v. Shofar Investment Corporation*, 79 DTC 5347, at 5349, and relied on by Iacobucci J, in his dissenting reasons in *Friesen*, supra note 4.

50 Supra note 3, at 6112.

51 Supra note 24.

52 *Anaconda* only held that the LIFO method is inappropriate if it fails to portray the actual results of the business's income-earning process more accurately than an alternative method. It did not hold that LIFO is never appropriate, as has been sometimes suggested: Vern Krishna, *The Fundamentals of Canadian Income Tax*, 5th ed. (Scarborough, ON: Carswell, 1995), 283 and 303. See Jackett, supra note 19, at 294:

> It should be understood, however, that the *Anaconda* case does *not* rule out the use of "Lifo," or any other rule of thumb, where it results in an amount of profit on the facts of the particular case that is nearer to the true profit, as that word is understood by the Courts, than the amount that any alternative method would produce [emphasis in original].

53 Peter W. Hogg, Joanne E. Magee, and Ted Cook, *Principles of Canadian Income Tax Law*, 3d ed. (Scarborough, ON: Carswell, 1999), 213. The debate over the correctness of the *Anaconda* decision is really a debate over the nature of the relationship between the concept of profit for tax purposes and that concept for accounting purposes. Commentators have thought that judges, in the formative cases, approved the measurement of profit following accounting principles, and consequently use accounting concepts as the starting point for profit computation. Thus, for example, there is a view that the "truer picture" or "more accurate picture" principle is an accounting concept, to be applied in the case of tax law to the correct measurement of revenues and expenses (that is, the income statement) in contrast, for example, to a truer or more accurate picture of closing balances in the balance sheet (See Krishna, supra note 52, at 282-307). This also means that the judgments to be brought to bear in deciding between two accounting methods are to be made by competent accountants, based on considerations important in accounting (see Hogg et al., supra).

This is not a correct view of the formative cases. The early judges took a legal, not an accounting, approach to the determination of profit. Their concern, in assessing profit, was to make findings of relevant facts to permit them to respond to a question of law. The judges

considered the relevant facts to be the facts concerning the actual income-earning process of the taxpayer and the results of that process. Accounting methods often provided an appropriate description of the results of the income-earning process and so gave judges useful guidance. But the courts, being charged with the ultimate decision, could not abdicate their responsibility to the expert witnesses on accountancy. They had to assess the profit on the facts, where the facts were known. Where all the facts could not be known, they had to assess whether a method of describing the income-earning process came as close as possible in the circumstances and on the known facts to what actually happened.

This was the basis of the *Anaconda* decision, and it flows from the cases that preceded it. The court was not concerned whether to favour a truer picture of the income statement over a truer picture of the balance sheet. In fact, the expert accounting evidence in the case pointed to the LIFO method as providing the truer picture of the income statement for the taxpayer's purposes. The court was concerned with answering the legal question, based on the facts, which of the LIFO and FIFO methods was a closer estimation of the actual profit from the business in the taxation year.

Former Chief Justice Jackett was one of the principal framers of the 1948 Act, including what is now section 9. He also acted as counsel to the Crown in the appeal to the Privy Council in *Anaconda*. It was the Crown's arguments that ultimately persuaded the minority of the Supreme Court of Canada and the entire panel of the Privy Council. Chief Justice Jackett later explained the *Anaconda* case this way (supra note 19, at 193-94):

> As a preliminary comment, it should be said that the Courts have recognized that there are cases where it is not possible to base the computation of profits on precise facts because the precise facts are not known and that, in such cases, it may be necessary to make an "estimate" by application of a "rule of thumb" to the facts that are known. In such a case, the only rule of law is that the true gains are to be ascertained as nearly as can be.
>
> As I understand it, it was this rule of law that the taxpayer ran foul of in the "Fifo" and "Lifo" case. What the taxpayer was seeking was to value inventories consumed in the manufacturing process on the basis of what was being paid currently to replace them; and, to achieve this result, it sought to value inventories at the beginning and end of a year on the assumption that the "last in" had always been the "first out." The old fashioned way of valuing inventories—and the one for which the Revenue contended in the "Lifo" and "Fifo" case—was based on the assumption that the "first in" had always been the "first out," which resulted in that case in the prices of earlier years, which were lower, being used to value the inventories consumed during the year. What the ultimate court said, as I understood it, was that an examination of the facts showed that an estimate based on Revenue's assumption was obviously closer to the true profit (if it had been possible to calculate the profit of each sale by reference to the actual facts) than the estimate based on the taxpayer's assumption.

While one can criticize the use of a legal approach to undertake what is essentially an accounting exercise, such an approach is a direct and necessary consequence of the policy decision that the determination of profit be a question of law, and not a question of fact, based on GAAP. A legislative amendment (such as first proposed in 1948) would probably be required to mandate a different approach.

54 Supra note 28.

55 *The Queen v. Friedberg*, 93 DTC 5507 (SCC).

56 *MNR v. Publishers Guild of Canada Ltd.*, 57 DTC 1017 (Ex. Ct.).

57 *West Kootenay Power and Light Company Limited v. The Queen*, 92 DTC 6023 (FCA); see also *Maritime Telegraph and Telephone Company, Limited v. The Queen*, 92 DTC 6191 (FCA).

58 The appendix to this paper provides a more detailed analysis of the development and rationale of the "more accurate" or "truer" picture principle, including a more detailed factual analysis of the *Anaconda*, *Publishers Guild*, and *West Kootenay* cases.

59 Supra note 6.

60 Supra note 4.

61 *Publishers Guild*, supra note 56; *Neonex International Ltd. v. The Queen*, 78 DTC 6339 (FCA); and *Canderel*, supra note 3.

62 *Dominion Taxicab Assn. v. MNR*, 54 DTC 1020 (SCC); *Associated Investors*, supra note 27; *Symes*, supra note 6; *Canderel*, supra note 3; and *Friesen*, supra note 4.

63 *Gresham Life Assurance*, supra note 48.

64 *Naval Colliery*, supra note 39; *Gardner Mountain*, supra note 28; *Anaconda*, supra note 24; and *Canderel*, supra note 3.

65 *Sun Insurance Office*, supra note 28; *Anaconda*, supra note 24; and *Canderel*, supra note 3.

66 *Anaconda*, supra note 24; and *J.L. Guay Ltée v. MNR*, 71 DTC 5423 (FCTD), aff'd. 73 DTC 5373 (FCA).

67 *Robertson v. Minister of National Revenue* (1944), 2 DTC 655 (Ex. Ct.). While this principle, as stated, appears to be a principle of computation, it is believed to be a foundation principle because it reflects the interpretation given the undefined term "income" that underlies the entire Act.

68 *Sun Insurance Office*, supra note 28; *Publishers Guild*, supra note 56; and *Canderel*, supra note 3.

69 *Associated Investors*, supra note 27; and *Canderel*, supra note 3.

70 *Aberdeen Town and County Bank*, supra note 25; *Whimster*, supra note 26; *Anaconda*, supra note 24; *Irwin*, supra note 23; *Gordon Kenneth Daley v. Minister of National Revenue*, 50 DTC 877 (Ex. Ct.); and *Canderel*, supra note 3.

71 *Ostime v. Duple Motor Bodies Ltd.*, [1961] 2 All ER 167 (HL); *Canadian General Electric Co. Ltd. v. MNR*, 59 DTC 1217 (Ex. Ct.), rev'd. on other grounds, 61 DTC 1300 (SCC); and *Friedberg*, supra note 55.

72 *Ken Steeves Sales Ltd. v. MNR*, 55 DTC 1044 (Ex. Ct.).

73 *MNR v. Colford Contracting Co. Ltd.*, 60 DTC 1131 (Ex. Ct.); *Ikea*, supra note 10; *Gardner Mountain*, supra note 28; and *Ken Steeves Sales*, supra note 72.

74 *MNR v. Benaby Realties Limited*, 67 DTC 5275 (SCC).

75 *Robertson*, supra note 67; and *Dominion Taxicab*, supra note 62.

76 *Oryx Realty*, supra note 49; *Associated Investors*, supra note 27; *Sun Insurance Office*, supra note 28; and *Ken Steeves Sales*, supra note 72.

77 *Oryx Realty*, supra note 49.

78 *Naval Colliery*, supra note 39; *Whimster*, supra note 26; *The Queen v. Burnco Industries Ltd. et al.*, 84 DTC 6348 (FCA); *Northwood Pulp and Timber Limited v. The Queen*, 98 DTC 6640 (FCA); and *The Queen v. Nomad Sand and Gravel Limited*, 91 DTC 5032 (FCA).

79 *Wilchar Construction Limited v. The Queen*, 81 DTC 5318 (FCA); and *Friedberg*, supra note 55.

80 *Fédération des Caisses Populaires*, supra note 11.

81 *Naval Colliery*, supra note 39; *Associated Investors*, supra note 27; and *Canderel*, supra note 3.

82 *Publishers Guild*, supra note 56; and *Canderel*, supra note 3.

83 *Naval Colliery*, supra note 39; *Gresham Life Assurance*, supra note 48; *Anaconda*, supra note 24; and *Consolidated Textiles*, supra note 30.

84 *Canderel*, supra note 3.

85 *Vallambrosa*, supra note 40; *Consolidated Textiles*, supra note 30; and *The Royal Trust Co. v. MNR*, 57 DTC 1055 (Ex. Ct.).

86 *Canadian General Electric*, supra note 71.

87 *Associated Investors*, supra note 27.

88 Supra note 4.

89 The definition of "inventory" was amended by a 1991 technical bill, effective for fiscal periods beginning in 1989 or later, to add all the words following "or would have been." The technical notes accompanying the amendment provide that the addition is intended to clarify that a farmer's livestock is included in inventory regardless of whether the farmer uses cash accounting or accrual accounting (see Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, May 1991), clause 192). Therefore, other than with respect to the business of livestock farming, a property will be inventory if its cost or value is relevant in computing a taxpayer's income from a business for a taxation year.

90 See, inter alia, *Irwin*, supra note 23, and *Symes*, supra note 6.

91 See *Oryx*, supra note 49, and *Shofar Investment Corporation*, ibid.

92 See *Oryx*, supra note 49, and *Shofar Investment Corporation*, ibid.

93 Supra note 24, at 1225.

94 Supra note 23, at 5228-29.

95 See, for example, *Jellaczyc v. MNR*, 85 DTC 184 (TCC). See also "Revenue Canada Panel," in *Creative Tax Planning for Real Estate Transactions—Beyond Tax Reform and into the 1990s*, 1989 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1989), 8:1-59, question 20, at 8:28, and "Revenue Canada Round Table," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53:1-188, question 50, at 53:57. See also "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 50:1-83, question 38, at 50:22-23. Here, Revenue Canada maintained that subsection 10(1) inventory writedowns did not apply to property held as an adventure in the nature of trade, notwithstanding the Federal Court Trial Division's decision in *Weatherhead v. MNR*, 90 DTC 1398 (TCC).

96 90 DTC 1321 (TCC). While *Bailey* was the first case to hold it to be appropriate to write down the value of undisposed property held in an adventure in the nature of trade, the stage was set by an earlier decision of the Tax Court. *Gilmour v. MNR*, 89 DTC 658 (TCC) was decided on the basis that the taxpayer held the subject property as capital property and not in an adventure in the nature of trade. The court went on to state, however (ibid., at 659-60):

> Before finishing, I should like to note that the dismissal of this appeal does not signal necessarily an acceptance on my part of the explanation of Revenue Canada, or of the assertions of the Respondent, *supra*, on any of the following:
>
> —that an inventory write down under subsection 10(1) of the Act is not available for land held as an adventure or concern in the nature of trade,
>
> —that any gain or loss will be reported in the year of disposition.

97 See the discussion of inventory by then-retired Chief Justice Jackett, supra note 19, at 292-93.

98 Supra note 49.

99 Ibid.

100 Supra note 26.

101 *Edward Collins & Sons, Ltd. v. The Commissioners of Inland Revenue* (1924), 12 TC 773 (Ct. Sess.).

102 Supra note 95.

103 *Van Dongen v. The Queen*, 90 DTC 6633 (FCTD), and *Skerrett v. The Queen*, 91 DTC 1330 (TCC). In *Van Dongen*, the court reviewed the decisions in *Bailey* and *Weatherhead*. Although the court held, in this particular case, that the taxpayer held the properties in question as capital properties and not as adventures in the nature of trade, the court still took issue with the minister's position that an inventory writedown under subsection 10(1) was not available for land held as an adventure in the nature of trade. The court stated that in its view, *Bailey* had settled the issue that land held as an adventure in the nature of trade was eligible for inventory breakdown. In *Skerrett*, the court focused on whether property held in an adventure in the nature of trade could be classified as inventory. Relying on *Bailey* and *Van Dongen*, the court held that such property could be inventory and that it was not necessary to have disposed of the inventory to be able to write down its value and create a deductible expense. It is interesting to note that despite these cases, the CCRA did not alter its administrative position that property held in an adventure in the nature of trade could not be written down to recognize a loss in the absence of a disposition.

104 92 DTC 6248 (FCTD).

105 Ibid., at 6250, citing *Stubart Investments Limited v. The Queen*, 84 DTC 6305 (SCC).

106 Supra note 104, at 6251, citing the Federal Court Trial Division's decision in *Maritime Telegraph and Telephone Company Limited v. The Queen*, 91 DTC 5038 (FCTD).

107 Supra note 104, at 6251.

108 Ibid.

109 Ibid., at 6251-52.

110 93 DTC 5313 (FCA).

111 Supra note 4.

112 Ibid., at 5570.

113 Ibid.

114 Ibid., at 5553.

115 Ibid., at 5561.

116 Ibid., at 5559-60.

117 Ibid., at 5561.

118 As to whether a business is "carried on," see *Tara Exploration and Development Co. Ltd. v. MNR*, 70 DTC 6370, at 6376 (Ex. Ct.), where Jackett P states that "[t]o carry on something involves a continuity of time or operations."

119 See, for example, *Ruland Realty Limited v. The Queen*, 98 DTC 2172 (TCC).

120 *Maison de Choix Inc. v. MNR*, 83 DTC 204 (TRB), and *The Queen v. The Consumers' Gas Company Ltd.*, 87 DTC 5008 (FCA).

121 Supra note 10.

122 Whereas *Ikea* dealt with the timing of inclusions of tenant inducement payments, the companion cases, *Canderel* and *College Park* (both discussed in the first part of this paper), raised the opposite issue—namely, whether a taxpayer may deduct such payments from income in the year they are made. The CCRA's position prior to the Supreme Court's decisions in these cases was that tenant inducement payments for non-anchor tenants should be amortized over the life of the lease (see CCRA document no. 9504407, March 22, 1995). The Supreme Court found that the payments made in those cases were "running expenses" not "causally linked to any single or specific stream of revenue" and were therefore wholly deductible in the year they were incurred. For the CCRA's remarks on these cases, see the comments of Roy Shultis

in Robert Couzin and Stephen S. Ruby, "The Impact of Recent Cases," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 52:1-32, at 52:8-9.

123 Interestingly, the CCRA has not yet amended paragraph 9 of *Interpretation Bulletin* IT-359R2, "Premiums and Other Amounts with Respect to Leases," December 20, 1983, which states that a tenant inducement payment would be income in the hands of a tenant "where the negotiation of leases is a regular part of the tenant's business operations (e.g. a chain store)" and a non-taxable receipt otherwise. The CCRA altered its policy on this bulletin following the introduction of paragraph 12(1)(x), and has been promising revisions since 1985. The expectation of its revision in light of the *Canderel* and *Ikea* decisions was mentioned in CCRA document 2000-0056045, December 6, 2000.

124 *Ikea*, supra note 10, at 6099.

125 Ibid., at 6100. This reasoning has been criticized on the basis that failure to amortize the amount of the payment over the life of the lease could distort Ikea's income in subsequent years, since profit would be understated by the amount of the lease operating expenses for those years. See Robert Jarman, "Has the Supreme Court of Canada Clarified the Subsection 9(1) Problem, or Merely Muddied the Water?" Case Comment, *Dominion Tax Cases*, March 9, 1998, 6-8. However, it is implicit in this criticism that GAAP are inherently superior to legal principles, contrary to the policy underlying section 9.

126 *Ikea*, supra note 10, at 6100.

127 Until 1983, paragraph 12(1)(b) read as follows:

> 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 . . .
>
> (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 or any part thereof is not due 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.

The paragraph has since been amended to provide that an amount shall be deemed to have become receivable in respect of services rendered on the earlier of the day on which an account is rendered and the day on which the account would have been rendered had there been no undue delay in rendering the account.

128 Supra note 57.

129 Ibid.

130 Supra note 73.

131 *West Kootenay*, supra note 57, at 6030-31. Commentators have expressed the view that the court could have reached the same decision under the general principles of subsection 9(1). This is probably correct, as the *Maritime Telegraph* decision attests. See also Donald K. Biberdorf, "Recent Case Law," in *1992 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1992), tab 2.

132 See also *The Queen* v. *Huang and Danczkay Ltd.*, 2000 DTC 6549 (FCA).

133 The change was premised on what the taxpayer perceived as its ability to take advantage of the amendments to paragraph 12(1)(b), noted above.

134 Note CCRA document no. 9413085, August 25, 1994, where, in response to the question of whether revenue from the performance of services should be recognized when the services

are completed or when it is possible to render the account, the CCRA wrote that income can be recognized at a date later than the date of completion of the services, on the basis that it may not yet be receivable at law.

135 These include new section 43.1, subsections 248(20) and (21), the new alter ego and joint partner trust rules subsumed into section 73, and the proposed new definition of "disposition" to be found in subsection 248(1).

136 For a thorough summary of the many CCRA administrative pronouncements and judicial decisions on dispositions, see Edwin G. Kroft, "An Update on Select Legal Issues Relating to Dispositions and Exchanges of Property," in *Real Estate Transactions: Tax Planning for the Second Half of the 1990s, 1995* Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 10:1-45.

137 SC 2001, c. 17. These amendments were added by the 2001 technical bill, effective for changes in residence that occur after October 1, 1996. For a complete overview of the new rules, see L. Alan Rautenberg, "The New Emigration Rules—The Story So Far," in *1999 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1999), tab 2.

138 The need for an overhaul of the emigration rules gained notoriety as a result of the auditor general's 1996 report, which was critical of certain advance tax rulings issued by the CCRA in 1985 and 1991. At the crux of these rulings was the issue of whether a resident of Canada could hold taxable Canadian property. *Income Tax Ruling* ATR-70, "Distribution of Taxable Canadian Property by a Trust to a Non-Resident," March 21, 1996, permitted a trust resident in Canada to distribute shares of a public corporation (which shares the trust had acquired in exchange for shares of a private corporation under the provisions of subsection 85(1) and were therefore, in the CCRA's view, deemed to be taxable Canadian property of the trust under paragraph 85(1)(i)) to a non-resident beneficiary free of Canadian tax. The non-resident beneficiary was also a trust and had become non-resident for the sole purpose of receiving the public company shares free of tax. The CCRA ruled that the interest in the first trust held by the beneficiary trust was taxable Canadian property, and therefore no deemed disposition occurred upon the beneficiary trust becoming non-resident. The legality of ATR-70 is currently being challenged by George Harris, a member of a public interest group called "Choices." See *The Queen v. Harris et al.*, 2001 DTC 5247 (FCA).

139 It remains relevant, however, for the purposes of the immigration rules in subsection 128.1(1).

140 See Canada, Department of Finance, *News Release*, no. 98-134, December 23, 1998.

141 Ibid.

142 One popular arrangement affected by these rules was an investment by a limited partnership in mutual fund commissions. The limited partnership would raise capital, which was used to pay the mutual fund's sales commissions in exchange for the right to future distribution and redemption fees. The partnership would deduct the entire "investment" in the current year and report the portion of the income stream earned for each following year. The CCRA had originally allowed the full deduction in the first year, but later changed its administrative position to allow a deduction of one-third of the expenditure each year.

143 See the "Backgrounder" accompanying Canada, Department of Finance, *News Release*, no. 96-082, November 18, 1996. The department also stated that these rules were necessary because "the accounting principle of conservatism" might have "operated to shorten the period over which an expenditure related to a right to receive income would otherwise be amortized under the matching principle." Note that this statement was made prior to the Supreme Court's decisions in *Ikea*, supra note 10, *Canderel* supra note 3, and *College Park*, supra note 9.

144 The matchable expenditure must be deductible under general principles (that is, it must satisfy section 9 and paragraph 18(1)(a)) but it cannot be an amount for which a deduction is provided under section 20 (such as a capital expenditure). As noted above, the section applies only to expenditures made to obtain a right to receive a stream of income in future periods.

145 There has been some discussion in the literature that tenant inducement payments, discussed above, could be "matchable expenditures," notwithstanding that they have been held in *Canderel* and *Toronto College Park* to be deductible in the year they were made. See, for example, Jean Potvin, "Inducement Payments," in *Report of Proceedings of Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 65:1-24. A contrary argument is that rent, even if computed by reference to revenues, profits, etc., is not a "right" belonging to a tenant, and is thus not capable of being "acquired" from the tenant. The exception in subsection 18.1(15) should therefore ordinarily apply (see below).

146 Subsection 18.1(14).

147 A "tax benefit" is defined in subsection 18.1(1) to mean a reduction, avoidance, or deferral of tax or other amount payable under the Act or an increase in a refund of tax or other amount under the Act.

148 Subsection 18.1(15). That subsection also excludes expenditures of a reinsurer in respect of commissions or other expenses related to the issuance of an insurance policy for which all or a portion of a risk has been ceded to the reinsurer.

149 See Canada, Department of Finance, 1994 Budget, Tax Measures: Supplementary Information, February 22, 1994, 20-23. Presumably, the mark-to-market rules also prevented financial institutions from relying on the decision in *Friedberg*, supra note 55, to change their tax reporting to a realized basis from the mark-to-market reporting required of them under GAAP.

150 The rules apply to "mark-to-market property," which includes shares (other than a share of a corporation in which the financial institution holds a "significant interest"—generally 10 percent of more of the votes and value of the corporation) and in certain circumstances, "specified debt obligations" (which includes loans, mortgages, bonds, notes, debentures, agreements of sale, and most other types of debt, other than those expressly excluded).

151 To "mark to market" a property means that the unrealized appreciation or depreciation in the value of the property in a year must be recognized for taxation purposes in that year. Subsection 142.5(2) implements this requirement by deeming a financial institution to have disposed of its mark-to-market property immediately before the end of the year for proceeds equal to its fair market value at the time of disposition and to have reacquired the property immediately thereafter at an equivalent cost. This effectively conforms profit measurement of financial institutions for tax purposes to only one method (which is recognized by GAAP) in respect of transactions in the defined types of property.

152 Where a share held by a financial institution is redeemed, the CCRA has indicated that the mark-to-market rules take precedence over the deemed dividend provisions in subsection 84(3), so as to avoid double taxation. See CCRA document no. 9631867, June 6, 1997.

153 Supra note 28.

154 Supra note 24.

155 Supra note 56.

156 Supra note 57.

157 Supra note 28, at 451.

158 Ibid., at 453.

159 Ibid., at 454 (emphasis added).

160 *MNR* v. *Anaconda American Brass Ltd.*, 54 DTC 1179, at 1183 (SCC), per Kerwin CJ (dissenting).

161 Supra note 24, at 1224, per Viscount Simonds, quoting *Whimster*, supra note 26, at 823.

162 Supra note 24, at 1225, per Viscount Simonds (emphasis added).

163 Supra note 25.

164 Supra note 56, at 1026.

165 Ibid., at 1027.

166 Supra note 3, at 6108.

167 Supra note 57, at 6028.

168 See the discussion in the third part of this paper under the heading "Timing of Inclusion of Unbilled Amounts," starting at the text accompanying note 127.

169 Supra note 57.