WILFRED JOSEPH LAWSON .... APPELLANT;

1969
*Feb. 5, 6
Mar. 10

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Valuation of closing inventory—Stock promoter—Valuation of shares—Specific identification—Certificate numbers—Stock exchange quotation—Cost to taxpayer or fair market value—Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(e), 14(2).

The appellant was a mining stock promoter. As a result of his extensive trading in the shares of a mining company, he held, at the end of his fiscal year 1955, an inventory of 568,900 shares. He was assessed for income tax on the basis that the proper valuation for his inventory was his average cost of all the shares bought by him. This was computed by dividing his total purchase of 1,609,860 shares into the total cost of $608,229.62. The Exchequer Court upheld the Minister's assessment with a variation based on a shorter averaging period. The taxpayer appealed to this Court.

Held: The appeal should be dismissed.

The appellant's closing inventory could not be valued on any basis lower than the average cost of the shares as determined by the trial judge. The latter was fully justified in holding that there was no evidence that a reasonable programme of disposition of the inventory would have brought the market price below cost. No basis could therefore be found in the evidence for establishing a market value lower than cost.

*PRESENT: Fauteux, Judson, Ritchie, Hall and Pigeon JJ.

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None of the different bases of computation submitted by the appellant to establish a cost lower than the cost determined by the trial judge could be accepted.

The method of "specific identification" by which one identifies the shares remaining in the inventory by an examination of the serial numbers on the certificates is inapplicable to company shares. As long as a shareholder continues to hold a certain quantity of shares none of his shares is distinguishable from any other.

No convincing evidence was given that the method known as "first in, first out" (FIFO) was a proper method for valuing such an inventory and it was not shown to be in use to any extent by persons in a situation similar to the appellant's.

The "project" method which consists in applying total receipts from the sales of some of the shares against the cost of all the shares sold or unsold—no sale being considered as yielding any profit until the entire cost of the venture is recovered—must be rejected for income tax purposes on the authority of *M.N.R. v. Anaconda American Brass Ltd.*, [1956] A.C. 85. What the appellant was really trying to accomplish by this method of accounting was to set up against the contingency that his inventory might drop in value, a reserve equal to his profit so far on the operation. Such a reserve is prohibited by s. 12(1)(*e*) of the *Income Tax Act.*

Revenu—Impôt sur le revenu—Évaluation d'un inventaire de fin d'année—Promoteur d'émissions de valeurs mobilières—Évaluation d'actions d'une compagnie—Identification spécifique—Numéros des certificats—Cote de la Bourse—Prix coûtant pour le contribuable ou juste valeur marchande—Loi de l'impôt sur le revenu, S.R.C. 1952, c. 148, art. 12(1)(e), 14(2).

L'appelant est un promoteur d'émissions d'actions minières. Comme résultat de son commerce considérable des actions d'une compagnie minière, il en détenait, à la fin de son année fiscale 1955, un inventaire de 568,900 actions. Il a été cotisé pour fins d'impôt sur le revenu d'après le principe que l'évaluation appropriée de son inventaire était le coût moyen de toutes les actions qu'il avait achetées. Le calcul a été fait en divisant l'achat total de 1,609,860 actions par le coût total de $608,229.62. La Cour de l'Échiquier, avec une modification basée sur une période plus courte pour le calcul de la moyenne, a maintenu la cotisation du Ministre. Le contribuable en appela à cette Cour.

Arrêt: L'appel doit être rejeté.

L'inventaire de fin d'année de l'appelant ne peut pas être évalué sur une base moindre que le coût moyen des actions tel que fixé par le juge au procès. Ce dernier était amplement justifié de statuer qu'il n'existait aucune preuve qu'un programme raisonnable d'écoulement de l'inventaire aurait fait baisser le prix du marché au-dessous du prix coûtant. En conséquence on ne peut trouver aucune base dans la preuve pour établir une valeur marchande moindre que le prix coûtant.

Aucune des bases de calcul proposées par l'appelant en vue d'établir un prix coûtant moindre que le prix coûtant fixé par le juge au procès ne peut être acceptée.

La méthode du «coût spécifique de chaque article» en vertu de laquelle on identifie les actions qui sont encore dans l'inventaire par un examen des numéros de série des certificats ne s'applique pas à des actions de compagnie. Tant qu'un actionnaire détient une certaine quantité d'actions, aucune de ses actions n'est distinguable des autres.

On n'a présenté aucune preuve concluante que le procédé du «premier entré, premier sorti» (FIFO) soit un procédé approprié à l'évaluation d'un tel inventaire et il n'a pas été démontré que ce procédé soit utilisé en général par des personnes dans une situation semblable à celle de l'appelant.

La méthode de la «comptabilité du projet» qui consiste à imputer le total des argents provenant de la vente de quelques-unes des actions au prix coûtant de toutes les actions vendues ou non vendues—c'est-à-dire qu'aucune vente n'est considérée comme donnant un profit tant que le prix coûtant entier de l'opération n'a pas été recouvré—doit être rejetée pour fins d'impôt sur le revenu vu la décision *M.N.R. v. Anaconda American Brass Ltd.,* [1956] A.C. 85. Ce que l'appelant tente en réalité d'accomplir par cette méthode de comptabilité est d'établir, contre l'éventualité d'une perte de valeur de son inventaire, une réserve égale au profit qu'il a réalisé à date. Une telle réserve est prohibée par l'art. 12(1)(*e*) de la *Loi de l'impôt sur le revenu.*

APPEL d'un jugement du Juge Cattanach de la Cour de l'Échiquier du Canada[1], en matière d'impôt sur le revenu. Appel rejeté.

APPEAL from a judgment of Cattanach J. of the Exchequer Court of Canada[1], in an income tax matter. Appeal dismissed.

R. E. Shibley, Q.C., and *M. L. O'Brien,* for the appellant.

M. A. Mogan and *G. V. Anderson,* for the respondent.

The judgment of the Court was delivered by

PIGEON J.:—Appellant is a mining stock promoter. In 1954 he "took over", as he says, Maneast Uranium Corporation Limited ("Maneast"). The shares were then quoted around 3 cents. He became president having effective control, distributed promotional material and started selling shares on the Toronto Stock Exchange between 20 and 34 cents. In October, he took down 100,000 treasury shares. In December, he entered into an underwriting agreement for 200,000 shares at 20 cents with an option on an additional 800,000 shares at 20 cents for the first 200,000

[1] [1965] 1 Ex. C.R. 64, [1964] C.T.C. 245, 64 D.T.C. 5147.

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shares, 25 cents for the next 200,000 shares, 30 cents for the following 200,000 shares and 35 cents for the balance. All these were taken down, the last two lots on May 10, 1955.

While selling as many shares as he could, appellant was also buying substantial quantities on the stock exchange in order, as he says, "to maintain the market". As a result of his operations he held, at the end of his fiscal year, May 31, 1955, an inventory of 568,900 shares. He was assessed for income tax on the basis that the proper valuation for this inventory was his average cost of all Maneast shares bought by him. This was computed at 37½ cents by dividing his total purchases of 1,609,860 shares (being 1,100,000 treasury shares plus 509,860 market shares) into the total cost of $608,229.62 (being $310,000.00 plus $298,229.62). However, on the appeal before the Exchequer Court, it being shown that on April 18 appellant had been in a "short position", respondent determined that the correct average cost was 34.1 cents per share on the basis of a shorter averaging period, from April 19 to May 31, 1955, and Cattanach J. ordered the assessment to be varied accordingly. Otherwise he dismissed the appeal without costs to either party.

The only question on the appeal to this Court is whether appellant's 1955 closing inventory should be valued on any basis lower than the average cost as above determined. Section 14(2) of the *Income Tax Act* reads:

> 14(2). For the purpose of computing income, the property described in an 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.

As there is no other manner permitted by regulation in such a case, the only bases to be considered are cost and fair market value.

On the Toronto Stock Exchange the closing bid on May 31, 1955 was 67 cents per share. There were in that month 535,440 shares traded at prices ranging between a low of 49 cents and a high of 73 cents. In the following month, there were 1,184,560 shares traded between a low of 63 cents and a high of $1.03. Cattanach J. said:

> ...there was a very substantial volume of sales at prices greatly in excess of what the shares cost the appellant and the Toronto Stock Exchange continued to list Maneast shares at prices in excess of cost to the appellant for almost a year after the end of the taxation year. On the other hand, there was no evidence that a reasonable programme of disposition in

respect of the appellant's inventory as of the end of May would have brought the market price below cost. It may well be inferred that, if the appellant's whole inventory had been thrown on the market at one time, the price would have dropped to nothing. There was no evidence, however, that by a carefully planned programme, he could not have disposed of all the shares at a price equal to or in excess of his cost. The onus was on the appellant to show that the actual fair market value of the inventory at the end of May 1955 was less than cost and in my opinion the appellant has failed to discharge that onus.

As against this finding appellant says that he was under obligation by virtue of the Stock Exchange rules "to run an orderly market" and that this prevented him from selling any more shares than he did. However, the fact is that by the end of December 1955, his inventory was down to 123,980 shares, the high and low within that month being 41 cents and 30 cents.

In my view, the trial judge was fully justified in holding that there was no evidence that a reasonable programme of disposition of the inventory would have brought the market price below cost. Therefore, even on the assumption that in appellant's special circumstances the Stock Exchange quotation at the material date was not to be taken as the market value, no basis can be found in the evidence for establishing a market value lower than cost. No attempt was made to show what another promoter would have been willing to pay for acquiring appellant's inventory.

There remain to be considered the different bases of computation submitted by appellant to establish a cost lower than 34.1 cents per share.

One of the methods suggested is described as "specific identification". It is sought to be applied by identifying the shares remaining in the inventory by an examination of the serial numbers on the certificates that were held for appellant by his broker. This method was properly rejected because it is inapplicable to company shares. As was pointed out by Kerwin J. (as he then was) in *Canada China Clay Ltd. v. Hepburn*[2], "the distinction between a share of capital stock of a company and the certificate of such share is (to be) borne in mind...". As long as a shareholder continues to hold a certain quantity none of his shares is distinguishable from any other. Appellant's witness

[2] [1945] S.C.R. 87 at 93, [1945] C.T.C. 91, [1945] 1 D.L.R. 273.

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Lachance, an expert accountant, said: "All shares are interchangeable one with the other". To endeavour to ascertain the cost by reference to the serial numbers of the certificates held would mean that the cost would be determined according to a criterion that has no relevance to the actual situation. The shares were clearly fungible things and the specific identification method was impossible of application.

Furthermore, as Cattanach J. noted, there were at least some 40,000 shares for which the origin of the certificates could not be traced. Appellant contended that the difficulty could be solved by valuing these at average cost. This contention is to be rejected because if in some way a portion of the inventory is valued on another basis, that portion cannot be used in striking an average, specially when the average largely reflects the excluded portion, the treasury shares. If all but some 40,000 shares are valued on the assumption that they are treasury shares the others must be valued as market shares. If this is done the result is a cost higher than the average calculated by the Minister.

The result is much the same if one attempts to apply the method known as "First in, first out" (Fifo). In order to arrive at a cost lower than the average it is necessary to apply this method on the assumption that treasury shares only were in the inventory. To make such a distinction is really not to apply Fifo because the very principle of every method of valuation is uniform application. In any case no convincing evidence was given that Fifo was a proper method for valuing such an inventory and it was not shown to be in use to any extent by persons in a situation similar to appellant's.

Appellant contends that the trial judge was in error in rejecting Fifo for the following reason:

> the evidence as to which stock certificates were used for particular sales did not lead to the conclusion that there was a tendency to use the oldest certificates first.

Appellant points out that in *Minister of National Revenue v. Anaconda American Brass Ltd.*[3], the Privy council held in favour of Fifo as a convenient assumption not as

[3] [1956] A.C. 85, [1956] 1 All E.R. 20, [1955] C.T.C. 311, 55 D.T.C. 1220, [1956] 2 D.L.R. (2d) 1.

corresponding with an actual user test. This does not invalidate Cattanach's main basis for the rejection of Fifo which is as follows:

> No evidence was given, however, that would lead to the conclusion that this assumption was closer to reality than the averaging basis adopted by the Minister.

This leaves for consideration the only costing method that would in fact yield a figure very substantially inferior to the average, namely, the "project" method of accounting. Shortly stated, this system consists in applying total receipts from the sales of *some* Maneast shares against the cost of *all* Maneast shares sold or unsold. In other words, no sale is considered as yielding any profit until the entire cost of the venture is recovered. It appears from some reported cases that the method is in fact applied by the Minister in the assessment of isolated transactions that do not fall within the description of a business in the ordinary sense but are assessable as such by virtue of the statutory definition (section 139(1)(*e*)): *Sissons v. Minister of National Revenue*[4]; *Weinstein v. Minister of National Revenue*[5]. However, the method is contended to be inapplicable to a regular business.

In my view, the decision in the *Anaconda* case is conclusive on that point. In that case, Lifo was rejected on the basis that it involved setting up as an element in valuing the inventory an "unabsorbed residue of cost" (at p. 101):

> It is in fact, so far as tax law is concerned, a novel and even revolutionary proposal that the physical facts should even where they can wholly or partly be ascertained be disregarded for the purpose of the opening and closing inventory and a theoretical assumption made which is based on a supposed "flow of cost" and an "unabsorbed residue of cost".

Seeing that the project method really consists in valuing the inventory by equating it with the unrecovered cost of the venture in Maneast shares, it must be rejected for income tax purposes on the authority of the *Anaconda* case.

Appellant laid great stress on the speculative character of the venture and endeavoured to liken it to a Christmas tree selling operation. He contended that as there was no proven value behind the Maneast shares they could, at any

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4 [1968] C.T.C. 363, 68 D.T.C. 5236.
5 [1968] C.T.C. 357, 68 D.T.C. 5232.

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time, become worthless like unsold Christmas trees after December 24. The comparison is inappropriate. There was no fixed time at which Maneast shares were sure to become worthless, on the contrary there was a possibility that they would become more valuable. As long as appellant's operation was going on the future was uncertain. What appellant is really trying to accomplish by the "project" method of accounting is to set up against the contingency that his inventory might drop in value, a reserve equal to his profit so far on the operation. This is contrary to a fundamental rule of the *Income Tax Act* that prohibits any "reserve, contingent account or sinking fund except as expressly permitted" (section 12(1)(*e*)). For this reason, no consideration can be given to what appellant testified concerning the extreme uncertainty of the operation:

> Most of those operations are really just glorified crap games. The purchasers of the shares buy them in the hope that if the market goes up they can make money out of the market. In the case of Maneast that was the situation. They were buying into an active market and that was the basis that we sold it on, that if we could get enough buyers into the market the price would go up and they would make a profit on the shares. Our customers were not interested as far as potentialities of the property were concerned; they were interested in what the stock was going to do.

Under our *Income Tax Act* if, for any reason foreseen or unforeseen, an inventory subsequently proves to be worth less than cost or fair market value at the closing date, the taxpayer is entitled to carry back one year and carry forward five years any resulting loss to the extent that it is not applied against income in the year in which it occurs. No alternative is given to set up a reserve against that contingency. This would amount to a deferment of income tax liability.

The appeal must be dismissed with costs.

Appeal dismissed with costs.

Solicitor for the appellant: J. G. McDonald, Toronto.

Solicitor for the respondent: D. S. Maxwell, Ottawa.