Docket: 2016-2816(IT)G

BETWEEN:

YORKWEST PLUMBING SUPPLY INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on April 19 and 20, 2018 and
January 28 and 29, 2019 at Toronto, Ontario by
The Honourable Justice Brent Paris with final argument
Heard on August 31, 2020 by The Honourable Justice David E. Spiro

Decision Rendered By: The Honourable Justice David E. Spiro

Appearances:

Counsel for the Appellant:	Duane R. Milot and Anna Malazhavaya (April 19 and 20, 2018 and January 28 and 29, 2019) Duane R. Milot and Kris Gurprasad (August 31, 2020)
Counsel for the Respondent:	Rita Araujo and Naomi Goldstein (April 19 and 20, 2018) Isida Ranxi and Diana Aird (January 28 and 29, 2019) Rita Araujo and Isida Ranxi (August 31, 2020)

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2012 taxation year is dismissed, with costs.

If the parties are unable to agree on costs, counsel may make written submissions to the Court, not exceeding ten pages, on or before December 18, 2020.

Signed at Ottawa, Canada, this 4th day of November, 2020.

"David E. Spiro"

Spiro J.

Citation: 2020 TCC 122
Date: 20201104
Docket: 2016-2816(IT)G

BETWEEN:

YORKWEST PLUMBING SUPPLY INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Spiro J.

I. Overview

[1] The Appellant is a Canadian-controlled private corporation that supplies plumbing equipment to contractors in the Greater Toronto Area. It had some 60 employees and annual sales of nearly $60 million during the period at issue. The Appellant is one of the leaders in its field and is a major player in high-rise and low-rise construction in the Greater Toronto Area. As such, it carries large quantities of inventory which it sells in the ordinary course of its business.

[2] The only year at issue is the Appellant's 2012 taxation year (March 1, 2011 to February 29, 2012). However, the Appellant's 2010 taxation year (March 1, 2009 to February 28, 2010), and 2011 taxation year (March 1, 2010 to February 28, 2011) are relevant as well.

[3] In this appeal, the issues are whether the *Income Tax Act* (the "Act") allows the Appellant to:

(a) write down the value of inventory in a taxation year after the goods are sold; or

(b) deduct the cost of inventory in a taxation year after the goods are sold.

[4] For the reasons that follow, I conclude that the Act does not allow the Appellant to do either of the above. The appeal is therefore dismissed.

II. Trial

[5] The trial was held before Justice Paris over two days in 2018 and two days in 2019. During the first two days of trial, Appellant's counsel called the Appellant's president, Mr. Carlo Perfetto, its controller, Mr. Pasqualino Montanaro, and its external accountant, Ms. Karen Jacobson as witnesses.

[6] On the third day of trial, Appellant's counsel called an expert accounting witness, Ms. Evguenia Khabas, to provide an opinion on Generally Accepted Accounting Principles ("GAAP"). Respondent's counsel called no evidence. On the fourth day of trial, January 29, 2019, Justice Paris heard argument from each party and reserved judgment.[1]

[7] Justice Paris resigned from the Court effective April 3, 2019. As Justice Paris had not given judgment within eight weeks of his resignation, the Appellant was given the choice of having a new trial before another judge or having another judge decide its appeal based on the trial record.[2]

[8] The Appellant chose the latter option. The parties agreed on the contents of the record that would be considered by another judge. I was appointed by the Chief Justice to give judgment based on the record agreed upon by the parties.[3]

[9] After reviewing that record, I had a number of questions and concerns that I asked counsel to address before me. Counsel had the opportunity to address those questions and concerns on August 31, 2020 when final arguments were heard. I decided this appeal after reviewing the agreed record and hearing final argument from counsel for each party.

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[1] Justice Paris allowed the Appellant to file and serve written submissions in reply to the written submissions of the Respondent which it did on February 27, 2019.
[2] Eight weeks is the maximum period provided by section 16 of the *Tax Court of Canada Act* for a judge of this Court to give judgment after their resignation.
[3] The record agreed upon by the parties is reflected in an order issued by the Chief Justice dated February 21, 2020.

III. Facts

[10] Until March 1, 2009, the Appellant used the periodic system for tracking inventory. It decided to transition to the more modern perpetual system for tracking inventory, effective March 1, 2009. That date marked the beginning of its 2010 taxation year.

[11] The periodic system requires that inventory be counted manually at regular intervals, typically at the end of the year. A periodic system takes into account the cost of goods sold in the year by means of a manual inventory count at year end. It is time-consuming and labour-intensive and appears to have been almost completely replaced in modern times by the perpetual system for tracking inventory.

[12] The perpetual system takes into account the cost of goods sold in the year as those goods are sold. It allows a business to know exactly how it is doing in real time as it tracks the purchase and sale of each item of inventory, and the corresponding cost and revenue, on a daily basis. It has obvious advantages over a periodic system for the control of inventory and the overall management of the business.

A. Transition from Periodic to Perpetual Inventory Tracking System

[13] The Appellant's transition from a periodic to perpetual inventory tracking system required the purchase of a new computer system. The introduction of the new system represented a significant disruption for the Appellant and required a great deal of time and attention from management for some time after March 1, 2009. Several issues arose during the course of the transition. One of those issues gives rise to this appeal.

[14] Immediately before March 1, 2009, the Appellant acquired $1,294,623 of inventory from a number of its suppliers. Those goods included a wide variety of products in significant quantities. Purchase orders in respect of those goods had not been created in the new system as they were generated before March 1, 2009. The problem was that invoices for those goods could not be paid out of the new system as their purchase orders had not been created within the new system. After receiving the invoices, many of which included multiple items, the Appellant needed to pay its suppliers for the inventory which the new system would not allow it to do. It required a solution that would allow it to pay its suppliers as expeditiously as possible.

B. Creation of the Orphan Account

[15] The solution adopted by the Appellant in early March 2009, was to re-use an "accounts payable" account number from the old system to create an account from which those invoices could be paid. The only purpose of that account was to allow the Appellant to pay suppliers for the $1,294,623 of inventory acquired immediately before March 1, 2009. In that sense, it was an "orphan" account as it was never integrated into the new system and was never designated as an inventory account.

[16] Management understood that this special purpose account would be temporary in nature and would have to be reviewed after serving its purpose. Unfortunately, management and staff were preoccupied with learning the new system and dealing with other issues related to the transition. It was for those reasons that the continued existence of the orphan account was overlooked by management until the summer of 2012.

[17] Meanwhile, the continued existence of the orphan account had an unanticipated effect with respect to the $1,294,623 of goods acquired immediately before March 1, 2009. Revenue from the sale of those goods was tracked in real time by the new system when each of those items was sold. However, the cost of each of those goods was not tracked in real time – or at all – in the new system and, more importantly, was not matched with the revenue from the sale of each of those goods as they were sold.

[18] The net effect was that the cost of each of the goods sold was trapped in the orphan account and not recognized by the new system. As the information in the Appellant's financial statements and tax returns for its 2010 and 2011 fiscal and taxation years was drawn exclusively from the new system, revenue from the sale of those goods was recognized in the years in which they were sold, but their cost was not taken into account in those years.

[19] As one might expect, most of the goods acquired immediately before March 1, 2009 were sold during the Appellant's 2010 taxation year (March 1, 2009 to February 28, 2010) but some were sold in the Appellant's 2011 taxation year (March 1, 2010 to February 28, 2011). By the time the Appellant's 2012 taxation year began, all or substantially all, of those goods had been sold in the ordinary course of the Appellant's business.[4]

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[4] I find it more likely than not that little, if any, of the inventory acquired immediately before March 1, 2009 would have been available for sale at the commencement of the Appellant's 2012 taxation year. Mr. Perfetto testified that 95% of the goods should have been gone by 2012

[20] It was not until the summer of 2012 that the Appellant realized that the continued existence of the orphan account had caused it to understate the cost of goods sold for its 2010 and 2011 fiscal and taxation years and, therefore, had caused it to overstate its gross profit for each of those years. Counsel for the Respondent acknowledged that the Appellant likely paid too much tax for its 2010 and 2011 taxation years due to this oversight.

C. Compensatory Adjustment

[21] In the summer of 2012, when management became aware of the continued existence of the orphan account, it decided to compensate by adjusting the trial balance for its 2012 fiscal year. Management sent the adjustment to the Appellant's accountant, Ms. Jacobson, who was then preparing the Appellant's 2012 financial statements and tax return.

[22] For financial statement purposes, this compensatory adjustment had two aspects in respect of the Appellant's 2012 fiscal year. One aspect was the write-down of the value of an asset (i.e., inventory) by $1,294,623 while the other was the addition of $1,294,623 to the cost of purchases made by the Appellant in 2012.[5]

[23] Mr. Perfetto succinctly summarized the solution adopted by the Appellant at the suggestion of Mr. Montanaro and Ms. Jacobson:

> We never claimed these deductions. We've got to claim the deductions. So how do you claim the deduction? You just stick it in that fiscal year; right? We're doing fiscal 2012 so we claimed the deduction.[6]

[24] Management considered whether to make the adjustments to the financial statements for each of its 2010 and 2011 fiscal years, but concluded that it would take more time than it was worth to track the year in which each of the goods was sold. There was no easy way of matching the goods acquired immediately before

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(Transcript, page 48, line 21 to page 49, line 5). At most, 5% of the goods were estimated by Mr. Perfetto to have been on hand at the commencement of the 2012 fiscal and taxation year. Particularly in a context where the Appellant made no effort to track the year in which each of the goods was sold (see paragraph 24 below), the legal maxim *de minimis non curat lex* comes to mind.

[5] Adding that amount to the cost of purchases made during the Appellant's 2012 fiscal year was consistently referred to by Ms. Khabas and counsel for the Appellant as "expensing" that amount. That is its economic effect, but it is an inaccurate way of describing what actually happened. I will return to the topic of accuracy later in these reasons.

[6] Evidence of Mr. Perfetto, Transcript, page 36, lines 1-5.

March 1, 2009 with their corresponding sales invoices. Management never undertook such a tracing exercise as it believed that such an exercise would have diverted time and energy from more important matters.[7]

[25] After the orphan account was discovered in summer of 2012, there was still time to file an amended return for the Appellant's 2010 taxation year, but management decided not to do so. By the time the Minister's audit of the 2012 taxation year began, the Appellant's 2010 taxation year was statute-barred.[8]

D. 2012 Financial Statements and Tax Return

[26] The Appellant prepared its 2012 financial statements and tax return on the basis that the unintentional understatement of the cost of goods sold in its 2010 and 2011 fiscal and taxation years could be cured by an intentional overstatement of the cost of purchases made in its 2012 fiscal and taxation year. This compensatory adjustment created a corresponding increase in the cost of goods sold in the Appellant's 2012 fiscal and taxation year and a corresponding decrease in the Appellant's gross profit for that year. A brief review of the Appellant's financial statements and tax return for that year illustrates the nature and effect of this aspect of the compensatory adjustment.

(1) Financial Statements

[27] The Appellant computed gross profit of $9,820,263 on its income statement for the 2012 fiscal year in the following way:[9]

	2012	2011

[7] I find that it would not have been impossible for management to determine which of the goods was sold when. I also find that it would have been time-consuming for the Appellant to have made that determination. Those findings only matter, however, to the extent that GAAP is necessary for the legal analysis.
[8] During the course of the audit, Ms. Jacobson wrote to the Canada Revenue Agency with a view to filing an amended return on behalf of the Appellant for one or both of its 2010 and 2011 taxation years, but nothing came of it. No amended returns for the 2010 or 2011 taxation years were filed with the Canada Revenue Agency nor was any evidence led at trial with respect to the nature and amount of any adjustments that the Appellant proposed to make in respect of either taxation year. See Exhibits R-3 and R-4 and Ms. Jacobson's testimony that she called her request to file amended returns a "Hail Mary", Transcript, page 217, lines 8-9.
[9] Exhibit A-1, Tab 2 at page 14.

Sales	$60,121,098	$54,583,702
Cost of goods sold		
Inventory, beginning of year	$3,935,760	$4,091,330
Purchases	$52,551,139	$43,839,469
	$56,486,899	$47,930,799
Less Inventory end of year	$6,186,064	$3,935,760
	$50,300,835	$43,995,039
Gross profit	**$9,820,263**	$10,588,663

[28] The cost of purchases made in the Appellant's 2012 fiscal year was stated to be $52,551,139. However, that amount includes the cost of the goods it acquired immediately before March 1, 2009, namely, $1,294,623. The result is that the Appellant's gross profit of $9,820,263 was understated by $1,294,623 on its financial statements for the 2012 fiscal year.

(2) Tax Return

[29] The same understatement of gross profit is reflected on the Appellant's tax return for its 2012 taxation year.[10] On Schedule 125 of the Appellant's return, the cost of purchases made in its 2012 taxation year was stated to be $50,967,418.[11] However, that amount includes the cost of the goods it acquired immediately before March 1, 2009, namely, $1,294,623. The result is that the Appellant's gross profit of $9,820,263 was understated by $1,294,623 on its income tax return for the 2012 taxation year, thereby causing an under-reporting of its taxable income for that taxation year by the amount of $1,294,623.

E. Audit and Reassessment

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[10] Exhibit A-1, Tab 3 at page 52.

[11] It is not clear why total purchases for 2012 appear as $52.5 million on the income statement while they appear as $51 million on the tax return. Appellant's counsel suggested in final argument

[30] During the course of an audit by the Minister of National Revenue (the "Minister"), the auditor correctly noted "at the end of the year 2012, the cost of goods was increased by journal entries, increasing the cost of goods sold by purchase invoices of 2009 in the amount of $1,294,622.93."[12]

[31] On April 1, 2015, the Minister reassessed to increase the Appellant's net income for its 2012 taxation year by $1,294,623, thereby increasing its taxable income by the same amount. That is the reassessment under appeal.

IV. Appellant's Expert Witness

[32] The Appellant called a certified professional accountant, Ms. Khabas, to provide an opinion on whether the compensatory adjustment made by the Appellant on the financial statements for its 2012 fiscal year was in accordance with GAAP. Ms. Khabas opined that the compensatory adjustment was in accordance with GAAP for the Appellant's 2012 fiscal year.

[33] Ms. Khabas explained that where a material error is discovered affecting prior periods, GAAP requires a retrospective restatement for the prior period affected by the error.[13] In this case, those would have been the Appellant's 2010 and 2011 fiscal years. She testified, however, that GAAP makes an exception where retrospective adjustments would be impracticable.[14] In such cases, she said, it is acceptable for the accounting adjustment to be made for the fiscal year in which the material error was discovered.

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that the discrepancy might be due to unrelated adjustments between the financial statements and the tax return. In any event, on both the financial statements and the tax return the purchases for 2012 include the $1,294,623 of inventory purchased immediately before March 1, 2009 and each reflects the same understated gross profit of $9,820,263. See Ms. Jacobson's evidence: Transcript, page 197, lines 4 to 16 (for the income statement), and Transcript, page 199, lines 8 to 20 (for the tax return).

[12] Exhibit A-1, Tab 12 at page 110.

[13] Exhibit A-5: Selected Sections of the CPA Canada Handbook, section 1506.27.

[14] Exhibit A-5: Selected Sections of the CPA Canada Handbook, section 1506.30. According to Ms. Khabas, GAAP allows entities to make adjustments to the current year rather than restating prior periods where it would be "impracticable" to make such a retrospective restatement. Section 1506.05(f) of the CPA Canada Handbook explains that applying a GAAP requirement is impracticable "when the entity cannot apply it after making every reasonable effort to do so." This was a factual issue on which the parties disagreed. Once again, the answer matters only to the extent that GAAP is necessary for the legal analysis.

[34] Ms. Khabas added that the Appellant's write-down of the value of its inventory by $1,294,623 for its 2012 fiscal year was in accordance with GAAP because the inventory acquired immediately before March 1, 2009 "did not physically exist as at the year ending February 29, 2012 and therefore its net realizable value was zero."[15]

[35] Although Ms. Khabas had been retained to render a professional opinion on whether certain deductions claimed by the Appellant for its 2012 fiscal year were consistent with GAAP and well-accepted business principles,[16] she concluded her report by asserting that the compensatory adjustment "would show an accurate picture of the actual profits for the 2012 year" for two reasons:

(a) the compensatory adjustment was consistent with GAAP; and

(b) the users of the financial statements (the Appellant's shareholders) were aware of the compensatory adjustment.[17]

[36] Ms. Khabas had not been qualified as an expert in the accurate picture of profit.

V. Positions of the Parties

A. Appellant's Argument

[37] Counsel for the Appellant contended that, on the evidence, it would not only have been impracticable but impossible for management to determine which of the goods purchased immediately before March 1, 2009 was sold when. He relied on Ms. Khabas' opinion that in cases of impracticability, GAAP allows accounting adjustments to be made in the fiscal year in which the material error is discovered rather than for the prior period(s) in which the error occurred.

[38] Based on Ms. Khabas' opinion, counsel argued that GAAP permits the inventory write-down to be taken for the Appellant's 2012 fiscal year as the "net realizable value" of the goods acquired immediately before March 1, 2009 had

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[15] Exhibit A-4: Report of Ms. Khabas at page 9. Ms. Khabas testified that if "it happens that the inventory that is reported on the books is no longer there, or the value has decreased, you have to decrease the value on the books" (Transcript, page 360, lines 11-13). She went on to explain that, in her opinion, the net realizable value of the goods at the end of the Appellant's 2012 taxation year was zero because all of the goods had by then been sold (Transcript, page 371, lines 12-22).
[16] Exhibit A-4: Report of Ms. Khabas at page 1.
[17] Exhibit A-4: Report of Ms. Khabas at page 10.

declined to zero by the end of that year. Even if the write-down is precluded by subsection 10(1) of the Act, counsel argued that the Appellant is nevertheless entitled to the deduction under subsection 9(1) of the Act on the basis of GAAP.

[39] Counsel also argued that the adjustment taken by the Appellant results in an "accurate picture" of the Appellant's profit for its 2012 taxation year under subsection 9(1) of the Act for the following reasons:

(a) the compensatory adjustment for 2012 was consistent with GAAP as it was impossible for the Appellant to have made the adjustment retrospectively for its 2010 and 2011 years;

(b) the Appellant's picture of profit for 2012 would have been inaccurate had the value of the inventory not been written down to zero;

(c) nothing in the Act, or in any "rule of law", precludes taxpayers from writing down the value of inventory when they find that goods are no longer in their possession;

(d) the matching principle is not a "rule of law" and, therefore, the cost of inventory need not be recognized only in the year in which the goods are sold; and

(e) deference should be given to the Appellant's choice of method of computing income for its 2012 taxation year as the compensatory adjustment is not tax avoidance but merely the correction of an error.

[40] In support of his argument, counsel relied on the third and fourth guidelines set out by Justice Iacobucci for ascertaining profit for a taxation year in *Canderel Ltd. v Canada,* [1998] 1 SCR 147:

> (3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.
> (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.[18]

[18] *Canderel Ltd. v Canada,* [1998] 1 SCR 147 at paragraph 53.

[41] In particular, counsel argued that the deduction of $1,294,623 in computing income for the Appellant's 2012 taxation year was not inconsistent with any provision of the Act nor was it inconsistent with established case law principles.[19]

[42] In final argument, counsel contended that adding the cost of goods purchased immediately before March 1, 2009 to the cost of goods purchased in the 2012 taxation year generated an "accurate picture of profit" for the Appellant's 2012 taxation year because that was the only choice open to it under GAAP.

B. Respondent's Argument

[43] Counsel for the Respondent argued that the compensatory adjustment for the Appellant's 2012 fiscal year was not in accordance with GAAP. One of the fundamental principles of GAAP is that the cost of inventory is recognized as an expense only in the period in which the related revenue is recognized.[20]

[44] Counsel argued that it was by no means impracticable for the Appellant to determine when the goods had been sold. The Appellant was, therefore, bound by GAAP's requirement that a restatement to correct an earlier material error should be made to the prior period(s) affected by the error.

[45] Counsel also argued that the opinion of Ms. Khabas should be rejected because her rationale for the inventory write-down in the 2012 fiscal year makes no sense. Businesses cannot write down inventory that is sold in the ordinary course of business and subsection 10(1) of the Act requires that inventory be held for sale before its value can be written down.

[46] Counsel then argued that even if the compensatory adjustment to the 2012 fiscal year is permissible under GAAP, it does not result in an "accurate picture" of the Appellant's profit for its 2012 taxation year. As it results in an understatement of the Appellant's gross profit for the 2012 taxation year, the compensatory adjustment distorts the Appellant's picture of profit for that year.

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[19] Appellant's written submissions in reply at paragraph 1.
[20] Exhibit A-5: Selected Sections of the CPA Canada Handbook, section 3031.33.

VI. Analysis

A. The Issues

[47] The issues in this appeal are whether the Act allows the Appellant to:

(a) write down the value of inventory in a taxation year after the goods are sold; or

(b) deduct the cost of inventory in a taxation year after the goods are sold.

B. Statutory Provisions

[48] The relevant statutory provisions are subsections 9(1) and 10(1) of the Act:

> 9(1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.
>
> …
>
> 10(1) For the purpose of computing a taxpayer's income for a taxation year from a business …, property described in an inventory shall be valued at the end of the year at the cost at which the taxpayer acquired the property or its fair market value at the end of the year, whichever is lower, or in a prescribed manner.

[49] In relevant part, "inventory" is defined in subsection 248(1) of the Act as:

> … 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 …

C. Can the Value of Inventory be Written Down in a Taxation Year After the Goods are Sold?

[50] In considering this issue, the starting point is the meaning of "inventory" for purposes of the Act. The word "inventory", as defined by subsection 248(1) of the Act, means goods available for sale in the year, not goods that had been sold in an earlier taxation year. As Justice Major, writing for the majority of the Supreme Court of Canada in *Friesen v Canada*, [1995] 3 SCR 103, noted:

> … In this respect the definition of "inventory" in the [Act] is consistent with the ordinary meaning of the word. In the normal sense, inventory is property which a business holds for sale.[21]
>
> …
>
> In the ordinary sense of the term, an item of property which a business keeps for the purpose of offering it for sale constitutes inventory at any time prior to the sale of that item.[22]
>
> [Emphasis added]

[51] If writing down the value of inventory is to have effect under the Act, it must be done in accordance with subsection 10(1). It cannot be achieved through section 9. This is the case even if subsection 10(1) generates a result inconsistent with GAAP. In the words of Justice Noлl (as he then was) in *CDSL Canada Ltd. v The Queen*, 2008 FCA 400:

> [32] Here, it seems undeniable that there is a conflict between section 9, which involves GAAP, and subsection 10(1), which requires that inventory be valued at the lower of cost or FMV. The question of whether subsection 10(1) of the Act overrides section 9 therefore had to be answered.
>
> [33] In my view, this issue has already been resolved. The Supreme Court determined in *Friesen* that subsection 10(1) is a mandatory provision requiring taxpayers who compute income from a business with inventory to value their inventory according to the terms of that subsection … that is, at the lower of cost or FMV. It is a mandatory provision that rules out the general application of section 9 regarding the valuation of inventory. That this method produces a result that is inconsistent with GAAP is no bar to its application.[23]
>
> [Emphasis added]

[52] Subsection 10(1) of the Act precludes the write-down claimed by the Appellant for its 2012 taxation year. Subsection 10(1) only allows a write-down of "inventory", meaning goods that are held for future sale. The Appellant is seeking a write-down for goods that have already been sold in the ordinary course of business.

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[21] *Friesen v Canada*, [1995] 3 SCR 103 at paragraph 24.

[22] *Friesen v Canada*, [1995] 3 SCR 103 at paragraph 47. The minority, led by Justice Iacobucci, did not part company with the majority on this point. There can be no doubt that both the majority and the minority in *Friesen* would have disallowed the inventory write-down had it been taken in a taxation year after the parcel of land had been sold.

[23] *CDSL Canada Ltd. v The Queen*, 2008 FCA 400 at paragraphs 32-33.

Such a write-down – even if permitted by GAAP – is precluded by subsection 10(1) of the Act.

D. Can the Cost of Inventory be Deducted in a Taxation Year After the Goods are Sold?

[53] When dealing with a trading business (i.e., a business selling inventory), the first step in computing profit for the year under subsection 9(1) of the Act is to compute the gross profit of the business for that year. Gross profit for a taxation year is revenue for the year less "cost of goods sold" in the year. The question then becomes how "cost of goods sold" in the year is to be computed.

[54] In *Oryx Realty Corporation v MNR*, [1974] 2 FC 44, Chief Justice Jackett of the Federal Court of Appeal referred to an ordinary trading business and described the formula for computing the "cost of sales"[24] for a taxation year:

> . . . 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.[25]
>
> [Emphasis added]

[55] In *MNR v Shofar Investment Corporation*, [1980] 1 SCR 350, the Supreme Court of Canada adopted Chief Justice Jackett's formulation of the rule for computing the "cost of sales" for a taxation year. Justice Martland, writing for the Court, noted:

> As Chief Justice Jackett points out, the practice "hardened into a rule of law" in the computation of the profit of a trading business is to deduct from the aggregate proceeds of all sales the cost of sales computed by adding the value placed on inventory at the beginning of the year to the cost of acquisitions of inventory during the year, less the value of inventory at the end of the year.[26]
>
> [Emphasis added]

[24] The terms "cost of goods sold" and "cost of sales" are used interchangeably in the case law.
[25] *Oryx Realty Corporation v MNR*, [1974] 2 FC 44 at paragraph 11.
[26] *MNR v Shofar Investment Corporation*, [1980] 1 SCR 350 at page 354.

[56] The Appellant is precluded from adding the cost of inventory purchased immediately before March 1, 2009 to the cost of purchases made in its 2012 taxation year as such an inclusion would be inconsistent with the case law principle for computing “cost of goods sold” for a taxation year:

> Cost of Goods Sold = (Value of Inventory at beginning of year + Cost of Inventory acquisitions during the year) - Value of Inventory at end of year[27]

[57] In *Timing and Income Taxation*, Brian J. Arnold summarizes how inventory accounting works under the Act. He uses the example of a business that manufactures its own inventory to illustrate how and when the cost of inventory is recognized for tax purposes:[28]

> The costs and expenses incurred in producing goods included in the inventory of a business are not recognized, as other expenses are, when paid, payable, or accrued; instead, under the principles of inventory accounting, they are included in computing the cost of inventory and recognized when the related goods are sold. Thus, if certain goods are sold during the year, the costs of producing those goods are deducted from the sales revenue to arrive at the taxpayer’s gross profit from sales for the year. To the extent that the goods are not sold during the year, the costs of producing them are not deducted in that year, but instead are included in closing inventory for the year and carried over as opening inventory of the immediately following year. If the goods are sold in the following year, the costs of producing them will be deducted in that year; otherwise, they will again be carried over at the end of the year – and so on, until such time as the goods are sold.
>
> In the absence of the inventory accounting rules, the costs and expenses incurred in producing inventory goods would presumably be deductible in the year in which they became payable, which in many cases would precede the year of sale. Inventory accounting ensures that costs and expenses incurred in producing goods for sale in the ordinary course of business are properly matched against the revenue from the sale of those goods.[29]

[Emphasis added]

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[27] Interestingly, this is the same formula suggested by Mr. Montanaro in his evidence (Transcript, page 60, lines 1-7) and by Ms. Jacobson in hers (Transcript, page 177, line 24 to page 178, line 1).
[28] The principles remain the same whether a business manufactures its own inventory or purchases its inventory from others.
[29] Brian J. Arnold et al., *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, 2nd ed. (Toronto: Canadian Tax Foundation, 2015) at 152.

[58] The case law principle is that cost of inventory is recognized only in the taxation year in which the inventory is sold. The cost of inventory is not recognized in the taxation year in which it is acquired (unless it was sold in that year) or in a taxation year after it was sold. The Appellant is, therefore, precluded from deducting the cost of the inventory acquired immediately before March 1, 2009 in computing income for its 2012 taxation year.

E. The *Canderel* Guidelines

[59] Counsel for the Appellant relied heavily on several of the guidelines set out by Justice Iacobucci in *Canderel Ltd. v Canada*, [1998] 1 SCR 147. It is for that reason that I set them out in their entirety (citations omitted):

> 53 . . . it may be both convenient and useful to summarize the principles which I have set out above:
>
> (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.
> (3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.
> (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 GAAP, 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.[30]
>
> [Emphasis added]

[30] *Canderel Ltd. v Canada,* [1998] 1 SCR 147 at paragraph 53.

[60] Counsel for the Appellant based much of his argument on the third guideline in *Canderel*, contending that the compensatory adjustment taken by the Appellant for its 2012 taxation year generates an "accurate picture of the Appellant's profit" for that year.

[61] I cannot agree with that proposition. Whatever "accurate" means, it does not mean "the only option available under GAAP". Counsel contended that it was "accurate" for income tax purposes because it was "necessary" for accounting purposes. That simply does not follow.

[62] As in *Bernick v The Queen*, 2004 FCA 191, counsel for the Appellant goes on to read the fourth guideline from *Canderel* as though accuracy is irrelevant. I share Justice Sharlow's view, as expressed in *Bernick*, that "an accounting method that cannot possibly produce an accurate result can never meet the *Canderel* standard."[31]

[63] As in *Bernick*, the Appellant relies on a false premise.[32] Here, the false premise is that the goods purchased immediately before March 1, 2009 were actually purchased during the Appellant's 2012 taxation year. A false premise cannot possibly form the basis of an accurate picture of income for the year for purposes of subsection 9(1) of the Act.

[64] In light of my conclusion regarding *Canderel* guidelines 3, 4(a) and (b), it is unnecessary to deal with the argument of Appellant's counsel based on guideline 4(c), namely, that the compensatory adjustment was not inconsistent with GAAP.

VII. Conclusion

[65] The Appellant has run headlong into a statutory provision (subsection 10(1) of the Act) as well as a case law principle (the formula for computing "cost of goods sold"), which preclude the compensatory adjustment it seeks for its 2012 taxation year.

[66] I am not unsympathetic to the Appellant's predicament. An orphan account that was intended to be a temporary expedient outlived its usefulness and prevented a portion of the cost of goods that were sold during the Appellant's 2010 and 2011

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[31] *Bernick v The Queen*, 2004 FCA 191 at paragraph 26.
[32] *Bernick v The Queen*, 2004 FCA 191 at paragraph 27.

taxation years from inclusion in the cost of goods sold for those years for tax purposes. As Mr. Perfetto stated at the conclusion of his examination-in-chief:

> I'm arguing the fact that we weren't allowed to claim something because we didn't take it on time. I mean, that's unfair, and that's why I'm here.[33]

[67] Unfortunately for the Appellant, an unintentional understatement of the cost of goods sold in its 2010 and 2011 taxation years cannot be remedied by an intentional overstatement of the costs of goods sold in its 2012 taxation year. The cost of inventory is recognized in the taxation year in which it is sold – not in an earlier year nor in a later one. In tax law, timing matters.[34]

[68] For all these reasons, the Appellant's appeal is dismissed with costs.

Signed at Ottawa, Canada, this 4th day of November, 2020.

"David E. Spiro"

Spiro J.

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[33] Evidence of Mr. Perfetto, Transcript, page 38, lines 10-12.

[34] This is a variation on Justice Linden's oft-cited *dictum* from his reasons for judgment in *The Queen v Friedberg*, [1992] 1 CTC 1 (FCA) at page 2: "In tax law, form matters."

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