BETWEEN:

INDUSTRIAL MORTGAGE AND TRUST COMPANY ..... APPELLANT;

1956
Mar. 22, 23
1958
Mar. 10

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

Revenue—Income Tax—In computing income method regularly followed by taxpayer in computing profit determines whether amounts receivable as interest shall be included—"Method" defined—Income Tax Act, 1948, c. 52, ss. 3, 4, 6(b), 11(1)(d) and 129(9).

The appellant in computing its income for 1949, as it had in previous years, brought into account on a cash received basis revenue from all sources except interest on government bonds and a remnant of mortgages taken prior to 1942 which it accounted for on an accrual basis. In assessing the appellant the Minister added to the income reported the amount of mortgage interest which became due but was not paid in 1949 on mortgages the interest from which in 1949 and in previous years had been brought into revenue on the cash received basis. The Income Tax Appeal Board having affirmed the assessment the appellant appealed to this Court. It submitted that the method used by it to compute its income was in compliance with s. 6(*b*) of The Income Tax Act, had been accepted by the Minister in the past and, accurately reflected its income. The Minister argued that the appellant's accounting practice did not amount to a method of computing profit of either of the kinds mentioned in s. 6(*b*) and that as s. 6(*b*) had no application, resort must be had to s. 4 which declares the income of a business to be the profit therefrom for the year. That the computation of such profit must take into account all the earnings of the business for the year and that as the receivables in question were sums earned in the year and had value, they had been properly included and any computation which failed to include them would not accurately reflect the profit of the business for the year.

Held: That interest not received in the year may be included in computing the annual profit of a business if the method used for such computation is based on accounting principles which require that it be brought into the computation. Thus unpaid interest may become part of the income of a business by reason of the special meaning given by s. 4 of *The Income Tax Act* to the word "income" when it refers to the income of a business but this is subject to s. 6(*b*) which directs that the method regularly followed by the taxpayer in computing his profit shall determine the basis on which interest shall be brought into the computation.

2. That the word "method" is not used in s. 6(*b*) in a narrow or technical sense but means the system regularly followed by the taxpayer in computing his profit.

3. That the system may include different practices for accounting for revenue from different sources and still be regarded as a "method" within the meaning of that word in s. 6(*b*).

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4. That the practices followed by the appellant amounted to a "method" within the meaning of the section and, as it had been followed for seven years up to and including 1949, it was the "method" regularly followed by the appellant in computing its profit within the meaning of s. 6(*b*).

5. That since the practice of the appellant during the period in question was to include interest from mortgages in revenue only when received, s. 6(*b*) amounted to a statutory direction for bringing into the computation of the appellant's income on a "received in the year" basis the interest on all mortgages in respect to which the appellant had followed that basis and impliedly excluded the use of the "receivable in the year" basis.

6. That as the amount added by the Minister was interest receivable, to the extent of such addition, the assessment was not in accordance with the statute and could not be sustained.

7. That the Minister's computation was not a more accurate than that made by the appellant and was not an accurate estimate of the mortgage earnings of the appellant for the year 1949 and because of this the sum assessed as the profit of the business for that year was not an accurate estimate of such profit.

8. That s. 129(9) of the Act does not apply as the method of computing profit therein referred to was not one adopted by the taxpayer.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before Mr. Justice Thurlow at London.

John D. Harrison, Q.C. for appellant.

K. E. Eaton and *J. D. C. Boland* for respondent.

THURLOW J. now (March 10, 1958) delivered the following judgment:

This is an appeal from the judgment of the Income Tax Appeal Board[1] dismissing an appeal by the appellant against its income tax assessment for the year 1949. In making the assessment under appeal, the Minister added to the income reported by the appellant an amount representing mortgage interest which became due to the appellant in 1949 but which had not been paid at the end of that year. This amount was not included by the appellant in computing its profit for the year 1949, and the issue in the appeal is whether or not the amount so added must be brought into account in computing the income of the appellant for the year 1949 for the purposes of *The Income Tax Act*, S. of C. 1948, c. 52.

[1] 13 Tax A.B.C. 374; 55 D.T.C. 497.

In 1949 and for some years prior thereto, the appellant carried on the business of a mortgage and trust company at Sarnia, Forest and Petrolia in the Province of Ontario. The revenues of this business consisted of interest, dividends, rentals, profits on sales of real estate and securities and estate, trust and agency fees. Approximately eighty-five per cent of the total revenue was interest and most, though not all, of such interest was derived from mortgages and bonds. The revenues of the business fell into two divisions, those derived from the employment of the appellant's own capital funds or assets and those derived from the employment of funds deposited with the appellant or loaned to it on the security of guaranteed investment certificates which it issued. A separate account, known as the guaranteed trust account, was maintained for the assets or funds representing these trust deposits and guaranteed investment certificates, and the revenue from the operation of this part of the appellant's business was accounted for separately from that pertaining to the appellant's capital, but the profit, after providing for operating expenses and for interest payable to depositors and certificate holders, formed part of the profits of the appellant company.

In 1949 the appellant had revenue from the employment of its capital from interest on mortgages, agreements of sale, collateral and sundry loans, and corporation bonds, all of which was taken into its revenue account on a basis of cash received; that is to say, when, and not until, the interest was paid. It also had revenue from dividends, rental of buildings, rental of safety deposit boxes, estate, trust and agency fees, and profits on sales of real estate, all of which was also taken into its revenue account on the same cash received basis. At the same time, it brought into revenue on an accrual basis interest on Dominion Government, Dominion Government Guaranteed, Provincial Government and Provincial Government Guaranteed bonds. The amount so brought into revenue account from such bonds was the total amount of interest earned on such bonds from day to day during the year, irrespective of the dates in the year when interest became payable. It included interest which accrued (but was not received because it was not yet due) from the last interest payment date in the year to the end of the year, but did not include interest received during the year which had accrued but which had

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not become payable before the beginning of the year. The latter amount had been taken into revenue in the previous year. This was apparently the only deviation from accounting on a strictly cash received basis for revenue obtained from the employment of the appellant company's capital during the year in question. In so far as mortgage interest alone was concerned, it had been taken into revenue on the cash received basis since January 1, 1942 and most, if not all, other items of revenue had been accounted for on the same basis for some years prior to 1942.

In its guaranteed trust account, the appellant had revenue in 1949 from interest on mortgages, bonds, and savings accounts, from dividends, and from profits on sale of securities. Of these, interest on savings accounts, dividends and profits on sale of securities were all taken into revenue on the cash received basis. Interest on corporation bonds, as well, was taken into revenue on the same cash received basis, but the interest on Dominion Government, Provincial Government, Provincial Government Guaranteed, and municipal bonds was brought into revenue on the same accrual basis as previously described with respect to similar bonds in the appellant's capital account. Mortgage interest was also taken into revenue on a basis of cash received except that, with respect to a number of mortgage loans made by the appellant prior to 1942 and on which the interest payments had never been in default, the interest was brought into revenue on a similar accrual basis.

There was an explanation for this difference in the appellant's accounting practice in respect to the interest on these particular mortgages. Prior to 1931 the appellant's accounts pertaining to interest on all bonds, mortgages, agreements of sale, and collateral loans had been on an accrual basis, while revenues other than interest on these items were being accounted for on a cash received basis. Between 1931 and 1941, as a result of defaults in payment of mortgage interest and of the appellant having taken into revenue a large amount of mortgage interest which it could not collect, a number of changes in the method of taking interest into revenue were made, each tending to some extent to bring the method nearer to a cash received basis on all items except government bonds. By January 1, 1942, when the last of these changes was made, the method of accounting for mortgage interest was that of taking into revenue the

interest on all new loans on a cash received basis while carrying on on the accrual basis in respect to the interest on old loans on which the interest had never been in default. If the interest on such a loan subsequently fell into default, the accounting for interest on it was immediately put on a cash received basis. With respect to loans on which the interest had been in default prior to January 1, 1942, as a result of steps which had been taken by the appellant the amount of unpaid interest which had been taken into revenue did not exceed one year's interest in the case of any such loan. Interest on these loans, when received, was applied first to interest falling due in the year the payment was received and, secondly, in discharge of interest previously accrued which had not been included in the appellant's revenue. Such sums thereupon became part of the appellant's revenue in the year of such payment. If a payment exceeded the interest for the current year and all arrears of interest for previous years which had not been taken into revenue, the balance was applied to arrears of interest which had previously been taken into revenue while the accounting for interest on the mortgage was on the accrual basis, but as such interest had already been taken into revenue in the year when it accrued, such balance was not again brought into the appellant's revenue. Similarly, when a mortgage, the interest of which never had been in default, was paid off, the sum representing accrued interest from the last interest date in the previous year to the end of that year, which had been taken into the appellant's revenue in that year, was not again brought into revenue.

At this point it may be useful to summarize the accounting practices followed by the appellant in 1949 and previous years in taking sums into its revenue. They were as follows:

Item	*Basis*	*Practice in Effect From*
Capital Account:		
Dividends	cash received	Prior to 1931
Rentals		
Real Estate	cash received	
S/D Boxes	cash received	
Estate, trust and agency fees	cash received	
Profits on sales of real estate	cash received	
Interest		
Sundry obligations	cash received	
Mortgages	cash received	By Jan. 1, 1942 on all mortgages, new and old.

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Item	*Basis*	*Practice in Effect Fram*
Agreements of sale	cash received	Jan. 1, 1937 on agreements made after that date, on all agreements by Jan. 1, 1942.
Collateral loans	cash received	Jan. 1, 1942 on new loans; no old loans outstanding in 1949.
Bonds		
Corporation	cash received	no date given in evidence.
Dominion Government Dominion Gov't. Guaranteed Provincial Government Provincial Gov't. Guaranteed	accrual	Prior to 1931.
Guaranteed Trust Account:		
Dividends	cash received	Prior to 1931.
Profits from sale of securities	cash received	Prior to 1931.
Interest		
Savings accounts	cash received	Prior to 1931.
Mortgages		
(1) made after Jan. 1, 1942	cash received	Jan. 1, 1942.
(2) made prior to Jan. 1, 1942		
(a) if interest never in default	accrual	Prior to 1931.
(b) if interest had at any time been in default	cash received	By 1935 in the case of any mortgage then in default and in any other case any later date on which default occurred in payment of interest.
Bonds		
Corporation	cash received	no date given in evidence.
Dominion Government Provincial Government Provincial Gov't. Guaranteed Municipal	accrual	Prior to 1931.

In round figures, the sums taken into revenue in 1949 on the accrual basis as interest on government bonds was $120,000, out of total revenue of $357,000. Of the $237,000 making up the difference, some portion (the evidence does not show precisely how much) related to the residue of mortgages still on the accrual basis, but the great bulk of it represented the amount taken into revenue on the cash received basis from sources other than government bonds.

The revenues received by the appellant in 1949 as interest on mortgages and agreements of sale amounted to $169,951.35, and receipts of discounts and capitalized interest, which had not previously been brought into revenue, amounted to $6,582.22, making total revenue receipts of $176,559.07 from this source. This gross sum

included $485.26 which the appellant received in 1949 in payment of arrears of interest which had been brought into revenue in previous years on mortgages which had been in default, $14,807.61 which the appellant received in 1949 in payment of arrears of mortgage interest which had not been taken into revenue in previous years, and $4,606.52 for interest accrued in 1948 from the last interest payment date in that year to the end of the year on mortgages taken before 1942 which had never been in default. The last-mentioned sum had been taken into revenue in 1948. The appellant deducted the $485.26 and the $4,606.52 from the total receipts above mentioned, to leave a sum of $171,441.79 which it brought into its 1949 revenue account. It also brought into revenue $3,716.70 for interest accrued in 1949 but not received on mortgages taken prior to January 1, 1942 which had never been in default. The total of these last two sums, $175,158.49, was the sum included by the appellant in the revenue account accompanying its income tax return for 1949 as its revenue from mortgages and agreements of sale.

At the end of the year 1949 there was due to the appellant mortgage interest in arrears which had never been taken into revenue, totalling $14,040.71. There was also due to the appellant a total of $958.01 for mortgage interest in arrears which had been included in revenue in previous years.

In assessing the appellant's 1949 income, the Minister added to the income as reported the sum of $18,715.42 as interest receivable on mortgages, less the sum of $4,674.71 which the appellant had previously taken into revenue on the accrual basis. (The latter sum is made up of the $958.01 for arrears included in revenue in earlier years and the $3,716.70 for accruals in 1949.) This made a net addition to the revenue as reported of $14,040.71. Then from the income so calculated, the Minister deducted $4,692.64 as a reserve for doubtful debts, pursuant to s. 11(1)(*d*) of *The Income Tax Act*. He did not deduct the amount of interest received in 1949 which was due and in arrears at the beginning of 1949. As previously mentioned, this amounted to $14,807.61. Had he done so, the mortgage revenue so calculated would have amounted to $174,391.59, that is to say, $766.90 less than the amount reported by the appellant.

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It will be observed that, notwithstanding the deductions made by the Minister after making the addition, the net amount added by the Minister in computing the appellant's mortgage revenue was entirely made up of interest which, though it became due in 1949, remained unpaid at the end of that year. It is this amount, rather than the deductions, with which the Court is concerned on this appeal, and the question for determination is whether or not the Minister correctly included such amount in the computation and assessment of the appellant's income for 1949.

Section 3 of *The Income Tax Act* declares that the income of a taxpayer for income tax purposes is his income for the year from all sources and includes income for the year from all businesses and property. It is then provided by s. 4 that, subject to the other provisions of Part I of the Act, income for a taxation year from a business or property is the profit therefrom for the year. The statute does not define "profit", nor does it prescribe any particular method or system by which the profit of a business or property is to be computed, but one of the provisions of Part I to which s. 4 is expressly made subject is s. 6(*b*), which is as follows:

> 6. Without restricting the generality of section 3 there shall be included in computing the income of a taxpayer for a taxation year
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> * * *
>
> (*b*) amounts *received in the year* or *receivable in the year (depending upon the method regularly followed by the taxpayer in computing his profit)* as interest or on account or in lieu of payment of, or in satisfaction of interest;

It may be noted that interest which is not received in the year is not income in the ordinary sense of the word because it does not come in. But, even though such unpaid interest is not received in the year, it may be necessary to include it in computing the profit of a business or property for a year if the method used to compute profit is based on accounting principles which require that it should be brought into the computation. In this way, unpaid interest which has become due during the year may become part of the income of a business or property by reason of the special meaning given by s. 4 to the word "income" when it refers to the income of a business or property. But this is subject to s. 6(*b*), which directs that the method regularly followed by the taxpayer in computing his profit shall determine the

basis on which interest shall be brought into the computation of the income of the taxpayer for the purposes of *The Income Tax Act*.

The argument advanced on behalf of the Minister for including in the computation of the appellant's 1949 revenue the amount in question, made up as it was of interest which became *receivable in the year* was that the accounting practices of the appellant did not amount to a method of computing profit of either of the two kinds mentioned in s. 6(*b*) of *The Income Tax Act,* that, accordingly, s. 6(*b*) has no application to this case except to indicate, by the expression *"receivable in the year"*, the limit to which Parliament intended interest should be included in computing profit, that because the matter cannot be resolved under s. 6(*b*) resort must be had to s. 4, which declares the income of a business to be the profit therefrom for the year, that the computation of the profit of a business of a year must take into account all of the earnings of the business for the year, including the receivables in question which were sums earned in the year and had value, and that any computation of profit in which such receivables are not brought into account does not accurately reflect the profit of the business for the year. This was followed by the submission that, in the Minister's computation, any uncertainty as to the value or collectibility of such receivables was adequately taken care of by the allowance of a deduction for doubtful debts.

This argument raises a question as to what is meant by the word "method" in s. 6(*b*) and a further question as to whether or not the appellant regularly followed a method of computing its profit. As I interpret it, the word "method" is not used in s. 6(*b*) in any narrow or technical sense but simply means the system or procedure which the taxpayer has regularly followed in computing his profit. The system or procedure, in my opinion, may be made up of a number of practices, and I can see no valid reason why, in a diverse business such as that of the appellant, such system or procedure could not include different practices for accounting for revenue from different activities or sources, depending on the nature of such activities or sources and of the revenues therefrom, and still be regarded as a "method" within the meaning of that word in s. 6(*b*). In my opinion,

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the practices followed by the appellant did amount to a "method" within the meaning of the section and, as that method had been followed by the appellant without change for the seven years immediately preceding 1949 and for 1949 as well, I have no hesitation in concluding that it was the "method" regularly followed by the appellant in computing its profit within the meaning of s. 6(*b*).

Now, in this method the practice followed by the appellant in accounting for interest revenue from all mortgages taken after January 1, 1942 and from all mortgages taken prior to that date on which the interest had been in default was that of including interest in revenue only when it was received. And while the accrual basis was still in use with respect to the decreasing remnant of mortgages taken prior to 1942, the interest on which had never been in default, the plain fact was that the appellant at no time during the period from the beginning of 1942 to the end of 1949 computed any part of its mortgage revenue, or for that matter any part of its revenue from any activity or source, by including interest or other revenue which had become receivable but was not received in the year. In this situation, I am of the opinion that s. 6(*b*) amounts to a statutory direction for bringing into the computation of the appellant's income on a *received in the year* basis the interest on all mortgages in respect to which the appellant had followed that basis. At the same time, since the *receivable in the year* basis was never followed by the appellant, s. 6(*b*) impliedly excludes its use as the basis for bringing the interest of such mortgages into the computation. As the amount added by the Minister was interest receivable on such mortgages, it follows, in my opinion, that, to the extent of such addition, the assessment is not in accordance with the statute and cannot be sustained.

There is, however, a further reason why, in my opinion, the assessment cannot be upheld. The main argument in support of the assessment was that the cash received basis used by the appellant to compute its mortgage revenue was not an appropriate method of computation of such revenue for the purposes of *The Income Tax Act* and that the method adopted by the Minister of computing such revenue by including receivable interest was the appropriate method and would reflect the true profit of the business for the year more accurately than the accounting practices followed

by the appellant. Whether or not, over a period of years, the method adopted by the Minister would reflect the true profit of the appellant's business more accurately than the appellant's method is a matter on which opinions may differ, but in the opinion of the only witness who gave evidence at the trial of the appeal the method followed by the appellant was more appropriate for the appellant's business and, in particular, for the computation of the appellant's mortgage revenue. This witness was Mr. C. A. Parker, a chartered accountant who has acted as auditor of the appellant company continuously since 1930, and, if it were necessary to come to a conclusion on this question, I would do so on the basis of his opinion. But even if over a period of years the method adopted by the Minister would be more appropriate I think it is clear that the Minister's computation of the appellant's mortgage revenue for 1949 was not a more accurate computation than that made by the appellant, for when, in computing revenue by the method which the Minister contends is more appropriate, receivables due at the end of the year are included as part of the earnings of the year, the receivables due at the beginning of the year which were earnings of previous years must be excluded from the computation. As previously mentioned, had this been done there would have been nothing for the Minister to add to the mortgage revenue as computed by the appellant. The mere fact that such receivables due at the beginning of 1949 had never been taken into revenue does not affect the matter. What is to be assessed is the profit for the year and, if the profit is to be computed on the basis of what has been earned in the year, what had already been earned before the year began does not enter into the computation. It follows, in my opinion, that the computation of mortgage revenue on which the assessment is made is not an accurate estimate of the mortgage earnings of the appellant for the year 1949, and because of this the sum assessed as the profit of the business for the year is not an accurate estimate of such profit.

Counsel for the Minister sought to overcome this objection of the assessment by invoking the special provisions of s. 129(9) of *The Income Tax Act*, but in my opinion this

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section does not apply where, as in this case, the method of computing profit referred to in the section is not one adopted by the taxpayer.

The appeal will be allowed and the assessment referred back to the Minister to be revised in accordance with the foregoing reasons. The appellant is entitled to its costs of appeal.

Judgment accordingly.