BETWEEN:

ATLANTIC ENGINE REBUILDERS LIMITED ..... APPELLANT;

AND

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

1963
June 11-14
1964
Aug. 17

*Revenue—Income tax—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 12(1)(e) and 85B(1)(a) and (b)—Sales of rebuilt engines for cash and rebuildable engines—Deposit to secure delivery of rebuildable engine to taxpayer—Whether deposits are receipts of income or revenue nature—Taxpayer entitled to deduction for liability to refund deposits—Liability to refund deposits a presently existing trading obligation.*

The appellant rebuilds worn engines and other motor vehicle parts and distributes them to car and truck dealers in the Atlantic provinces. The great bulk of the used engines and parts obtained by the appellant for rebuilding comes from the dealers to whom the appellant delivers the rebuilt products. During 1958, the year in question, the appellant delivered its rebuilt products under an agreement by which the purchasing dealer paid a certain price and undertook to deliver to the appellant a rebuildable engine or part of the same model as that delivered to him, and in addition, he was required to pay a core deposit, the whole of which was refundable to the dealer on delivery of the rebuildable engine or part. The agreement contained no time limit for the delivery of the rebuildable engine or part to the appellant and no provision for forfeiture of the core deposit in the event of non-delivery. In general the core deposits were set at amounts greatly in excess of the value of the rebuildable engines or parts required to be delivered by the dealer.

In computing its income for 1958 the appellant included the amount of the core deposits charged in respect of engines or parts more than seven months before the end of the year. These were brought into income on the assumption that they were no longer likely to be redeemed. The appellant also credited the value of engines the delivery of which was secured by the remaining deposits but it did not include such remaining deposits or the amount by which they exceeded the value of the engines the delivery of which was secured by them. The respondent added the latter amount to the appellant's income and assessed tax accordingly.

*Held:* That the deposits here in question were receipts of an income nature because they arose from the appellant's trading transactions of which in each case the deposit formed a part.

2. That the deposits as well as the value of the rebuildable engines to which the appellant became entitled as a result of the transactions should have been included in the receipts for the year.

3. That the appellant in computing the profit from its business was entitled to a deduction in respect of the liability to refund the deposits which arose on their receipt, such liability not being contingent and the amount necessary to provide for its retirement when due not being a

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reserve or contingent account or sinking fund within the prohibition of s. 12(1)(e) of the *Income Tax Act*.

4. That although the appellant may in effect have understated its revenue by omitting the core deposits unredeemed at the end of 1958, it has in that event also understated to the same extent its liabilities incurred in the same transactions. It follows that the Minister could not properly add the deposits to the appellant's income without at the same time allowing an equivalent amount as a deduction.

5. That the appeal is allowed.

APPEAL under the *Income Tax Act*.

The appeal was heard by the Honourable Mr. Justice Thurlow at Moncton.

*G. B. Cooper* and *Donald J. Friel* for appellant.

*G. W. Ainslie* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

THURLOW J. now (August 17, 1964) delivered the following judgment:

The issue in this appeal, which is from a re-assessment of income tax for the year 1958, is the liability of the appellant for tax in respect of a sum of $38,213.00 representing the balance of amounts known in the appellant's business as core deposits which the Minister, in making the re-assessments, included in the computation of the appellant's income. Two questions arise in connection with these deposits the first being that of whether they must be included in the computation of the appellant's income and the other, whether, if the deposits must be included, the appellant is entitled to a deduction in respect of its liability to repay them.

The circumstances in which the amounts in question arose are as follows. The appellant since early in 1955 has carried on, under a franchise arrangement with the Ford Motor Company of Canada, an operation which consists of rebuilding worn engines and certain other parts for Ford cars and trucks and distributing the rebuilt engines and parts to Ford dealers in the Atlantic provinces. To carry on this operation successfully a constant supply of used engines and parts of the types or models for which the demand is active is required for use as the raw material to be processed.

Some of these used engines and parts are purchased outright from persons offering them for sale but the great bulk of them is obtained and the necessary supply thus assured in transactions with the Ford dealers to whom the rebuilt products are delivered. Throughout the year 1958 the appellant delivered its products on the basis of a model for model exchange but upon terms which, besides requiring the dealer to deliver to the appellant a rebuildable engine or part of the same model as that delivered by the appellant and to pay a price, also required the dealer to pay a core deposit the whole of which was refundable to the dealer upon delivery to the appellant of the rebuildable engine or part. The term requiring payment of a core deposit had not been in effect prior to 1957 but was adopted by the appellant in that year as a device to coerce the dealers, who otherwise tended to be slow about it, into making prompt delivery of used rebuildable engines or parts. In the ordinary case there would be some delay on the part of the dealer in delivering a rebuildable engine or part and it is not difficult to understand that if the engine to be replaced by the rebuilt engine was not in rebuildable condition or was not available by reason of its having been sold to a competitor of the appellant some considerable time might elapse before an engine of the required model became available for delivery to the appellant. In this situation the appellant deliberately set the core deposits for various models at amounts greatly in excess of the prices at which rebuildable engines and parts of the particular models could be purchased on the open market. In general the value of the used engine or part was but 30% of the amount at which the core deposit was set. While the terms of the transaction required payment of both price and deposit within 30 days no time limit was fixed within which delivery of the used engine or part was required and there was no provision for forfeiture of the deposit or for applying it in discharge of the dealer's contract to deliver an engine. On the other hand when a used engine or part of the required model was delivered by the dealer either prior to or at the time of delivery of the rebuilt engine or part by the appellant no core deposit was imposed. The core deposit requirement was very effective and over a three year period resulted in delivery of used engines by dealers equal in numbers to 96% of the number of rebuilt engines delivered by the appellant to them.

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That the nature and substance of these transactions was as I have described them is to my mind fully established by the evidence including in particular Exhibits 1, 2, 6 and 7. Exhibit 1 is a catalogue and price list of the appellant which sets out terms and prices similar to those on which the appellant distributed its products during 1958 and page 4, among other items, contains the following:

CORE DEPOSIT

At time of shipment a core deposit will apply on all assemblies shipped by Engine Rebuilders Ltd. (refer to price list). This amount is refundable upon receipt of the complete rebuildable used engine in the original shipping crate.

On a typical page among those dealing with prices one finds at the top of the page: "Model for Model Exchange Engine price list" and below in several columns the core deposits, suggested retail and trade prices and dealers net prices in respect of various models of engines. Exhibits 2, 6 and 7 are typical invoices used by the appellant in each of which in the column headed "item" are the printed words "Rebuilt Motor Exchange". Moreover, the whole course of conduct of the appellant's business as described by the witnesses and in particular the witness, Richard Douglas Bannon, indicates that the nature and substance of the transactions was that of an exchange of engines with a money payment to represent the difference in values but requiring as well a deposit to ensure that the dealer would honour his part of the contract to exchange engines by delivering a rebuildable used engine or part. I emphasize this interpretation of the transactions because of the insistence by counsel for the Minister on his submission that the substance of the transactions was that of an outright sale at a price composed of both price and core deposit and a subsequent repurchase by the appellant from the dealer of a used engine at a price equal to the core deposit. In my view such a conclusion is not warranted by the evidence and I reject it.

Several further features of the transactions which appear to me to be established should also be mentioned.

(1) When a rebuilt engine was delivered by the appellant to a dealer the consideration therefor was the price plus a rebuildable engine of the same model.

(2) The amount of the core deposit was not part of the consideration for the rebuilt engine delivered by the appellant.

(3) When a core deposit was paid by a dealer a corresponding obligation to repay it arose and existed throughout the period during which the deposit was held by the appellant though such obligation did not become due or recoverable by the dealer until he had delivered a rebuildable used engine of the model in question.

(4) The acceptance by a dealer of a rebuilt engine on the terms which I have mentioned raised a contractual obligation on his part to deliver a rebuildable used engine of the same model which obligation remained in effect until it was performed or was discharged by agreement. The fact that in practice the appellant did not enforce this obligation by suing for damages but employed the technique of retaining a deposit of much greater value than that of the engine is not in my view, inconsistent with the existence of the obligation.

(5) When a rebuildable used engine was delivered by the dealer pursuant to the contract it was delivered in discharge of this obligation and the consideration for it was the rebuilt engine which the appellant had already delivered to him.

(6) The refunding of the deposit was not the consideration for the engine which the dealer so delivered.

Of the charges for core deposits made by the appellant during the year 1958 in transactions of this nature $51,020 remained unredeemed by the delivery of engines or parts at the end of the year. Of this $44,307.97 had been actually received by the appellant during the year and the remaining $6,712.03 was made up simply of unpaid charges in the customer's accounts. In the ordinary course of business most of this would be refunded or re-credited within a few months as the used engines were delivered.

In computing its income for the year 1958 for the purposes of the *Income Tax Act* R.S.C. 1952, c. 148 the appellant credited its core expense account with an amount of $5,485 which amount represented all such unredeemed deposits with respect to engines as had been charged more than seven months before the end of the year together with $1,000 representing unredeemed deposits in respect of smal-

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ler parts. In so doing the appellant acted on the assumption that in view of the delay it was unlikely that these deposits would ever be redeemed and in effect brought them into income. It also credited to the same account a sum of $7,322 which it calculated to be the value to it of the engines the delivery of which was secured by the remaining deposits, thus in effect bringing their value into income as well, but it did not credit or include either such remaining deposits or the amount by which they exceeded the value so attributed to the engines and parts the delivery of which was secured by them. The difference of $38,213 between the amount of such remaining deposits and the value of the engines, delivery of which was so secured, was thus in no way included in the appellant's computation and it was the Minister's action in adding this amount to the appellant's declared income and assessing tax accordingly which gave rise to the present appeal.

The Minister's case for including the unredeemed core deposits in the computation was based first on s. 85B of the Act and in particular on subsection (1)(*b*) thereof on the basis of their having been "amounts receivable in respect of property sold in the course of the [appellant's] business in the year" which are specifically required by that subsection to be brought into the computation and alternatively on the contention that these deposits were in any event trading receipts which apart altogether from s. 85B must under established principles be taken into account when computing income from the appellant's business within the meaning of sections 3 and 4 of the Act.[1]

From this position counsel went on to submit that the appellant was not entitled to any deduction in respect of its liability to repay the deposits as the liability was in his submission at most a contingent liability which would come into existence only upon delivery by the dealer of a used engine or part and any deduction in respect thereof was prohibited by s. 12(1)(*e*) of the Act.

Sections 3 and 4 and paragraphs (*a*) and (*b*) of subsection (1) of s. 85B provide as follows:

> 3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all
>
> (*a*) businesses, . . .

[1] R.S.C. 1952, c. 148.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

85B. (1) In computing the income of a taxpayer for a taxation year,

(a) every amount received in the year in the course of a business

(i) that is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been earned in the year or a previous year, or

(ii) under an arrangement or undertaking that it is repayable in whole or in part on the return or resale to the taxpayer of articles in or by means of which goods were delivered to a customer,

shall be included;

(b) every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable 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; . . .

With respect to the interpretation of these paragraphs s. 85B(2) provides that

85B. (2) Paragraphs (a) and (b) of subsection (1) are enacted for greater certainty and shall not be construed as implying that any amount not referred to therein is not to be included in computing the income from a business for a taxation year whether it is received or receivable in the year or not.

S. 12(1)(e) reads as follows:

12. (1) In computing income, no deduction shall be made in respect of

(e) an amount transferred or credited to a reserve contingent account or sinking fund except as expressly permitted by this Part

Having regard to the conclusion which I have expressed as to the nature and effect of the transactions I doubt that s. 85B(1)(b) can apply to require that the deposits in question be brought into the computation of the appellant's income. First the transactions in which the deposits arose were not strictly speaking sales at all but a type of barter or exchange. Secondly, at the end of the year, which I regard as the time when the subsection applies, the bulk of the deposits were not receivable but had already been received. Thirdly, and this is the chief source of my doubt, the deposit required under these contracts for the purpose of securing the performance of the dealer's undertaking to deliver a used engine does not appear to me to be clearly "receivable

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in respect of goods sold" within the meaning of that expression in the subsection. However, in view of the conclusion which I have reached as to the treatment of the deposits for tax purposes apart from s. 85B(1)(b) I do not regard it as necessary either to reach a firm conclusion on whether s. 85B(1)(b) applies or to consider the extent of the changes which the enactment of that subsection has wrought in what is required to be included in the receipts when computing the income of a business to which the subsection applies further than to say that the subsection does not appear to me to permit the omission of anything which prior to the enactment would have been required to be brought into the computation as receipts.

As I see it the question whether the deposits must be brought into account in computing the appellant's income turns on the answer to the question whether they are receipts of an income or revenue nature. If so they are part of the revenue of the business and must be brought into the computation.

That the deposits here in question were receipts of an income nature is, I think, indicated by the fact that they arose from the appellant's trading transactions of which in each case the deposit formed a part. Each deposit secured the performance of a specific trading obligation and if applicable to any purpose the purpose was that of compensating the appellant for the loss resulting from the failure of the dealer to honour that particular trading obligation. In the meantime however until the deposit was refunded or so applied the appellant was free to deal with it as its own. There was no trust attaching to the money. From what I have said of them it is I think clear that these core deposits did not have the dual quality of both part payment and security as did those considered in *Elson v. Price Tailors Ltd.*[1] but were purely security deposits, resembling in that respect those considered in *Davies v. The Shell Company of China Ltd.*[2] though at the same time differing from them in that there the contracts under which the deposits were made contained provisions as to their disposition in certain default situations, which however did not arise. The deposits in the *Shell of China* case were held to be capital rather than trading receipts but the deposits in the present case appear to me to have been much more closely related to

[1] [1963] 1 All E.R. 231. [2] 32 T.C. 133.

the appellant's trading transactions than were the deposits considered in that case and in my view were receipts of a trading or revenue nature within the principle of *Landes Brothers v. Simpson*[1], *Imperial Tobacco Company v. Kelly*[2] and *Tip Top Tailors Ltd. v. M. N. R.*[3] The deposits as well as the value of the rebuildable engines to which the appellant became entitled as a result of the transactions should accordingly in my opinion have been included in the receipts for the year.

But if I am right in concluding that these deposits should have been included in the computation as receipts it seems to me to follow inexorably that in computing the profit from its business the appellant was entitled to a deduction in respect of the liability to refund the deposits which arose on their receipt. These in my opinion were not contingent liabilities and the amount necessary to provide for their retirement when due was not a reserve, contingent account or sinking fund within the prohibition of s. 12(i)(*e*) of the Act. They were in my opinion presently existing trading obligations arising from trading transactions the profits from which could not be computed if the deposits were brought into the account without an offsetting deduction in respect of the obligations which the receipt of the deposits had engendered. Jenkins L. J. appears to have had the same concept in mind when in posing the question for decision in *Davies v. The Shell Company of China* he said at page 155:

> Therefore, as it seems to me, the question here really resolves itself into this: On the facts of this case, were these deposits trading receipts received by the Company in the course of its trade, *and giving rise to corresponding trade liabilities in the form of the Company's obligation as to repayment,* or should they be regarded simply as loans received by the Company and thus as receipts of a capital nature giving rise to a corresponding indebtedness on capital account and not forming part of the Company's trading receipts or liabilities at all?

The emphasis has been added.

As I view it one might analyze the typical transaction in the present case by saying that on delivery of a rebuilt engine to a dealer the appellant became entitled to receive

(*a*) a sum of money as price

(*b*) a used rebuildable engine and

(*c*) a deposit to secure delivery of the rebuildable engine.

[1] 19 T.C. 62. [2] 25 T.C. 292.
[3] [1957] S.C.R. 703.

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The trading receipts from such a transaction thus consist of the total of (*a*), (*b*) and (*c*) but on receipt of the deposit (*c*) the appellant became liable to repay a like amount to the dealer some day not earlier than the delivery of the rebuildable engine and the trading account must accordingly show this liability as well. This liability in my opinion was not one that arose on delivery of the engine but existed from the time of receipt of the deposit. It became due and payable when the engine was delivered which in the ordinary course would be within a short time and continued to be an existing obligation until in the course of business it was discharged by payment or was otherwise settled. It appears to me that even in the case of the deposits which the appellant has treated as unlikely to be redeemed and has in effect brought into its income the dealer after the end of the year was still entitled to deliver an engine and claim a refund of his deposit and in view of the lack of provision in the contract for forfeiture of the deposit there appears to have been no limit on the time within which this right was open to the dealer. But whether a right of forfeiture at some stage existed or not it appears to me that the appellant's liability persisted until it was discharged by payment or forfeiture or was released by agreement and it would be only then that the liability would necessarily disappear from its trading accounts.

Moreover, when at length it did disappear it would not be because the liability had never arisen or existed but because in a subsequent transaction it had been discharged or released and if at that stage a profit was shown by reason of the liability having been discharged for less than the full amount of the deposit the latter transaction in my opinion rather than the one in which the deposit was received would be the transaction from which such profit was realized.

I should add that the fact that the rebuildable engines to be delivered by the dealers were to be used by the appellant as inventory in its business is in my view entirely irrelevant and that the cases on anticipated losses on inventory contracted for but not delivered at the end of the accounting period, which were cited by counsel for the Minister, in my opinion, are not applicable.

Moreover, as the conclusion which I have reached by reference to the nature of the transaction is the same as it would be under the principle expounded by Lord Radcliffe in *Owen v. Southern Railway of Peru*[1] it is unnecessary to deal with the contention of counsel for the Minister that that case is inapplicable under the *Income Tax Act* because of the provisions of s. 12(1)(*e*).

It follows that while the appellant may in effect have understated its revenue by omitting the core deposits unredeemed at the end of 1958 it has in that event also understated to the same extent its liabilities incurred in the same transactions. It also follows that the Minister could not properly add the deposits to the appellant's income without at the same time allowing an equivalent amount as a deduction. The appeal therefore succeeds and it will be allowed with costs and the re-assessment will be varied accordingly.

*Judgment accordingly.*

[1] 36 T.C. 602.