36, 1955

No. 12 of 1955.

In the Privy Council.

ON APPEAL
FROM THE SUPREME COURT OF CANADA.

BETWEEN

THE MINISTER OF NATIONAL REVENUE . . . . *Appellant*

AND

ANACONDA AMERICAN BRASS LIMITED . . . . *Respondents.*

RECORD OF PROCEEDINGS
VOLUME V

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VOLUME V

In the Supreme Court of Canada.

No. 1. Formal Judgment, 1st November 1954.

No. 1.

FORMAL JUDGMENT.

IN THE SUPREME COURT OF CANADA.

Monday, the 1st day of November, 1954.

Present :

THE HONOURABLE THE CHIEF JUSTICE OF CANADA.
THE HONOURABLE MR. JUSTICE TASCHEREAU.
THE HONOURABLE MR. JUSTICE ESTEY.
THE HONOURABLE MR. JUSTICE LOCKE.
THE HONOURABLE MR. JUSTICE CARTWRIGHT.

BETWEEN

THE MINISTER OF NATIONAL REVENUE . Appellant

AND

ANACONDA AMERICAN BRASS LIMITED . Respondent.

JUDGMENT.

THE appeal of the above-named Appellant from the judgment of the Exchequer Court of Canada pronounced in the above cause on the 7th day of

In the Supreme Court of Canada.

No. 1. Formal Judgment, 1st November 1954, *continued.*

June in the year of our Lord One thousand nine hundred and fifty-two, having come on to be heard before this Court on the 22nd, 23rd, 24th and 25th days of March in the year of Our Lord One thousand nine hundred and fifty-four, in the presence of Counsel as well for the Appellant as the Respondent, whereupon and upon hearing what was alleged by Counsel aforesaid, this Court was pleased to direct that the said appeal should stand over for judgment and the same coming on this day for judgment.

THIS COURT DID ORDER AND ADJUDGE that the said judgment of the Exchequer Court of Canada should be and the same was affirmed and that the said appeal should be and the same was dismissed with costs to be paid by the said Appellant to the said Respondent.

(Sgd.) PAUL LEDUC,
Registrar.

No. 2. Reasons for Judgment.

No. 2.

REASONS FOR JUDGMENT.

MINISTER OF NATIONAL REVENUE
V.
ANACONDA AMERICAN BRASS LIMITED.

CORAM : THE CHIEF JUSTICE, TASCHEREAU, ESTEY, LOCKE and CARTWRIGHT, JJ.

(a) The Chief Justice.

(a) THE CHIEF JUSTICE.

This appeal involves the ascertainment of the proper amount of excess profits for its 1947 taxation year of the Respondent Company Anaconda American Brass Limited pursuant to the Excess Profits Tax Act 1940. By Section 2 (1) (*f*) of that Act " profits " means the amount of the Company's net taxable income as determined under the Income War Tax Act and in accordance with the well-known Section 3 (1) of the latter, " income " means the annual net profit ; that is, profits are not to be ascertained over any period except (as applied to the present case) the 1947 calendar year.

The statement of Lord Clyde in *Whimster & Co.* v. *The Commissioners of Inland Revenue* (1925), 12 Tax Cas. 813, as to the two fundamental matters to be kept in mind in computing annual profits is accepted in England and is applicable here. It appears at p. 823 of the report :—

> " In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently

with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes."

The second of these propositions was approved by the House of Lords in *Ryan* v. *Asia Mill Ltd.* (1951) 32 Tax Cas. 275. At p. 293, Lord Porter states :—

> " It was also common ground that in computing such profits the value of the Appellant Company's stock-in-trade in hand at 13th January, 1945, was, in accordance with the principles enunciated in *Whimster & Co.* v. *Commissioners of Inland Revenue* [1926] S.C. 20 at page 25, required to be included at a figure representing its true cost to the Appellant Company."

At p. 300, Lord Radcliffe, with whom Lord Normand agreed, puts it thus :—

> " Here we are dealing with the application of ' the principle of commercial accounting . . . that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and the end of the period covered by the account should be entered at cost or market price, whichever is the lower.' "

Lord Clyde's two propositions were approved by the Court of Appeal in *Patrick* v. *Broadstone Mills Ltd.* [1954] 1 A.E.R. 163. At p. 171 Lord Justice Singleton (with whom Birkett and Hodson, L.JJ., agreed, although the former added a comment of his own) set out the extract given above. After setting out the headnote in *Sun Insurance Office* v. *Clark* [1912] A.C. 443 as it appears in 6 Tax Cas. 59 and Lord Loreburn's examination in his speech in that case of the previous decision of the House of Lords in *General Accident, Fire and Life Assurance Corpn. Ltd.* v. *McGowan* [1908] A.C. 207, Lord Justice Singleton extracts what the Lord Chancellor had said (p. 77) towards the end of his speech :—

> " I am equally anxious that your Lordships should not be supposed to have laid down that the method applied by the Commissioners in the present case has any universal application. If the Crown wishes in any future instance to dispute it they can do so by evidence, and it is not to be presumed that it is either right or wrong. A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, viz. : that the true gains are to be ascertained as nearly as it can be done."

Leave to appeal to the House of Lords in the *Patrick* case was refused by the Court of Appeal (35 Tax cas. 72) and no motion for leave has been made to the House itself.

In the Supreme Court of Canada.

No. 2. Reasons for Judgment.

(a) The Chief Justice, *continued.*

Two other preliminary but important matters may be mentioned. The first of these is that in *Russell* v. *Town and County Bank* (1883) 13 A.C. 418 at p. 424, Lord Herschell stated :—

> " The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts."

Lord Fitzgerald, at p. 429, in the same case, stated :—

> " ' Profits ' I read on authority to be the whole of the incomings of a concern after deducting the whole of the expenses of earning them—that is, what is gained by the trade."

The second is Lord Cairns' statement in *Coltness Iron Company* v. *Black* (1881) 6 A.C. 315 at p. 324 :—

> " It may be proper for a trader or for a trading company, to perform in his or their books an operation of this kind every year, in order to judge of the sum that can in that year be safely taken out of the trade and spent as trade profits."

This part of Lord Cairn's speech was reiterated by Lord Buckmaster (with whom Lord Atkinson concurred) in *Naval Colliery* v. *Commissioners of Inland Revenue* (1928) 12 Tax Cas. 1017 at p. 1047, to which Lord Buckmaster added :—

> ". . . But it cannot be done when the question is the amount of profits received."

To the same effect are these statements by Lord Sands in the *Whimster* case :—

> " The consideration of how it would be prudent for a trader to act does not solve the question here presented to us as one of Revenue Law. Under this law the profits are the profits realised in the course of the year." (p. 826.)
>
> " The manner in which they have adjusted their accounts was probably quite reasonable as a domestic arrangement, but it would lead to great confusion if such haphazard and speculative estimates were to enter into the business of the collection of the public revenue." (p. 827.)

The Respondent was incorporated in Canada in 1922 but is a subsidiary of The American Brass Co., a United States corporation. It operates a primary brass mill and, from raw metals which it purchases from various Canadian mining companies and from scrap, it produces semi-finished copper and copper brass alloys in the form of sheets, rods, seamless tubes, and shapes. About 90% of the metal content of its products consist of copper (over 80%) and zinc (about 15%). It purchases from companies with which it has no connection all its raw metals at the market and has always avoided speculation in their price as it seeks to make a profit entirely from their fabrication. The prices charged for its products are based upon the replacement cost of the metal content of its product and a processing charge which includes all expenses, other than the replacement cost of the metal, and an allowance for profit. The processing charge has never been affected by fluctuations in the prices of the raw metals, which,

particularly in the case of copper and zinc, have, since the lifting of price controls on June 10th, 1947, varied considerably. With unimportant exceptions: from January 1st, 1947, until February 28th, 1947, it accepted orders on the condition that the price would be that shown on its price list in effect on the first day of the month in which the order was shipped; from February 28th, 1947, until December 31st, 1947, it accepted orders on the condition that the price would be that shown on the price list in effect on the date when the order was shipped.

During the first few days of each month the Company calculated the raw materials which would be required, and what orders it would fill by shipment, in the next calendar month. The amount of raw materials ordered was the amount so estimated to be required in that next calendar month. The Company's business is not seasonal; its turnover is slow (about three or four times a year) and the inventory required is large physically and in value. One pound of metal in the inventory has the same value as another, no attempt is made to identify any portion of the inventory, and any record of scrap would be of very little use.

The Company commenced and ended the year 1947 with an inventory of raw materials. The question is not as to the quantities but as to values. It is settled, if not admitted, that the values must be taken at market or cost, whichever be lower. The difficulty arises because the Company put a value on its inventory at the end of 1947 on the LIFO assumption, that is, last in first out, while the Apellant valued that stock on the FIFO assumption, that is, first in first out. Neither theory is based on any presumption as to the actual physical movement of the metals in the course of operations. As to LIFO, to quote Mr. De Roche, a witness for the Company, it is an "assumption as to the order in which costs should flow into cost of sales and for the establishing of the amount of cost to be assigned to the quantity on hand"; it is "indicative of the flow of cost which are employed in the method." If the Company piled its metals in such a way as to be able to allocate the actual purchase prices to the various lots there would be no difficulty, because the cost of what had been used in processing, whereby its profits were made, would be known. Since it did not do this it was necessary to adopt some method, the result of which would most nearly approach the known facts.

As to copper, which accounts for more than 80% of the metal content of the Company's products, the situation in 1947 was that the Company purchased 63,268,555 pounds and at the end of the year 14,291,007 pounds were on hand. Slightly more than the total closing inventory, i.e., 14,745,979 pounds had been purchased in the last three months of the year at 21·5 cents per pound. In using the LIFO assumption the Company went back to the year 1936 when the theory had been adopted by it for corporate purposes and allocated the cost of the closing inventory of 14,291,007 pounds in the following manner:—

> "(A) 6,500,000 pounds were regarded as having a cost of 7·5 cents per pound (the average cost of the copper in the inventory when LIFO was adopted in 1936) amounting to $487,500;
>
> (B) 802,697 pounds were regarded as having a cost of 9·466 cents per pound (the average price paid in 1936) amounting to $75,983·30;

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(a) The Chief Justice, *continued.*

(C) 17,577 pounds were regarded as having a cost of 11·191 cents per pound (the average price paid in 1937) amounting to $1,967·04 ;

(D) 639,807 pounds were regarded as having a cost of 10·443 cents per pound (the average price paid in 1938) amounting to $66,847·04 ;

(E) 973,477 pounds were regarded as having a cost of 11·036 cents per pound (the average price paid in 1939) amounting to $107,432·92 ;

(F) 3,151,684 pounds were regarded as having a cost of 11·5 cents per pound (the price paid in 1945) amounting to $362,443·66 ;

(G) 2,205,765 pounds were regarded as having a cost of 11·5 cents per pound (the price paid in 1946) amounting to $253,662·97." 10

As more than two-thirds of the copper inventory is continuously in process, it is evident that about two-thirds of the 14,291,007 pounds could not have been used in manufacturing the products sold in 1947. What is required is the cost of the metals used in processing so as to ascertain the profit for that year and not what the Company adopts as a wise plan to cover fluctuations over the years in the cost of its raw materials. I would think that an assumption, the result of which indicates that 6,500,000 pounds had been in the premises since 1936, would be unwarranted and that it is contrary to the facts is shown by the evidence of Mr. Evans, the Company's Works Manager, and Mr. Richardson, an accountant called 20 as a witness on behalf of the Company. At p. 139 of the record the following appears in the examination-in-chief of Mr. Evans :—

" Mr. PATTILLO : *Q.* And do you happen to know, Mr. Evans, of your own knowledge whether you have on hand at the plant, copper that has been received from the refineries that has been there for a good many years and that has never yet gone into the mill?—*A.* I would not know whether there would be any around there or not.

His LORDSHIP : *Q.* Is it likely that there would likely be any considerable portion of quite old copper in the plant ?—*A.* No, there would not be, sir, any large quantity that you could identify 30 as being an old lot. There might be. There is only one instance that I know of where we had some cast billets which had been in the yard for about five years—that is an alloy.

Q. Some cast billets ?—*A.* Yes.

Q. That were in the yard, and was that any particular kind of alloy ?—*A.* It was a special alloy for which we had no orders during that period."

At p. 284 Mr. Richardson is under cross-examination :—

" Mr. PICKUP : *Q.* Is not the difference this on that one point—that LIFO, as you say, does not reflect physical realities ; FIFO 40 may or may not ?—*A.* It may approximate them. I would doubt if you would ever have a case where it could be said that it exactly reflected physical realities.

Q. But in many cases you would have it where it substantially reflected physical realities. That is true, isn't it ?—*A.* That is right.

His LORDSHIP: *Q.* Would it be possible for the LIFO method to reflect physical realities?—*A.* It would be possible to be a reasonable reflection of the movements in a particular year but cumulatively you would get probably further and further from reality. That is, at the end of ten years on the method you would probably not have at that stage the quantity of material on hand ten years old corresponding to the quantity which was priced at the prices of ten years ago, for instance.

Mr. PICKUP: Well, if we look at Exhibit 7, we find that the exhibit is showing that in 1947 at the end of the year the Company is still, so far as reality is concerned, operating on the basis of having an inventory that it had prior to 1936 and some more raw copper that it got in 1936, 1937, 1938 and 1939. Is that what you mean (and I think it is) when you say it is actually further and further away from the reality if you use LIFO?—*A.* Well I cannot speak as to the realities in this particular case but I do not imagine that any of the Company witnesses would claim for a minute that there is a quantity of metal now on hand acquired in the year 1936 equal to the quantity which is priced at that price. I did not hear their evidence."

In the United States FIFO had been in use for years and efforts to secure permission from the taxing authorities to use the LIFO method in connection with such industries as The American Brass Company did not succeed until 1938. It was only when legislation in that year permitted the use of this method for tax purposes, subject to certain conditions, that the United States parent company made its tax returns in that form. Such a method, either with or without conditions, has never been permitted in Canada. This was known to the Company, which, although for corporate purposes had made use of the theory as early as 1936, adopted it for tax purposes in Canada only on June 16th, 1947, when it filed its tax returns for the year 1946. Before that date very considerable increases in the price of copper and zinc had occurred as a result of the relaxation and later of the removal of price controls. The Company's appeal to the Exchequer Court from the Appellant's assessment of it for 1946 was abandoned and was dismissed without costs.

Even though the LIFO assumption is recognized as a proper accounting method for corporate purposes, the authorities noted above show that that is not sufficient and, therefore, the view of the learned President of the Exchequer Court that the question to be determined was whether LIFO was an acceptable accounting method for the Company is, in my opinion, incorrect. The LIFO method does not determine the Company's profits for 1947 more accurately than the FIFO method which latter, for the reasons given, is more in accordance with the known facts. The following statement by Lord Loreburn in *Sun Insurance Office* v. *Clark* [1912] A.C. 443 may, I think, be repeated with advantage:—

> "A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, viz.: that the true gains are to be ascertained as nearly as it can be done."

In the Supreme Court of Canada.

No. 2. Reasons for Judgment.

(a) The Chief Justice, *continued.*

(b) Taschereau, J.

(c) Estey, J.

The appeal should be allowed, the judgment of the Exchequer Court set aside, and the assessment made by the Appellant restored with costs throughout.

(b) **TASCHEREAU, J.**

For the reasons given by Locke, J., and Cartwright, J., I would dismiss this appeal with costs.

(c) **ESTEY, J.**

The Respondent, at its primary brass mill in Toronto, produces copper and copper-base alloys for which it requires and purchases large quantities of copper and zinc and smaller quantities of lead and tin. At all times it has on hand a quantity of these metals. In 1946, for the first time, and again in 1947 the Respondent, in preparing its income tax returns, computed the value of the inventories of these metals under the LIFO system of accounting. The Appellant refused to accept this computation and insisted that the valuation of these metals be computed, as in former years, under the FIFO system. Upon an appeal to the Exchequer Court the learned President upheld the Respondent's contention. In part, the learned President stated :

> " Under the circumstances, I find that the LIFO method was appropriate in the circumstances of the Appellant's business. This means that it was entitled to use the method in ascertaining the cost of the metal content of its finished products that was properly chargeable against its gross income for sales and that the method correctly reflects its net taxable income in 1947 and I so find. It follows that the appeal from the assessment for 1947 must be allowed."

In a business such as that of the Respondent it is, in any practical sense, impossible to precisely identify each item in its inventory and allocate to it the exact cost thereof. It is, therefore, conceded that some assumption or arbitrary method must be adopted in determining the valuation.

In 1946 the difference in the computation under the two systems was not sufficient to warrant that the proceedings in respect to that year be continued and we are, therefore, here concerned only with the year 1947. The valuation of the inventory as computed under LIFO for the year 1947 was $1,611,756·43 less than the valuation computed under the FIFO system. The older system which the Respondent used in computing its income tax returns prior to 1946, and which the Appellant in this case insists upon, is known as FIFO. Under this system it is assumed that the items in the inventory first received are the first used, or, as expressed by the letters " FIFO," first in first out.

Under the LIFO system the difference material hereto is that it is assumed the last items received are the first used. This may be illustrated by observing how the Respondent's copper inventory was computed in 1947. On January 1, 1936, the year in which the Company adopted the LIFO system, it had on hand 6,500,000 pounds of copper, the average

price of which, in 1935, was 7·5 cents per pound, a total of $487,500·00. The weight and the price of the copper added to the above 6,500,000 pounds in the subsequent years are as follows :—

Date	*Weight*	*Cost per lb.*	*Total*
Jan. 1, 1937	802,697 lbs.	9·466c	$ 75,983·30
Jan. 1, 1938	17,577 „	11·191	1,967·04
Jan. 1, 1939	639,807 „	10·443	66,847·04
Jan. 1, 1940	973,477 „	11·036	107,432·92
Jan. 1, 1946	3,151,684 „	11·5	362,443·66
Jan. 1, 1948	2,205,765 „	11·5	253,662·97

The foregoing figures show that on December 31, 1947, the total inventory of copper was 14,291,007 pounds and the cost thereof $1,355,836·93.

In the years December 31, 1939, to December 31, 1944, inclusive, as well as in 1947, the company used more copper than it purchased. In such years under the LIFO system the excess used over purchases was subtracted from the surplus in the last year in which there was a surplus. This may be illustrated by referring to the years 1946 and 1947. In 1946 the excess in the quantity purchased over that which was used was 2,936,468 pounds. In 1947 the Company used more than it purchased to the extent of 730,703 pounds. This quantity was, in the inventory, deducted from the 1946 surplus, leaving, as shown in the above table, as of January 1, 1948, 2,205,765 pounds and, of course, the earlier weights remained unchanged. The value of these 2,205,765 pounds was, therefore, computed at 11·5 cents per pound, being the average cost thereof in 1946.

The inventory of all metals, as of December 31st, 1947, computed on the LIFO basis, totalled $1,848,497·89. Mr. Gordon, who supervises the auditing of Respondents' books, when asked if this figure was either the cost or the market price of the metals, replied : " No. It is certainly not the market price—nothing to do with it—and it depends on what you mean by ' cost price.' It is ' cost ' as considered on the last-in, first-out basis." The accountants called as witnesses made it clear that the LIFO method is not intended to indicate physical flow of goods. Rather, as one stated, " it is a statement of an assumption as to the order in which costs should flow in and out of an inventory account on the calculation under this method." When asked if he would apply the same principle if it was known, as a fact, that the raw materials last in were not the first used, he replied : " In appropriate circumstances I would apply the principle because, as I indicated, I do not think that physical identification of goods has anything to do with proper determination in certain circumstances." Or, as otherwise stated, " in my opinion, first-in, first-out again is a description of a costing method and refers to the order in which items of cost recorded through the inventory account should be taken out of the inventory account." And again, " I thought I had made it clear that the question of physical identification is not, in my opinion, a factor which governs the determination of income."

In 1936 the Respondent adopted the LIFO system of accounting, but until 1946 continued to file its income tax returns as prepared under

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(c) Estey, J., *continued.*

the FIFO system because it had been informed that the Department of National Revenue would not accept returns prepared under the LIFO system.

In the years immediately preceding the war the prices of these metals, particularly copper, which constitutes 83% of the Respondent's inventory, remained rather constant. Throughout the war period and until June 10, 1947, the prices of these metals were fixed. With the increase in the price of these metals, particularly copper, the difference in the computation of the inventory under FIFO and LIFO was such that the company decided to insist upon the Appellant accepting its computation of its inventory under the LIFO system. That the difference may be substantial is evident from the fact that in 1947 the computation of the inventory arrived at under the LIFO system was $1,611,756·43 less than that arrived at under the FIFO system. Though the company computed its income tax returns in 1946 on the LIFO basis, the change in prices was not such as to make a great difference, but in 1947, as indicated by the figures, the position was entirely changed.

The issue here raised is whether, under the Income War Tax Act and the Excess Profits Tax Act, the Minister must accept returns computed under any recognised accounting system which is deemed appropriate to its business by a company, or whether the Minister in a particular case may insist upon that accounting system which will the more closely arrive at the actual value of the inventory.

Mr. Richardson stated :—

> " The question is as to what portion of the expenditure for the purchases of raw material, for labour and for manufacturing supplies, and expenses, is properly chargeable against the gross revenues from sales during the year ; and what portion is properly to be carried forward as a charge against future periods."

In order to more fully appreciate the purpose and object of the LIFO system it is of some assistance to consider the circumstances under which it was developed. Mr. Peloubet, of the accounting firm of Pogson, Peloubet and Company of New York, explained that in the years 1916 and 1917 management then using the FIFO method was disturbed not so much by the general increase but by the fluctuation in prices. As he stated :—

> " . . . what they did not like was the fluctuation and the idea : ' If we end the year with a higher price, we are going to show a terrific profit which is not there and if we end it at a low price we are going to show an apparent shortage which is not there '."

Mr. Peloubet also stated :—

> " . . . the management of the company realized in the middle and late 20's that their accounts were not on a correct profit basis, that they were not correct for dividend purposes. Of course, it

had no relation at that time to taxation because no one even thought of taxation in connection with this but the company was definitely disturbed about their profit showing and they were definitely disturbed about the amount of inventory profits that were shown."

There is no necessary conflict between a system that computes profits for dividend purposes and one that computes profits for taxation purposes, but, of course, there may be.

It is obvious that if the Respondent continues in business and to use the LIFO method of accounting for 100 or even 1,000 years and never, at any time, utilizes its entire inventory or stock of metals, the inventory will be computed as containing some copper at 7·5 cents per pound, i.e., the average price paid in 1935, or, as otherwise stated, if the 6,500,000 pounds shown in the inventory as on hand on January 1, 1936, never becomes exhausted the remaining portion thereof, whatever it may be, will be computed at 7·5 cents per pound, irrespective of what current market values may be. It is this feature that I assume Mr. Richardson had in mind when he said the longer the period the farther the inventory computation becomes from reality. He quite properly pointed out that FIFO is often far from reality because, whatever the system used, some arbitrary assumption must be made, but the problem which must be decided for taxation purposes is which of the two more nearly approaches the actual value, or market value. The respective assumptions are: under FIFO the first metals received are the first used in production and under LIFO the last metals received are the first used.

The income tax law is concerned with the commercial and industrial operations within the taxation period and with the computation of profits upon operations carried on in an exchange or market sense during that period. Therefore, an accounting system which tends to minimize fluctuations in prices and business losses and gains and, therefore, provides a more even accounting history for dividend and other purposes, may possess the greatest merit from a corporate point of view, but it does not follow that the Minister must, for taxation purposes, accept that method.

Throughout the evidence the profits shown in periods of rising prices are referred to as fictional profits and the losses in periods of falling prices as fictional losses. It is obvious that accountants, in so describing these losses are considering the interests of the company over a period of years and, as Mr. Peloubet states, such fictional profits and losses were not " correct for dividend purposes." Mr. Richardson stated :—

> " The objective is to arrive properly at profits or losses and in the sort of illustration which I gave you on Exhibits 25 and 26 it may arrive at a more stable result by avoiding the showing of fictional profits or losses ; it is not a process of levelling for the sake of levelling. There is nothing arbitrary about the process about which you could say : ' This is something which a prudent business man might feel that he should do in the interests of conservatism ' or anything of that kind."

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(c) Estey, J., *continued.*

Then, after pointing out that where physical identification is, as here, impossible, some assumed basis must be accepted, he was asked :—

> " *Q.* Well, do you agree with this, that above all any assumption adopted should not be unduly out of line with the ascertainable unquestioned physical facts ?—*A.* No. I do not agree with that, Mr. Pickup."

In fact, as Richardson stated, referring to both systems :—

> " They are not based on presumption as to the physical movement—or what we sometimes call the ' physical flow of goods through the inventory and out to customers,' but rather are indicative of the flow of costs which are employed in the method."

or, as he stated when specifically referring to LIFO :—

> " It represents rather an assumption made as to the order in which costs should flow from the inventory account into the cost of sales in the process of determining income."

It is the accountants' conception of how " costs should flow " that commends the LIFO system. They find in LIFO that over a period of years it, to a large extent, eliminates the artificial profits or losses and goes far to compute how the costs of the company should flow.

It may well be that where, as here, the inventory is neither subject to " physical determination " nor to " style changes or obsolescence " that, from the point of view of the company which is concerned with how costs should flow and dividends be paid over a period of years, LIFO is the more acceptable system of accounting. It does not, however, follow that, apart from legislation particularly directed to LIFO, its computation of the inventories must be accepted by the Minister.

The word " profits " is not defined in either the Income War Tax Act or the Excess Profits Tax Act, but it has been repeatedly defined as that surplus in the taxation period by which the receipts from a trade or business exceed the expenditures necessary for the purpose of earning those receipts. Fletcher Moulton, L.J., stated in *In re Spanish Prospecting Company, Limited* [1911] 1 Ch. 92 at 98 :—

> " The word ' profits ' has in my opinion a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respects from this fundamental signification. ' Profits ' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.
>
> . . . Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value—the value in exchange—of these

assets might have altered greatly in the meanwhile . . . A depreciation in value, whether from physical or commercial causes, which affects their realisable value is in truth a business loss."

The income tax statutes are concerned with business and commercial enterprises the assets of which possess a value to the extent that they may be used or exchanged. As stated by Fletcher Moulton, L.J., in *In re Spanish Prospecting Company, Limited, supra*, at p. 100 :—

> " The figure inserted to represent stock in trade must be arrived at by a valuation of the actual articles. Property, of whatever nature it be, acquired in the course of the business has a value varying with the condition of the market."

It is, therefore, the current commercial trading or market values that these statutes contemplate should be used in the computation of profits. If it be, from a business or commercial sense, impracticable to determine that valuation with accuracy, then that method which more closely approximates the current market value should be used.

In *Whimster & Co.* v. *The Commissioners of Inland Revenue* (1925), 12 T.C. 813, the company prepared its income tax returns and allowed for losses which it anticipated in the following year. It had, in fact, settled with one of its partners who was retiring upon the basis of that statement. It was conceded that such was not a usual method and was not " in accordance with ordinary commercial practice." Lord Clyde stated at p. 823 :—

> " In such a case the trader may, as a matter of ordinary commercial prudence, decline to treat the profits shown in his accounts in the same way as he would have done if the circumstances of his business had been liable only to the normal fluctuations of trade. He may, for instance, prefer to carry his profits forward, or put them to reserve, rather than consume or divide them. But they are none the less profits of the year or accounting period to which the accounts relate, and as such assessable to Income Tax or Excess Profits Duty . . . It is therefore nothing to the point—say, as regards assessment to Income Tax—that if a particular trader's profits were computed on an average of two years instead of three, or simply on the results of the year immediately preceding the year of assessment, an apparent profit might be turned into an apparent loss."

and at p. 825 :

> " But all this cannot affect the answer to the question : what are the actual profits made during the accounting period ? Whatever the bargain made with the retiring partner—generous or strict, fair or unfair—the question remains the same and so also does the answer."

The metals here in question do not suffer a physical depreciation in value. Their commercial or market values, however, do fluctuate from time to time. Under LIFO the current market value is used to compute the value of only that quantity assumed to be added to the inventories in

In the Supreme Court of Canada.

No. 2. Reasons for Judgment.

(c) Estey, J., *continued.*

the last year and the valuation of the balance of the inventories is computed by using the market values of former years. The assumption under FIFO eliminates many of the former years and, therefore, the computation thereunder more closely approximates the current value than that made under LIFO.

Moreover, the LIFO system is comparatively new. While the reason for its development in the early 20's, as explained by Mr. Peloubet, had no relation to taxation, it has become more widely adopted in the United States since the passage of the legislation in 1938 and 1939, permitting a company to compute its income tax returns under the LIFO system, subject to certain specified conditions. As stated by Mr. Butters :—

> " In contrast, since 1939 few management decisions on LIFO have been made without reference to their tax effects. Decisions as to whether to use LIFO how to apply it, and even as to the industries in which the method constitutes acceptable accounting practice, have been dominated by tax considerations."

The LIFO system provides an alternative method which, as illustrated in this case, may produce a valuation substantially different from FIFO. While the Income War Tax Act and the Excess Profits Tax Act contemplate that the valuation of these inventories be computed according to the recognised or accepted accounting methods, these statutes do not contemplate that a company may, from time to time, adopt that which may best serve its ends. Many companies would not, and I do not suggest the Respondent did or would, from year to year, adopt that method which would result in a lower tax. It would seem that the statutes do not provide against this possibility. Moreover, that it can be done by a company in any year without changing its accounting system is illustrated by the fact that the Respondent adopted the LIFO system in 1936 for accounting purposes, but continued to compute its income tax returns on the FIFO basis until 1946. It was no doubt such considerations which caused the United States to enact legislation in 1938 and 1939 which permitted a company to prepare its income tax returns under the LIFO system, but only upon certain conditions, which may be summarised :—

(A) The company must start with a cost inventory on the same basis as it ended its last FIFO period of cost.

(B) Once adopted the LIFO method cannot be changed without the consent of the appropriate revenue officials.

(C) The company must keep its corporate accounts on the same basis as its tax accounts.

(D) It is not a compulsory system, but a company may elect to adopt the LIFO method.

The Income War Tax Act and the Excess Profits Tax Act, 1940, do not contain any such provisions.

In my opinion the Minister was justified in refusing the Respondent's computation and requiring that the company compute its inventories upon a basis that more nearly approximated the current market value thereof.

In my opinion the appeal should be allowed with costs.

(d) **LOCKE, J.**

This is an appeal by the Minister of National Revenue from a judgment of the President of the Exchequer Court by which the appeal of the Respondent from an assessment for excess profits tax for the taxation year 1947 was allowed. While the Respondent also appealed from the assessment for income tax made in respect of the same year, we were informed that the parties had agreed that they would regard themselves in that matter as bound by the outcome of this appeal, this for the reason that the question for determination is the same in both appeals, that is, as to the amount of the taxable income of the Respondent as defined by section 3 (1) of the Income War Tax Act.

The facts disclosed by the evidence as to the manner in which the Respondent company carried on its operations are described fully in the judgment appealed from and it is unnecessary to repeat them. The Respondent operates what is described in the evidence as a primary mill producing copper and copper alloys in the form of sheets, rods and tubes for use in the manufacturing operations of motor car and other manufacturers.

It is, according to the evidence of the Manager of the Copper and Brass Research Association, a typical brass mill similar to those of the American Brass Company, of which the Canadian Company is a wholly owned subsidiary. The point to be determined is as to what is the method of inventory accounting which will most accurately determine the income of the Respondent for the year in question, as that term is defined by the Act.

It is clear from the evidence that, in view of the magnitude of the operations and the manner in which it is necessary they should be carried on, the cost of the metal content of the products sold cannot be calculated with exactness on the basis of what is referred to by the accountants as the " physical flow " of the inventory. It is also shown by the evidence that, at least as conditions were during the year 1947, there was no means by which the Respondent Company could hedge its purchases of raw material and it is the fact that, owing to the fluctuations in copper and zinc prices which took place during the year 1947, the calculation of such costs was not exact.

Neither of the statutes defines the manner in which manufacturing costs of this nature are to be calculated and, in the absence of any such direction, they are to be determined, in my opinion, upon the ordinary principles of commercial trading. My consideration of the evidence in this matter leads me to the conclusion that, in a business operation such as this, the last in first out method of inventory accounting determines what was the true income with greater accuracy than any other method which it was practical to apply.

I respectfully agree with the conclusion of the learned President of the Exchequer Court and would accordingly dismiss this appeal with costs.

In the Supreme Court of Canada.

No. 2. Reasons for Judgment.

(e) Cartwright, J.

(e) CARTWRIGHT, J.

In this appeal I agree with the reasons and conclusion of the learned President and propose to add only a few observations.

In my view the only questions of difficulty raised in this case are questions of fact. I do not disagree with any of the principles of law stated in the authorities quoted in the reasons of my Lord the Chief Justice and I do not understand the learned President to have done so. The effect of these authorities is, I think, accurately summarized in the statement quoted from the judgment of Earl Loreburn, L.C., in *Sun Insurance Office* v. *Clark* [1912] A.C. 443 at page 454 that the only rule of law is " that the true gains are to be ascertained as nearly as it can be done." Where, as in the case at bar, the dispute as to what are the true gains for a particular year centres on the question as to which of two well-recognized systems of accounting will in the case of the business carried on by the Respondent most nearly arrive at the true figure for the materials cost of its sales for such year that question is one of fact. In my opinion the evidence fully supports the findings of fact made by the learned President on this crucial question.

While I have already expressed my agreement with the reasons of the learned President, I wish to quote two paragraphs therefrom which sum up his findings and in support of which the evidence seems to me to be overwhelming :—

> " After careful consideration of the opinions of the experts I have come to the conclusion that where a manufacturing company avoids speculation or trading in its materials and makes the sales price of its finished products closely reflect the current replacement cost of their materials content and matches its purchases of materials to its sales of finished products so that the inflow of the materials equals the outflow of the materials content of the finished products and it must continuously maintain a large inventory and the rate of its turnover is slow the LIFO method of inventory accounting and ascertaining the materials cost of its sales for the year is the method that most nearly accurately reflects its income position according to the manner in which it carries on its business and is the method that ought to be applied in ascertaining the materials cost of its sales and determining its net taxable income."
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> * * * * *
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> " While I need not say more I also find that the method employed by the Minister in arriving at his assessment was not a proper one. This is not a case in which either of two accounting methods is acceptable. Only the one method, namely, the LIFO method, is appropriate. The Minister used the FIFO method in ascertaining the Appellant's materials cost of sales which left it with a much larger income than it earned. The result of this method has been to ascribe to it greater profit than could have come to it through its processing charges. The additional profit so ascribed is said to be inventory profit. The criticisms of the FIFO method mentioned by Mr. Richardson apply here. It seems plain to me that when a company so conducts its business as to avoid the risk of profit or loss through the rise or fall of its raw materials its

income position cannot be correctly determined if so-called inventory profits or losses which it has not earned or sustained are brought into its accounts. To do so is to use an accounting system that is not in accord with its business policy and practice and does not fairly reflect its income position."

In a year in which the prices of the metals used by the Respondent remain constant it is a matter of little importance so far as the result is concerned whether the FIFO or the LIFO method of accounting is used. The evidence appears to me to establish that in a year in which the prices of such metals rise or fall the LIFO method will show the true gain for the year as nearly accurately as is possible while the FIFO method will in the case of a rise show a fictitious profit and in the case of a fall show a fictitious loss.

I would dismiss the appeal with costs.

No. 3.

ORDER of Her Majesty in Council granting special leave to Appeal.

(L.S.)

AT THE COURT AT BUCKINGHAM PALACE.

The 7th day of April, 1955.

Present:

THE QUEEN'S MOST EXCELLENT MAJESTY

LORD PRESIDENT — MR. HEATHCOAT AMORY

MR. SECRETARY LENNOX-BOYD — MR. BOYD-CARPENTER

WHEREAS there was this day read at the Board a Report from the Judicial Committee of the Privy Council dated the 22nd day of March 1955 in the words following, viz.:—

"WHEREAS by virtue of His late Majesty King Edward the Seventh's Order in Council of the 18th day of October 1909 there was referred unto this Committee a humble Petition of the Minister of National Revenue in the matter of an Appeal from the Supreme Court of Canada between the Petitioner Appellant and Anaconda American Brass Limited Respondent setting forth (amongst other matters) that the Petitioner desires to obtain special leave to appeal from a Judgment of the Supreme Court of Canada (Taschereau Locke and Cartwright JJ. Kerwin C.J. and Estey J. dissenting) pronounced on the 1st November 1954 dismissing the Petitioner's Appeal from a Judgment of the President of the Exchequer Court of Canada pronounced on the 7th June 1952 allowing an Appeal

In the Privy Council.

No. 3. Order of Her Majesty in Council granting special leave to Appeal, 7th April 1955, *continued.*

of the Respondent from an assessment made for its 1947 tax year pursuant to the provisions of the Excess Profits Tax Act 1940: that on the assessment of the income tax and excess profits tax of the Respondent for the year 1947 the Petitioner increased the amount of taxable income declared by the Respondent by the sum of $1,611,756·43 as a result of reducing by that amount the cost attributed by the Respondent to the metals used by it during the year thus increasing the excess profits tax of the Respondent for 1947 by approximately $241,000 and the income tax for the same year by approximately $483,000: that the Appeal taken by the Respondent to the Exchequer Court was from the assessment of the excess profits tax (the parties having agreed that on the Appeal from the assessment of the income tax they would regard themselves as bound by the outcome of the Appeal with respect to the excess profits tax): that an important difference in principle between the parties has arisen between the two methods of determining cost of inventories of metals and cost of metals used namely the FIFO method (first-in-first-out) of the Petitioner and the LIFO method (last-in-first-out) of the Respondent: And humbly praying Your Majesty in Council to grant the Petitioner special leave to appeal from the Judgment of the Supreme Court of Canada dated the 1st day of November 1954 and for further or other relief:

"THE LORDS OF THE COMMITTEE in obedience to His late Majesty's said Order in Council have taken the humble Petition into consideration and having heard Counsel in support thereof and in opposition thereto Their Lordships do this day agree humbly to report to Your Majesty as their opinion that leave ought to be granted to the Petitioner to enter and prosecute his Appeal against the Judgment of the Supreme Court of Canada dated the 1st day of November 1954:

"And Their Lordships do further report to Your Majesty that the authenticated copy under seal of the Record produced by the Petitioner upon the hearing of the Petition ought to be accepted (subject to any objection that may be taken thereto by the Respondent) as the Record proper to be laid before Your Majesty on the hearing of the Appeal."

HER MAJESTY having taken the said Report into consideration was pleased by and with the advice of Her Privy Council to approve thereof and to order as it is hereby ordered that the same be punctually observed obeyed and carried into execution.

Whereof the Governor-General or Officer administering the Government of the Dominion of Canada for the time being and all other persons whom it may concern are to take notice and govern themselves accordingly.

W. G. AGNEW.

No. 12 of 1955.

In the Privy Council.

ON APPEAL
FROM THE SUPREME COURT OF CANADA.

BETWEEN

THE MINISTER OF NATIONAL REVENUE . . . . *Appellant*

AND

ANACONDA AMERICAN BRASS LIMITED . . . . *Respondents.*

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