Privy Council Appeal No. 12 *of* 1955

The Minister of National Revenue - - - - - *Appellant*

v.

Anaconda American Brass Limited - - - - - *Respondent*

FROM

THE SUPREME COURT OF CANADA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 13TH DECEMBER, 1955

Present at the Hearing :

VISCOUNT SIMONDS
LORD OAKSEY
LORD REID
LORD KEITH OF AVONHOLM
LORD SOMERVELL OF HARROW

[*Delivered by* VISCOUNT SIMONDS]

This appeal from a judgment of the Supreme Court of Canada which dismissed an appeal from a judgment of the President of the Exchequer Court of Canada raises a question of novelty and importance. The appellant is the Minister of National Revenue, the respondent a limited company, Anaconda American Brass Limited.

The Minister on the assessment of the respondent company to income tax and excess profits tax for the year 1947 increased the amount of taxable income declared by the company by the sum of $1,611,756.43 with the result that its excess profits tax for that year was increased by about $241,000 and its income tax by about $483,000. Against this assessment the company appealed to the Exchequer Court : the learned President of the Court allowed the appeal and, as already stated, the Supreme Court dismissed the Minister's appeal from his judgment. It is only the excess profits tax with which this appeal is concerned.

The excess profits tax is levied under the provisions of the Excess Profits Tax Act, 1940, which by section 3 provides that in addition to any other tax or duty payable under any Act there shall be assessed levied and paid a tax in accordance with the rate set out in the Second Schedule thereto upon the excess profits of every corporation or joint stock company residing or ordinarily resident in Canada or carrying on business in Canada. The rate set out in the Second Schedule is 15 per cent. of the excess profits in the case of corporations or joint stock companies. " Profits " in their case is by the same Act defined to mean for any taxation period the amount of net taxable income for the same period as determined under the provision of the Income War Tax Act. Under the latter Act income is, so far as is relevant, defined as meaning the annual net profit or gain ascertained and capable of computation as being the profits from a trade or commercial or financial or other business.

The question then is whether the Minister correctly assessed the annual net profit or gain of the company for the year 1947 or, to state the question more accurately, whether the company has established that his assessment was incorrect.

The material facts of the case are not in dispute.

The company carries on the business of purchasing metals, manufacturing them into sheets, rods and tubes and selling the manufactured metals. About 98 per cent. of the metals purchased by the company consist of copper (over 80 per cent.) and zinc (about 15 per cent.). The other principal metals are lead, tin and nickel. The prices which the company charges for its products are closely related to the prices paid by it to replace the metals used in manufacturing its products, and, when market prices of purchased metals are increased, it at once correspondingly increases the prices of its products.

The company is constantly purchasing metals to replace those that are being used. Its practice is to make an estimate at the beginning of each month of the quantity of metals which will be used during the next month and to order from its suppliers the same quantity to replace such metals. It maintains an inventory or stock of metals at all times of about one-third to one-quarter of its annual requirements so that it turns over its inventory three or four times a year. About two-thirds of the copper and zinc inventory is continuously in process in the plant: this indicates that the average time in process is about eight weeks.

The company did not keep records from which the actual metals used during the year could be identified or the amounts paid for those metals determined. But it kept records of the quantities of metals (*a*) in its inventory at the beginning of the year, (*b*) purchased during the year and (*c*) in its inventory at the end of the year. It also kept records of the prices paid for the metals purchased from time to time.

Thus in the year 1947 the company knew what stock it had in hand at the beginning, what stock it had purchased during the year, and what stock it had in hand at the end of it. It also knew what prices it had paid during the year for the metals it purchased. But it did not know and could not ascertain either in respect of all the metals which it used during the year what price had been paid for them or in respect of all the metals which it had at the end of the year what price had been paid for them. Yet in order to determine its annual profit or gain for the year 1947 it is necessary to ascribe the proper cost to the metals used and the proper cost or value to the metals remaining in stock. In the absence of knowledge an assumption or estimate must be made and it is at this stage that the difference between the parties arises.

It is convenient first to explain the manner in which the company made up its return for the year 1947, stating only by way of premise that, whereas the prices of raw materials had for some time before that year been comparatively stable, in that year, as the result of the relaxation and then the removal of war-time controls, there had been large increases of price, for example of copper on the 22nd January from 11·5 cents per pound to 16·625 cents per pound and on the 10th June to 21·5 cents per pound. It was under these circumstances that in 1947 for the first time the company made a return for income tax purposes in which a system known as L.I.F.O. or last-in-first-out was adopted. It was a system which it had used for its own corporate purposes for some time previously in respect of copper, but neither it nor any other taxpayer in Canada had adopted it for taxation purposes. It must now be briefly explained.

It must in the first place be explained that L.I.F.O. does not mean that the metal last to be received into stock is in fact the first to be processed and sold. On the contrary the actual physical flow of the raw material is regarded as irrelevant: that which was purchased in previous years and was in stock at the opening of the relevant financial year or that which was purchased during that year may have been processed and the products sold during that year: this is of no account. It is to cost that L.I.F.O. looks and in the simplest terms it means that the cost per pound of the metal most recently purchased and added to stock is the cost per pound of metal content to be charged against the next sale of processed metal products. It is the necessary corollary of this that

to the stock which is in fact in hand at the end of the year there must be attributed the cost of metal which has not yet been exhausted by the cost attributed to metal consumed; this has been called the unabsorbed residue of cost. Thus in the case under appeal the stock of copper in hand at the close of the year 1947 (the "closing inventory" as it is conveniently called) consisted of 14,291,007 pounds: and under the L.I.F.O. system it was treated as follows:—

(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 L.I.F.O. 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;

(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.

The total cost of the 14,291,007 pounds of copper in the closing inventory was thus assumed to have been $1,355,836.93 and this was the figure attributed to the closing inventory in the return for income tax. It is to be observed that the price attributed by the company to nearly half its inventory was 7·5 cents per pound, a price less than any price prevailing since 1935. The result is obvious. By attributing the higher cost to the metals processed and the lower cost to those retained in stock the company was able to show far lower profits than if it had followed the accustomed and traditional method of return. The question is whether the new method is permissible for income tax purposes.

It is necessary to emphasise the words "for income tax purposes". For a large part of the argument upon this appeal and throughout the proceedings has been devoted to showing that in Canada the L.I.F.O. method is in certain conditions a proper and generally accepted method of accountancy and that those conditions are conspicuously present in the case of the appellant company. This was the view accepted by the learned President of the Exchequer Court of Canada and by the Supreme Court. It is accepted unreservedly also by their Lordships.

The appellant Minister took the view that, however appropriate the L.I.F.O. method might be for the corporate purposes of the company, it did not truly reflect its profit for income tax purposes. He accordingly increased the assessable income by the sum of $1,611,756.43. In doing so he adopted the method known as the F.I.F.O. or first-in-first-out method which assumes that the metal first purchased is the metal first used. Upon this assumption the metal in stock at the end of the year 1947 was the metal most recently purchased, and inasmuch as it appeared that during the year 1947 the company purchased no less than 63,268,555 pounds of copper and more than 14,291,007 pounds (the quantity in the closing inventory) had been purchased at the price of 21·5 cents per pound in the last three months of the year, he determined the cost of the copper in the closing inventory at $3,072,566.50. This figure may be contrasted with the $1,355,836.93 appearing in the company's return.

At this point it is possible to define more closely the position of the parties. The Minister concedes that in the absence of physical identification some assumption about the material in fact used during the financial year must be made. He does not dispute that there may be in the closing inventory some metal which had been purchased in previous years. But he contends that the method which he has adopted attains more nearly

the result postulated by Lord Loreburn in *Sun Insurance Office* v. *Clark* [1912] A.C. 443 "that the true gains are to be ascertained as nearly as can be done". He urges that it is a principle of income tax law which has been adopted from commercial accounting practice that the values of the stock-in-trade at the beginning and end of the period covered by the account should be entered at cost or market value whichever is the lower and he says that for this purpose the actual stock in hand must be regarded and its actual cost so far as possible ascertained and that an assumption or estimate is necessary only so far as ascertainment is not possible. Upon this basis he says that the F.I.F.O. method more nearly than the L.I.F.O. method represents the facts and supports that contention by reference not only to the large purchases of metal during the last months of 1947 which can hardly have been processed during that year but also to the fact that the L.I.F.O. method involves the assumption of 6,500,000 pounds of copper purchased in or before 1936 being still in stock at the end of 1947. He says therefore that his assessment has not been displaced by any evidence that the L.I.F.O. method more nearly represents the true income of the company. He is not concerned to contend that the company (or some other taxpayer) may not be able to establish that some other method than F.I.F.O. more accurately represents the income for tax purposes where the raw material used is homogeneous and no substantial part of it can be identified. Nor is it necessary for their Lordships to determine whether some other method, as for instance the "average cost" method, may not in some circumstances be properly adopted for tax purposes. What the Minister urges is that the L.I.F.O. method does not more nearly than F.I.F.O. produce the true income in the present case and that is the question for their Lordships' decision.

The company on the other hand contends that, inasmuch as the Income War Tax Act does not contain any definition of "annual net profit or gain" nor any directions how profits or cost of sales are to be ascertained, these matters can only be determined by the application of ordinary commercial principles except where such principles are expressly excluded by the Act. It then says that it is a question of fact what are ordinary commercial principles and that the learned President of the Exchequer Court has found as a fact, and the majority of the Supreme Court has concurred in his finding, that the companys' return had been made in accordance with those principles. The contention in short is that annual income for income tax purposes is determined by accepted accountancy practice unless the Act otherwise provides, and that in the present case the learned President has found not only that L.I.F.O. was an acceptable accounting method but that it was the most acceptable method and that the method adopted by the Minister was not a proper one.

These contentions of the company have been in their Lordships' opinion rightly rejected by the minority of the Supreme Court (Kerwin C.J. and Estey J.). The income tax law of Canada as of the United Kingdom is built upon the foundations described by Lord Clyde in *Whimster and Co.* v. *C.I.R.* 12 Tax Cases 813 in a passage cited by the Chief Justice which may be here repeated. "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 ascertaining that difference must be framed consistently with 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." For many years before

and ever since this decision what is to be valued at the beginning and end of the accounting period has for tax purposes been taken to be the actual stock so far as it can be ascertained. It is in fact, so far as tax law is concerned, a novel and even revolutionary proposal that the physical facts should even where they can wholly or partly be ascertained be disregarded for the purpose of the opening and closing inventory and a theoretical assumption made which is based on a supposed "flow of cost" and an "unabsorbed residue of cost". An expert witness called for the company observed that he did not imagine any of the company's witnesses would claim for a minute that there was a quantity of metal then on hand acquired in the year 1936 equal to the quantity which was valued at the then cost. Yet there was no less than six and a half million pounds of copper in the 1947 closing inventory to which the 1936 cost was ascribed. He might have added that year by year the same thing would happen so long as the business went on and existing stocks were not seriously diminished: in 1987 as in 1947 the closing inventory would carry stock to which 1936 costs would be ascribed. This illustrates clearly the L.I.F.O. method and shows how far it has travelled from the conception which has prevailed in the assessment of income for tax purposes.

It was strongly pressed by the respondent that in dealing with homogeneous material the actual user test, if it could be applied by identification of parcels purchased at varying prices, would lead to capricious and illogical results. Assuming that this is so and that actual user should not in some cases be regarded as the final test, this does not in their Lordships' opinion establish the case for L.I.F.O. It might be that in such cases, though their Lordships do not decide it, the average cost method could properly be adopted, for that method like the F.I.F.O. method brings in to the account the cost of every purchase in its order. But the present case shows that under the L.I.F.O. method, if the business continues and stock is carried forward, substantial purchases may never come into the profit account at all.

Their Lordships do not question that the L.I.F.O. method or some variant of it may be appropriate for the corporate purposes of a trading company. Business men and their accountant advisers must have in mind not only the fiscal year with which alone the Minister is concerned. It may well be prudent for them to carry in their books stock valued at a figure which represents neither market value nor its actual cost but the lower cost at which similar stock was bought long ago. A hidden reserve is thus created which may be of use in future years. But the Income Tax Act is not in the year 1947 concerned with the years 1948 or 1949: by that time the company may have gone out of existence and its assets been distributed. Seventy years ago Lord Herschell said in ***Russell*** v. *Town & County Bank* (13 A.C. 418 at p. 424) "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". This is only one of many judicial observations in which it is implicit that no assumption need be made unless the facts cannot be ascertained and then only to the extent to which they cannot be ascertained. There is no room for theories as to flow of costs: nor is it legitimate to regard the closing inventory as an unabsorbed residue of cost rather than as a concrete stock of metals awaiting the day of process. It is in their Lordships' opinion the failure to observe, or, perhaps it should be said, the deliberate disregard of, facts which can be ascertained and must have their proper weight ascribed to them, which vitiates the application of the L.I.F.O. method to the present case. It is the same consideration which makes it clear that the evidence of expert witnesses, that the L.I.F.O. method is a generally acceptable, and in this case the most appropriate, method of accountancy, is not conclusive of the question that the Court has to decide. That may be found as a fact by the Exchequer Court and affirmed by the Supreme Court. The question remains whether it conforms to the prescription of the Income Tax Act. As already indicated, in their Lordships' opinion it does not.

The history of the adoption of the L.I.F.O. method in Canada by the company and presumably by other companies is of some interest. The method appears to have originated in the U.S.A. and there to have been adopted by an American corporation which was the parent of the respondent company some time before 1938. But it was only by an amendment of the existing revenue law that it was in that year permitted to be adopted for tax purposes. In 1939 further amendments were made and the method is now permitted subject to statutory conditions which are summarised in the judgment of Mr. Justice Estey in the Supreme Court. The many differences which exist between the revenue laws of the U.S.A. and Canada do not permit too much weight to be given to the fact that it is sought to do in Canada without legislation what in the U.S.A. is only permissible with statutory safeguards. But it at least supports the view that new theories of accountancy though they may be accepted and put into practice by business men, do not finally determine a trading company's income for tax purposes. Again, though their Lordships recognise that this appeal must be determined by reference to Canadian law, they notice that in the U.S.A. in a case in which the so-called " base stock " method was under discussion Mr. Justice Brandeis used words which are apt to describe the L.I.F.O. method also. " In years of rising prices the base stock method causes an understatement of income: for it disregards the gains actually realised through liquidation of low price stock on a high price market. . . . This method may like many reserves which business men set up in their books for their own purposes serve to equalise the results of operations during a series of years . . .": see *Lucas* v. *Kansas City Structural Steel Co.* 280 U.S. S.C.R. 263 at p. 265. In this passage the distinction is nicely made between what is permitted for tax purposes and what prudent business men may think fit to do.

So also in the United Kingdom, an attempt has been vainly made to uphold the base stock method for income tax purposes. In the recent case of *Patrick* v. *Broadstone Mills Ltd.* (1954 1 W.L.R. 158) Lord Justice Singleton in words that are equally apt, if applied to the L.I.F.O. method, declined to accept the base stock method as conformable to income tax law, though it might be approved by accountancy practice.

In the result their Lordships are of opinion that this appeal must be allowed, the judgments of the Supreme Court and the Exchequer Court set aside and the appeal of the respondent company from the Minister's assessment rejected and they will humbly advise Her Majesty accordingly. They repeat that they have reached this conclusion not because they dissent from any finding of fact by the learned President of the Exchequer Court of whose lucid and exhaustive judgment no criticism can from this aspect fairly be made but because his findings of fact do not offer a complete solution of the question.

The respondent company must pay the costs of this appeal and of the proceedings in the Courts of Canada.

(39584) Wt. 8064—69 150 1/56 D.L.

In the Privy Council

THE MINISTER OF NATIONAL REVENUE

v.

ANACONDA AMERICAN BRASS LIMITED

DELIVERED BY VISCOUNT SIMONDS

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