TAX FOR THE Owner-Manager

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Valuing Inventory: Legal Analysis Overrules GAAP

Yorkwest Plumbing Supply Inc. v. The Queen (2020 TCC 122) addressed the narrow technical question of whether the Act permits a taxpayer to write down and/or deduct the value of inventory in a taxation year after the goods are sold. The unfortunate facts that gave rise to this case are relatively simple. The appellant was a CCPC that supplied plumbing equipment to contractors in the greater Toronto area. Until March 1, 2009, the appellant used a periodic system for tracking inventory; it transitioned to a modern "perpetual" system effective after that date. A periodic system requires that inventory be counted manually at regular intervals—typically, at the end of every year. In contrast, a perpetual system takes into account the cost of the goods sold as they are sold.

This otherwise helpful development for the appellant gave rise to a tax dispute by virtue of the appellant's purchasing of $1,294,623 of inventory from its suppliers immediately before March 1, 2009 (the date of transition to the new inventory system). Because the purchases occurred before the transition date, they were not included in the database of the new perpetual system, and invoices for the goods could not be paid out of the new system. This technical problem was resolved by the creation of an independent "orphan account," which used an accounts payable number from the old system, but which was not integrated into the new system.

The new perpetual inventory system thus was operating only with partial information: it was tracking revenue associated with the sales of the purchased inventory in the orphan account, but it was not accounting for the corresponding cost. Most of the inventory in the orphan account was sold in the appellant's 2010 taxation year, although some was sold in its 2011 taxation year. By the time the appellant's 2012 taxation year had begun, most of the inventory in the orphan account had been sold.

Because the appellant's management was preoccupied with other matters, the orphan account was neglected until the summer of 2012. As a result, the appellant's income was overstated for its 2010 and 2011 taxation years.

The appellant considered restating its income for the 2010 and 2011 fiscal years, but it decided against this approach in view of the technical demands and time commitment. After the orphan account was discovered in the summer of 2012, there was still time for the appellant to file an amended return for its 2010 taxation year, but the management decided not to do so. To address the overstatement of income, the appellant made a "compensatory adjustment" in respect of its 2012 taxation year. The adjustment had two aspects: (1) writing down the value of an asset (the inventory) by $1,294,623, and (2) adding the same amount to the cost of purchases made in the 2012 taxation year. Thus, in respect of its 2012 fiscal year, the appellant understated its income by $1,294,623. The overstatement was discovered by the minister during an audit. On April 1, 2015, the minister reassessed the appellant's net income for its 2012 taxation year by $1,294,623 (reflecting a reversal of the compensatory adjustment). The question before the TCC was whether the appellant was entitled to make this compensatory adjustment.

The appellant had retained an accounting expert who opined that when a material error is discovered that affects prior periods, GAAP requires a retrospective adjustment of the periods affected by the error. However, she further said that GAAP makes an exception when a retrospective adjustment would be impracticable. Therefore, in the expert's view, the adjustment was consistent with GAAP.

The TCC considered whether the appellant was entitled to write down the value of its inventory in a taxation year after the goods were sold or to deduct the cost of its inventory in a year after the goods were sold. The court began by reviewing the relevant statutory provisions—in this case, subsections 9(1) and 10(1). Subsection 9(1) deals with the general computation of a taxpayer's income from a business, and subsection 10(1) mandates the valuing of inventory at the lesser of cost and FMV at the end of the year, allowing a writedown of inventory in certain circumstances.

With respect to the question of whether inventory can be written down in a year after the goods were sold, the court noted that subsection 248(1) provides that "inventory" constitutes goods available for sale in the year, not goods sold in an earlier year (an interpretation supported by *Friesen v. Canada*, 1995 CanLII 62 (SCC)).

Relying on *CDSL Canada Limited v. Canada* (2008 FCA 400), the TCC held that a writedown of inventory must occur pursuant to subsection 10(1) and not pursuant to section 9. In *CDSL*, the FCA held that subsection 10(1) is "a mandatory provision that rules out the general application of section 9 regarding the valuation of inventory." Thus, the fact that GAAP may have permitted the writedown was irrelevant because section 9 had no application to the case at bar. The TCC further held that subsection 10(1) only allows a writedown of "inventory," which

is defined to mean goods that are held for future sale. Because the appellant had written down goods that had already been sold and not goods that were held for sale, it was not entitled to write down its inventory pursuant to subsection 10(1).

The TCC then turned to the question of whether the appellant was entitled to deduct the cost of inventory in a year after the year in which the goods were sold. The court held that the appellant could not do so. It cited subsection 9(1), which requires the determination of the gross profit (revenue less cost of goods sold in the year) from the business for the taxation year. The court cited *Minister of National Revenue v. Shofar Investment Corporation* (1979 CanLII 177 (SCC)), in which the SCC held that the cost of goods sold was computed by adding "the value placed on inventory at the beginning of the year to *the cost of acquisitions of inventory during the year*, less the value of inventory at the end of the year" (emphasis added by TCC).

Thus, the TCC confirmed the case-law principle requiring that the cost of inventory be recognized only in the year in which the inventory is sold: the appellant was not entitled to deduct the inventory that formed part of its orphan account in its 2012 taxation year because the inventory had not been sold in that year.

Finally, the appellant argued that on the basis of *Canderel Ltd. v. Canada* (1998 CanLII 846 (SCC)), the compensatory adjustment generated an accurate picture of the appellant's profit for the year. The court held that the appellant was relying on a false premise—that the goods purchased immediately before March 1, 2009 were actually purchased in 2012—and that "[a] false premise cannot possibly form the basis of an accurate picture of income for the year for purposes of subsection 9(1) of the Act." The court concluded by noting that the appellant had "run headlong" into the relevant statutory provisions and case law; although the court was not unsympathetic to the appellant's predicament, it observed rather wryly that "[i]n tax law, timing matters."

This case serves as an important reminder that tax rules can often be harsh and that reasonable commonsense adjustments to address good-faith errors by taxpayers will often not survive a rigorous application of the law. While the TCC's decision and the minister's assessment are technically correct, the result is a windfall for the Crown and is arguably unfair. It raises an interesting question: how should our tax system address situations in which there is a clear tension between an equitable outcome and a technically correct outcome? An answer to that question is outside the scope of this article; however, some form of discretionary fairness rule that allows a deviation from the technical rules when justice demands it may be worthy of consideration.

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