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LIFO-Cost of Inventory Under the Income Tax Act

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LIFO—Cost of Inventory under The Income Tax Act

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The obstacles in the path of applying modern accounting methods to the computation of income for tax purposes are of real and important concern. One such problem, which is the subject of this article, is the method of costing inventory for tax purposes. In most businesses it is almost impossible to precisely identify each item in its inventory and to allocate to it an exact cost, and therefore some arbitrary method must be adopted. Of the major methods of costing inventory recognized by accountants, LIFO (last in first out) seems to be the only one objected to by the Minister of National Revenue for tax purposes.

The problem is more easily stated than solved. Accounting methods and accepted commercial practice have changed radically in the last thirty years. The Balance Sheet, formerly the most important of the annual financial statements has been downgraded in favour of the Statement of Profit and Loss. The refusal of the courts to accept LIFO in determining income appears to be based on earlier judicial decisions which in turn were predicated on the generally accepted commercial practice of emphasising the Balance Sheet. The present *Income Tax Act*[1] recognizes many exceptions to the principle of regarding the income tax year without reference to previous or subsequent years, i.e. the provisions allowing the farmer to average his income over five years and the loss carryovers permitted taxpayers by the Act. As prices for the businessman can fluctuate as violently as the weather for the farmer, perhaps our present situation should also qualify as an exception to avoid the inequity of taxing, in some businesses, fictional paper profits on inventory perhaps never to be realized. The specific problem here then merges with the larger one of whether accepted commercial and accounting methods will be adopted in determining income for tax purposes.

The relevant sections of the *Income Tax Act* are Sections 14(2) and Section 139(1)(w):

> Section 14. "For the purpose of computing income the property described in an inventory shall be valued at its cost to the taxpayer or its fair

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

market value, whichever is lower, or in such other maner as may be permitted by regulation."
Section 139(1)(W). "'inventory' means a description of property the cost or value of which is relevant in computing a taxpayers' income."

The only regulation issued provides that "for the purpose of computing the income of a taxpayer from a business:

(a) all the property in the inventory may be valued at the cost to the taxpayer, or

(b) all the property in the inventory may be valued at the fair market value."[2]

The taxpayer may thus value his inventory at cost, market, or perhaps a combination of the two, but nowhere in the Act is "cost" or "market" defined. The Income Tax Department has recognized that the average cost and FIFO (first in first out) methods of determining the cost of inventories are appropriate for income tax purposes. However, it has not been prepared to accept the LIFO (last in first out) method. In *M.N.R. v. Anaconda American Brass Ltd.*,[3] it was held by the Privy Council, reversing judgments of the Exchequer Court,[4] and the Supreme Court of Canada,[5] that the LIFO method was not appropriate in determining income under the *Income War Tax Act.*[6] I shall return to this decision but first I would like to briefly discuss the meaning of "cost".

It is generally accepted commercial and accounting practice that where, as in most types of businesses, it is impossible to ascertain the specific cost of items in an inventory, some assumption is necessary for the purpose of determining the cost of inventory on hand at the end of any year. The most authoritative statement from an accounting point of view in Canada on the meaning of "cost" as used in inventory valuation is to be found in Bulletin No. 5 of the Canadian Institute of Chartered Accountants. The most common and widely accepted of these assumptions are:

1. *Average Cost*

Under this method the cost of each item of a particular type which is on hand at the end of the year is taken to be the weighted average of the cost of all such items which were (a) on hand at the beginning of the year, and (b) acquired during the course of the year.

2. *FIFO (first in first out)*

If this method is used the items first purchased are assumed to have been disposed of first and the cost of the inventory on hand at the end of the year is considered to be the cost of the items most recently acquired.

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[2] Dominion Income Tax Regulations, Part XVII, s. 1800.
[3] [1956] A.C. 85.
[4] *Anaconda American Brass Ltd. v. M.N.R.*, 52 DTC 1111.
[5] *M.N.R. v. Anaconda American Brass Ltd.*, 54 DTC 1179.
[6] R.S.C. 1927, c. 97.

3. *LIFO (last in first out)*

Under this method, generally speaking, the last items acquired are assumed to have been disposed of first and the cost of the items on hand at the year end is considered to be the cost of the same number of items first acquired.

The choice of methods to be employed depends on the type of business and the following general rule was stated in Bulletin No. 5 of the Canadian Institute of Chartered Accountants:

> "The method selected for determining cost should be one which results in the fairest matching of costs against revenues regardless of whether or not the method corresponds to the physical flow of goods. Thus if the selling price of the finished products varies currently with the price of the raw material, the LIFO method of cost determination may be appropriate even though the goods first received are those first disposed of."

The above principle has been recognized by The Canadian Institute of Chartered Accountants and the American Institute of Accountants.

LIFO is also recognized as appropriate in a business which has a large investment in inventory consisting of a few basic materials and a relatively stable inventory. If prices of the materials in the inventory are subject to wide price fluctuations LIFO is essential to arrive at a realistic profit picture for the year.

LIFO commends itself to accountants because it shows how costs not physical goods should flow, and over a period of years it eliminates the artificial profits and losses to a large extent. The questions remain then whether physical identification is a factor which governs the determination of income and whether the Minister can insist upon the accounting system which will more closely arrive at the actual inventory.

Legislation in the United States[7] enacted in 1938 and 1939 permitted a company to prepare its income tax returns under the LIFO system upon certain conditions which may be summarized as follows:

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

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

(iii) The Company must keep its corporate accounts on the same basis as its tax accounts.

(iv) It is not a compulsory system, but a Company may elect to adopt the LIFO method.[8]

The Privy Council in the *Anaconda* case took notice of several American decisions where the "base stock" method was considered and held unacceptable for income tax purposes. Any analogy between this method and LIFO is slight, for although they are similar in purpose, the techniques are radically different. The base

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[7] Int. Rev. Code of 1939, s. 22.
[8] *Ibid.*, s. 22(d)

stock system of valuing certain process stock at a fixed figure and not at cost or market value is not correct for income tax purposes.[9] LIFO and the "base stock" methods then cannot be treated as the same or even very similar.

The Minister's objection to LIFO appears to be the fact that the use of this method creates a hidden reserve. There is truth in this, but in a period of falling prices the FIFO method which the Minister accepts would also create a hidden reserve. Under the FIFO and average cost methods, where prices have risen during the year in question, the closing inventory will be valued at a higher amount per unit than the opening inventory, thus increasing the taxable income for the year. Conversely, the use of LIFO in a period of rising prices, decreases the value of the closing inventory, increases the cost of goods sold and thus reduces taxable income for the year. It thus can be argued that in a period of fluctuating prices, the LIFO method results in a more accurate determination of income earned during the year whereas the FIFO and average cost methods result in improperly inflating or deflating the income of the business by reason of increases or decreases in the rate at which the basic inventory of the business is valued. LIFO then matches the current cost of raw materials to current sales and gives a truer determination of the year's income in most businesses. Income determined under the FIFO method contains inventory profits which, of course, will fluctuate up or down from year to year.

The decision of the Privy Council in the *Anaconda* case constitutes an endorsement of the FIFO method and suggests without deciding the matter that in certain cases the average cost method could properly be adopted. The company in this decision was a wholly owned subsidiary of a United States parent company producing copper and other alloys. The parent company used the LIFO method initially for its own internal purposes in 1936 and in 1946 it filed its income and excess profits tax returns on this method.

The Exchequer Court, the Supreme Court of Canada and the Privy Council, all agreed that in Canada the LIFO method is in certain conditions a proper and generally accepted method of accountancy and that those conditions are conspicuously present in the instant case. The Minister contended that however appropriate the LIFO method might be for the corporate purposes of the company it did not truly reflect its profit for income tax purposes and accordingly assessed the company on the FIFO method. The President of the Exchequer Court in reversing the Minister's decision not only recognized the LIFO method as an acceptable and recognized inventory accounting method in the circumstances that are appropriate to it, but also he stated:

> "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 the case in which neither of two accounting methods is acceptable. Only the one method, namely the LIFO method, is appropriate."[10]

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[9] See *Patrick v. Broadstone Mills*, [1954] 1 All E.R. 163.

[10] *Anaconda American Brass Ltd. v. M.N.R.*, 52 DTC 1111, at p. 1126.

Thus it would appear that in the absence of specific statutory provisions or judicial guidance as to the proper method of computing inventory values, the Minister has no right to enforce upon a taxpayer the method of his choice. The taxpayer has a right to rely upon that method which accepted accounting principles prescribes as most suitable to his particular facts and circumstances. This is evidenced by the court's remarks:

> "To put it in other phraseology . . . The method that ought to be selected is the one that is in accord with the Company's genius of profit-making and most nearly accurately reflects its income position according to the manner in which it carries on its business."[11]

In dealing with the objection that LIFO creates "a hidden reserve" the Court stated:

> "The objection is due to a misconception of the true nature of the closing inventory."[12]

In evidence one of the expert witnesses stated that "the closing inventory is not to be regarded as an asset to be valued but rather as a residue of unabsorbed costs incurred in the past but applicable to the future to be charged against the gross income of a future period."[13] Thorson P. stated:

> "The FIFO method is not based on any assumption of a physical flow of goods out of stock in the order in which they were received into it, but on an assumption of a flow of cost factors namely that the cost of the items of goods first in will be regarded as the cost of the items first out."[14]

The President further held that where a manufacturing company avoids speculating 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 materials equals the outflow of the materials content of the finished products and it continuously maintains a large inventory and the rate of its turnover is slow, the LIFO method of inventory accounting is the method that most nearly accurately reflects its income position according to the manner 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.[15]

The Supreme Court of Canada, on the appeal, upheld the findings and conclusions of the Exchequer Court in a three to two decision.[16] In confirming the use of LIFO the Court has shown that it is well aware of the implications inherent in modern accounting theory. Locke J. states:[17]

> "Neither of the statutes (*Income War Tax Act and the Excess Profits Tax Act*) defines the manner in which manufacturing costs of this nature

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11 *Ibid.*, at p. 1122..
12 *Ibid.*, at p. 1124.
13 *Ibid.*, at p. 1124.
14 *Ibid.*, at p. 1119.
15 *Ibid.*, at p. 1126.
16 *M.N.R. v. Anaconda American Brass Ltd.*, 54 DTC 1179.
17 *Ibid.*, at p. 1188.

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."

Cartwright J. takes this further and states:[18]

"In my view the only question of difficulty raised in this case are questions of fact . . . 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 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 the bar, the dispute as to what are the true gains for a particular year centers on the question as to which of the 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 material 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 of this crucial question."

The dissenting judgments were apparently founded on the objection that LIFO is based upon an accounting assumption and not necessarily a fact. The two dissenting judgments tended to confirm the method which most closely follows a physical flow of the inventory. The Chief Justice held that even though LIFO is recognized as a proper accounting method for corporate purposes, this is not sufficient and it does not determine the company's true profits since the first in first out method is more in accordance with the known facts. Estey J., also dissenting, states:[19]

". . . but the problem which must be decided for taxation purposes is which of the two more nearly approaches the actual value or market value."

It is submitted that this is not the real issue in question. The proper question is the determination of the true profit of the business for the year for income tax purposes within the meaning of Sections 3 and 4 of the Income Tax Act.

The Privy Council reversed the Exchequer Court and the Supreme Court of Canada and followed the minority of the Supreme Court of Canada.[20] Their Lordships accepted LIFO as a proper accounting method and appropriate in the instant case but found the real issue to be whether LIFO was permissible for income tax purposes or whether this method most correctly reflected income within the structure of the Canadian income tax law. The view that LIFO is based upon an accounting assumption and not necessarily a fact and that it does not truly reflect the company's profit for income tax purposes, was accepted by the Privy Council. Their Lordships appear to accept the view of the Minister of National Revenue, which view it was held approximated more closely the result postulated in very general terms by Lord Loreburn in *Sun Insurance Office v.*

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[18] *Ibid.*, p. 1188.
[19] *Ibid.*, p. 1185.
[20] *M.N.R. v. Anaconda American Brass Ltd.*, [1956] A.C. 85.

Clark,[21] i.e. that a true profit for income tax purposes is reached by applying the tried and true method of determining the cost of goods by the first in first out method of inventory valuation. This is indicated by the following statement:

> "For many years before and ever since this decision (*Whimster & Co. v. C.T.R.* 12 T.C. 813), what is to be valued at the beginning and end of the accounting period has for tax purposes to be 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 upon a supposed "flow of cost" and "unabsorbed residue of cost."[22]

The Privy Council seems to rely on the same decision (*Sun Insurance Office v. Clark*),[23] that one of the majority judges relies on in the Supreme Court of Canada.[24] This decision gives unqualified approbation to ordinary principles of accountancy but the Privy Council uses the broad definition of profits found therein to sanction one and reject another of two then recognized and accepted accounting methods of costing inventory. The Privy Council adds to this the concept that income tax is an annual affair and Their Lordships stated they were not concerned with the profits of the company before or after the year of the charge for by that time the company may have gone out of existence and its assets have been distributed. Section 85(e) of the present *Income Tax Act* perhaps outdates this argument by providing for the inclusion of inventory sold by a taxpayer disposing of or ceasing to carry on a business or part of a business, as income of the last taxation year in which the taxpayer carried on business. The Privy Council further stated:

> "Seventy years ago Lord Herschell said in *Russel v. Town and County Bank* 13 App. Cas. 418 at 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. 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 LIFO method to the present case. It is the same consideration which makes it clear that the evidence of expert witnesses that the LIFO method is a generally acceptable and in this case the most appropriate method of accounting is not conclusive of the question that the Court has to decide. That may be found as a fact by the Exchequer Court and approved 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."[25]

A disturbing feature of the *Anaconda* decision was the insistence on a "balance sheet" or "statement of affairs" approach to income

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12 [1912] A.C. 443, at p. 450.

22 *M.N.R. v. Anaconda American Brass Ltd.*, [1956] A.C. 85 at p. 101.

23 [1912] A.C. 443.

24 *M.N.R. v. Anaconda American Brass Ltd.*, 54 DTC 1179 at p. 1188 per Cartwright J.

25 *M.N.R. v. Anaconda American Brass Ltd.*, [1956] A.C. 85 at p. 102.

determination. The one important matter appeared to be to ascertain the "facts" or "physical reality" of the inventory and any conflicting facts dealing with a proper flow of costs to be matched against revenues earned over a period of time was treated as mere theorizing and was disregarded.

It should be observed that the decision of the Privy Council in the *Anaconda* case was based on the *Income War Tax Act*,[26] which did not contain any provision comparable to Section 14(2) of the present Act or the regulations passed thereunder. Furthermore, the *Income War Tax Act* did not contain a provision such as Section 4 of the present Act which provides that subject to the other provisions of Part I of the Act, income for a taxation year from a business or property is the profit therefrom for the year. Neither Section, however, defines inventory "cost" or "profit" so the position would appear to be much the same now as under the *Income War Tax Act*. It is possible that enunciation of the valuation of closing inventory by statute or regulation is not favoured due to the hazards inherent in a rigid statutory definition, but a great deal of flexibility in the administration of the Act would seem to have disappeared with the repeal of Section 14(1) of the *Income Tax Act* in 1958, under which any method of computing income by a taxpayer once accepted by the Minister, must be used in subsequent years unless permission by the Minister is obtained to change the method adopted. The Minister is no doubt bound by the *Anaconda* decision to reject LIFO in establishing income subject to tax and if it is felt that our Supreme Court is bound to follow the Privy Council's judgment then the only way to remedy this unsatisfactory state of affairs is by amending legislation.

Presumably the Supreme Court of Canada is the court of last resort for this country since the abolishment of civil appeals by the Privy Council in 1949. Does the principle of *"stare decisis"* require our Supreme Court to follow the decision of the Privy Council in the *Anaconda* case? An affirmative answer to this proposition would appear to be contrary to the concept of a court of last resort. In *Woods Manufacturing Company Limited*,[27] the Chief Justice had this to say:[28]

> "It is fundamental to the due administration of justice that the authority of decisions be scrupulously respected by all courts upon which they are binding. Without this uniform and consistent adherence the administration of justice becomes disordered, the law becomes uncertain and the confidence of the public in it undermined. Nothing is more important than that the law as pronounced including the interpretation by this Court of the decisions of the Judicial Committee should be accepted and applied as our tradition requires. . . ."

The suggestion from these words is that the Supreme Court is free to interpret the decisions of the Privy Council while according these pronouncements strong persuasive authority. Any other state of affairs would appear inconsistent with the present position of our Supreme Court. Also, how persuasive or binding should a previous

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26 R.S.C. 1927, c. 97.
27 [1951] S.C.R. 504.
28 *Ibid.*, at p. 515.

decision of the Supreme Court be on the same court now that it is the court of last resort even though it was then over-ruled by the Privy Council? Perhaps it is beyond the realm of probability that the Supreme Court in considering another case on LIFO would distinguish the *Anaconda* case on the basis that times have changed and so have the methods of measuring income.

In 1955 the United Kingdom Royal Commission on the Taxation of Profits and Income under the chairmanship of Lord Ratcliffe, one of the distinguished law lords of the Privy Council, stated:

> "There is nothing in the tax code itself that prescribes any rules for ascertaining the basis of cost or for valuing stock in trade. The presumption is that such rules are to be extracted from trade practice and the principles of commercial accountancy."[29]

The Commission found no special sanctity in the FIFO method, it being no more than an estimate, and it appeared that other methods could be used with equal propriety for ascertaining commercial profits. The Commission recommended therefore that different businesses should be free, with suitable safeguards, to adopt the method which best suited their particular commercial needs.

After the war Japan experienced a period of rapid inflation. The wholesale price index of a variety of commodities rose astronomically. An example is the index of metal and metal products. Taking 1948 as a base year (100) the index was 358.8 in 1950, 637.6 in 1951 and 575.9 in 1952. It will be seen that in these circumstances a strict adherence to FIFO was ridiculous and in 1950 with the revision of the Tax Law,[30] Japan introduced and permitted the use of a form of LIFO. It is hoped that no such extreme price advances are required to underline the necessity of accepting LIFO for tax purposes in this country.

The following schedule it is hoped will illustrate the possible extremes attendant upon the use of FIFO in a period of rising prices. The only variable will be the above mentioned metal price indices in Japan. In order to keep other factors constant, the following assumptions will be made:

(i) 1,000,000 units of the product were sold in each year;

(ii) 1,000,000 units of raw material were purchased in each year;

(iii) The increase in the cost of purchase is added in each year to the selling price;

(iv) Expenses are kept constant each year at $800,000;

(v) Income Tax rate remains constant at 50%;

(vi) Purchases are valued at the average at the opening and closing price indices for the year.

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29 (1956), The Canadian Chartered Accountant, at p. 300.
30 (1954), Canadian Tax Journal, at p. 315.

SCHEDULE

	1948	1950		1951		1952	
		FIFO	LIFO	FIFO	LIFO	FIFO	LIFO
SALES	$2,000,000	3,229,400	3,229,400	5,917,400	5,917,400	7,002,900	7,002,900
Opening Inventory	1,000,000	1,000,000	1,000,000	2,294,000	1,000,000	4,982,000	1,000,000
Purchase	1,000,000	2,294,000	2,294,000	4,982,000	4,982,000	6,067,500	6,067,500
Closing Inventory	1,000,000	2,294,000	1,000,000	4,982,000	1,000,000	6,067,500	1,000,000
Gross Profit	1,000,000	2,229,400	935,400	3,623,400	935,400	2,020,900	935,400
Expenses	800,000	800,000	800,000	800,000	800,000	800,000	800,000
Net Profit Before Taxes	200,000	1,429,400	135,400	2,823,400	135,400	1,220,900	135,400
Tax (50%)	100,000	714,700	67,700	1,411,700	67,700	610,450	67,700
Net Profit After Taxes	100,000	714,700	67,700	1,411,700	67,700	610,450	67,700

It may be seen from the above schedule that the income subject to taxation varies with the method used in costing the closing inventory. Although an extreme example, it serves to point up the increased tax burden that some taxpayers must bear merely because their business operations necessitate a large investment in inventory. Such a taxpayer in a period of rising prices is at a distinct disadvantage and the injustice of the matter is no less prevalent in Canada than elsewhere. Although price advances in Canada have not been inflationary, none the less, there has been a steady rise in prices in the last number of years. Examining the cash position of our hypothetical concern, in 1951 under the FIFO method of valuation, it should be noted that of the $5,917,400 received from sales, $2,688,000 cash would be required to finance the constant inventory figure of 1,000,000 units, $800,000 would be paid out for expenses and $1,411,700 for income taxes, leaving a cash account of $1,017,700. It may readily be assumed that expenses would increase during this period, but this would only be offset by decreased taxes in the amount of 50% of such increased expenses. The possible result is that the concern would be required to borrow cash to pay its taxes and in effect would be subsidizing the government on its credit. This could hardly be said to be the intention of the legislators.

LIFO in Canada then is in a vacuum. The legislature is inactive perhaps because of the dangers of too rigid a definition of cost and/or the expectation that the court will alleviate the situation. The courts on the other hand might be quite hesitant to overrule the recent Privy Council decision on this point. In the absence of statutory definition what then is to assist the court in defining "profit" under Section 4 of the present Income Tax Act? Surely it is the test of commercially accepted trading and accounting methods not of thirty years ago but of today. No question of tax avoidance enters into the argument at all; LIFO can cut both ways, beneficial on occasion and prejudicial on other occasions. An interesting illustration of this is the *Anaconda* case itself. Had the Minister accepted the Supreme Court's decision and applied LIFO in that case he would have collected substantially more revenue in subsequent years due to the sharp decrease in the market price of the metal mainly concerned, namely copper.