



Ottawa, Friday, August 31, 1990

Appeal No. AP-89-016

IN THE MATTER OF an application heard on March 6, 1990, pursuant to section 81.19 of the *Excise Tax Act*, R.S.C., 1985, c. E-15;

AND IN THE MATTER OF a Notice of Decision of the Minister of National Revenue dated December 2, 1988, with respect to a Notice of Objection filed pursuant to section 81.17 of the *Excise Tax Act*.

BETWEEN

SILVAN NATURAL SPRINGS LIMITED

Appellant

AND

THE MINISTER OF NATIONAL REVENUE

Respondent

DECISION OF THE TRIBUNAL

The appeal is dismissed. The Tribunal concludes that Silvan Natural Springs Limited did not incur a bad debt within the meaning of subsection 68.21(2) of the *Excise Tax Act* when the company was not paid a portion of the purchase price of mineral water which it sold to National Importers Ltd. The Tribunal also orders that the question of claimed bad debts regarding sales by Silvan Natural Springs Limited to Hasty Market, K. Frosch and R. Gaul be referred to the Minister of National Revenue for reconsideration.

Robert J. Bertrand, Q.C.

Robert J. Bertrand, Q.C.
Presiding Member

Kathleen E. Macmillan

Kathleen E. Macmillan
Member

Sidney A. Fraleigh

Sidney A. Fraleigh
Member

Robert J. Martin

Robert J. Martin
Secretary

UNOFFICIAL SUMMARY

Appeal No. AP-89-016

SILVAN NATURAL SPRINGS LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

Excise Tax Act - Whether amount owed to the appellant constitutes a bad debt - Bad debt - Generally accepted accounting practices.

DECISION: *The appeal is dismissed. The appellant did not incur a bad debt as that phrase is defined according to generally accepted accounting practices.*

There was also a question as to whether three other amounts, arising from sales to three other distributors, constituted bad debts. Because neither Revenue Canada nor the respondent made a determination regarding this matter, it is referred to the Minister of National Revenue for reconsideration.

Place of Hearing: Vancouver, British Columbia

Date of Hearing: March 6, 1990

Date of Decision: August 31, 1990

Tribunal Members: Robert J. Bertrand, Q.C., Presiding Member

Kathleen E. Macmillan, Member

Sidney A. Fraleigh, Member

Clerk of the Tribunal: Janet Rumball

Appearances: Alex MacNicol, for the appellant

Bruce S. Russell, for the respondent

Case Cited: *Re Denison Mines Ltd. and Ontario Securities Commission, 122 D.L.R. (3d) 98.*

Statute Cited: *Excise Tax Act, R.S.C., 1985, c. E-15, subs. 68.21(2), as amended by R.S.C., 1985, c. 7 (2nd Supp.), subs. 34(1).*

Other Reference Cited: *CICA Handbook, December 1975.*

Appeal No. AP-89-016

SILVAN NATURAL SPRINGS LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

TRIBUNAL: ROBERT J. BERTRAND, Q.C., Presiding Member
KATHLEEN E. MACMILLAN, Member
SIDNEY A. FRALEIGH, Member

REASONS FOR DECISION

SUMMARY

The issue in this appeal is whether the Minister of National Revenue (the Minister) should have allowed the appellant to claim a certain amount as a bad debt. If the amount can be categorized as a bad debt, the appellant is entitled to a refund of any sales tax paid in relation to this amount under subsection 68.21(2)¹ of the *Excise Tax Act* (the Act).

The appellant sold \$60,197.26 worth of a raspberry-based fruit drink product called "Razz" to a distributor. The distributor paid for the product, but subsequently found out that the goods were defective and had them destroyed. The distributor incurred \$13,422.77 in service costs associated with the purchase and destruction of the defective "Razz." Thus, the distributor incurred a total cost of \$73,620.03 regarding the "Razz." Sometime later, the appellant sold a different product, mineral water, to the distributor. The appellant had to pay sales tax on the sale of the mineral water to the distributor, but the distributor deducted \$73,620.03 from the amount which it owed the appellant for the purchase of the mineral water. The appellant applied the \$60,197.26 which it received from the "Razz" transaction against the mineral water transaction. However, because the appellant received no monies to make up the difference (\$13,422.77) between the \$73,620.03 deducted by the distributor and the \$60,197.26 already paid to the appellant by the distributor, the appellant considered that it had incurred a bad debt in respect of the difference. Accordingly, it asked the Department of National Revenue for Customs and Excise (Revenue Canada) to refund the sales tax paid in relation to this amount.

The Tribunal declares that the appellant did not incur a bad debt as that phrase is defined according to generally accepted accounting practices.

1. R.S.C., 1985, c. E-15, as amended by R.S.C., 1985, c. 7 (2nd Supp.), subs. 34(1).

There was also a question as to whether three other amounts, arising from sales to three other distributors, constituted bad debts. Because neither Revenue Canada nor the respondent made a determination regarding this matter, it is referred to the Minister for reconsideration.

THE LEGISLATION

The relevant provisions of the Act, as they read during the assessment period of October 1, 1985, to December 31, 1987, are as follows:

68.21(2) Where ad valorem tax under Part III or VI has been paid by a licensed manufacturer in respect of an arm's length sale occurring on or after February 16, 1984 and the manufacturer has established, in accordance with generally accepted accounting practices, that any debt owing to him in respect of the sale has become in whole or in part a bad debt and has accordingly written off the debt as a bad debt in his books of account, an amount equal to the proportion of the amount of that tax that the amount of the debt written off is of the price for which the goods were sold shall ... be paid to that manufacturer if he applies therefor in the two years after the end of his fiscal period during which the debt was so written off.

THE FACTS

The facts in this case have been gathered from documents submitted in evidence, the testimony of Mr. Alex MacNicol, the appellant's Acting General Manager, and Ms. Margaret Cheung, a Certified General Accountant and senior auditor employed by the respondent. Ms. Cheung performed the federal sales tax audit of the appellant during the assessment period in question.

The appeal to the Tribunal was made on February 15, 1989. The reason for the appeal was the refusal of Revenue Canada and, subsequently, the Minister to allow the appellant to claim a certain amount as a bad debt in relation to sales of a product to National Importers Ltd. (National). If the amount could be categorized as a bad debt, the appellant would be entitled to a refund of any sales tax paid in relation to this amount under subsection 68.21(2) of the Act.

The decision of Revenue Canada was made on March 25, 1988, by Notice of Assessment number PAC 3894. The Minister confirmed this decision by Notice of Decision number 80219AE dated December 2, 1988.

There was also a claim by the appellant that three other amounts also constituted bad debts. The claimed bad debts relate to accounts with three other distributors: Hasty Market, K. Frosch and R. Gaul. However, Revenue Canada has not made a determination in relation to these amounts and, consequently, the Minister has not made an assessment in regard to this matter.

The facts in this case are as follows. During the assessment period in question, Silvan Natural Springs Limited (Silvan) was a Vancouver, British Columbia, licensed manufacturer of carbonated beverages. It has since become insolvent. One of the beverages which it produced

was a raspberry-based fruit drink called "Razz." The product was bottled by another company which Silvan contracted to do the job.

In the summer of 1985, Silvan sold a quantity of the bottled product to its primary "Razz" selling agent, National, a company with operations in Toronto, Ontario, and in Vancouver, British Columbia. National purchased the product from Silvan in Vancouver and paid Silvan \$60,197.26, representing the invoiced value of the goods. Silvan paid federal sales tax on the invoiced amount of "Razz."

National then transported the goods to Toronto, paying part of the freight costs in so doing (\$1,795.28). National incurred an additional cost of \$4,137.93 to promote and advertise the "Razz" and other Silvan products.

However, sometime after the sale, but before most of the goods were resold, a large portion of the "Razz" was found to be defective due to problems in quality control during the bottling of the product. National had the product destroyed, paying \$4,533.11 in freight charges for shipping the product from Toronto to a destruction site in Vancouver and \$2,810.50 for destruction and clean-up costs.

Thus, the expenses incurred by National in purchasing and, subsequently, destroying the defective "Razz," are as follows:

Invoiced price:	\$60,197.26
Freight:	\$6,474.34
Destruction:	\$2,810.50
Advertisement:	\$4,137.93
Total service costs:	<u>\$13,422.77</u>
Total cost:	<u>\$73,620.03</u>

Mr. MacNicol testified that, in his opinion, the amounts charged were greater than they need have been. For example, the witness stated that it was not necessary for National to have shipped the defective "Razz" back to Vancouver in order to have the product destroyed when this could have been done in Toronto.

Silvan did not pay any sales tax on the service costs incurred by National.

Subsequent to the sale of the defective "Razz," Silvan sold a different product, mineral water, to National. This was a federal sales taxable transaction.

Without Silvan's consent, National deducted \$73,620.03 from the amount which it owed to Silvan for the purchased mineral water. As Mr. MacNicol stated, National set off its costs associated with the purchase, advertisement, freight and destruction of "Razz" against part of the purchase price of the mineral water.

The appellant was able to apply the \$60,197.26 paid by National for the defective "Razz" against the purchase price of the mineral water. However, Mr. MacNicol claimed that Silvan received no monies from National to make up the difference between the \$73,620.03 deducted by National against the purchase price of the mineral water and the \$60,197.26 already paid to Silvan. In other words, Mr. MacNicol stated that Silvan incurred a bad debt because the company did not receive \$13,422.77 on the purchase price of the mineral water.

Ms. Cheung disagreed with Mr. MacNicol's interpretation for two reasons. First, she stated that National and Silvan each owed the other \$13,422.77: Silvan to National for the service costs associated with the "Razz," and National to Silvan for the mineral water. However, instead of the parties passing cheques to each other for the same amounts, the sums were "netted out of the books."

Second, Ms. Cheung testified that Silvan did not incur a bad debt, as that word is defined according to generally accepted accounting practices (GAAP). Basing her opinion on the bad debt provisions of the Canadian Institute of Chartered Accountants (CICA) Handbook, Ms. Cheung stated that according to GAAP, a bad debt is defined as a credit loss incurred because the purchaser of goods does not have the financial resources to pay the amounts owed. Here, National did not pay the \$13,422.77 owed for the purchased mineral water not because it lacked the monies to do so, but because it wanted to recover its service costs associated with the "Razz."

Ms. Chueng conducted, as part of her routine activities, a sales tax audit of the appellant in late 1987. Her sales tax treatment of the sale of mineral water by Silvan to National, as confirmed by Revenue Canada and the Minister, is the nub of this appeal.

Because the "Razz" sold to National was destroyed and the monies paid to Silvan for the "Razz" were deducted against payments for mineral water, Revenue Canada treated the sale of "Razz" as if it had not occurred. Consequently, it gave Silvan a credit for the federal sales tax which the appellant paid on the invoiced price of the "Razz." Silvan was allowed to apply the federal sales tax credit against its federal sales tax liability for the sale of \$60,197.26 worth of mineral water to National.

In other words, even though Silvan did not receive monies for the sale of \$60,197.26 worth of mineral water, Revenue Canada did not treat this situation as a bad debt. Revenue Canada still obliged Silvan to pay sales tax on this amount, but because Revenue Canada gave Silvan a sales tax credit (from sales tax paid on the "Razz"), Silvan was allowed to offset the credit against its sales tax liability incurred for the \$60,197.26 worth of mineral water.

However, Revenue Canada could not give Silvan a sales tax credit to be applied against the appellant's sales tax liability regarding the \$13,422.77 worth of mineral water because Silvan did not pay sales tax on the \$13,422.77 that constituted the service costs incurred by National respecting the "Razz."

It is this requirement to pay federal sales tax for an amount which the appellant claims not to have received - indeed, the appellant claims that such amount constitutes a bad debt and, thus, any sales tax paid on the amount should be returned to the appellant - that has given rise to this appeal.

THE ISSUE

The issue in this appeal is whether Silvan incurred a bad debt, within the meaning of subsection 68.21(2) of the Act, because the company was not paid for a portion (\$13,422.77) of the purchase price of mineral water which it sold to National. If it can be so characterized, then Silvan is entitled to a refund of the sales tax portion of the bad debt.

The appellant contended that the mineral water sold to National in the amount of \$13,422.77 should be characterized as a bad debt because, the appellant claims, National withheld payment in that amount. The appellant argued that, as the amount is a bad debt and as the appellant paid sales tax on this amount, it is entitled to a refund.

The respondent contended that, pursuant to the bad debt provisions of the Act, the concept of a bad debt must be determined according to GAAP. The respondent argued that Silvan has not received any monies for the \$13,422.77 because National has chosen to set off this amount against the service costs which it incurred for the purchase and eventual destruction of the "Razz." The respondent submitted that National did not want to pay Silvan the amount in issue because of its service costs.

The respondent argued that the uncontradicted evidence indicates that, according to GAAP, a bad debt is defined as a credit loss because the debtor cannot pay the amount owed. Thus, the respondent contended that a distinction must be made between an unwillingness to pay and an inability to pay. Here, National was able to pay Silvan for the mineral water, but was unwilling to pay the full amount owed to Silvan because of Silvan's corresponding debt to National. Consequently, the respondent argued, Silvan cannot claim the \$13,422.77 as a bad debt according to GAAP.

DECISION

The Tribunal does not consider that Silvan incurred a bad debt within the meaning of subsection 68.21(2) of the Act, when the company was not paid for a portion (\$13,422.77) of the purchase price of mineral water which it sold to National.

As a precondition to claiming a refund under the bad debt provisions of the Act, the legislation makes it quite clear that there must be a bad debt, as that concept is understood according to GAAP. Relevant generally accepted accounting practices have to be established to the satisfaction of the Tribunal.

Ms. Cheung, a Certified General Accountant and a Revenue Canada expert witness, asserted that, in her opinion and relying on the CICA Handbook, a bad debt arises under GAPP when credit losses are incurred due to the financial insolvency of the purchaser/debtor.

The relationship between the principles enunciated in the CICA Handbook and GAAP has been noted by Mr. Justice Robins in the Ontario High Court of Justice, Divisional Court decision

in *Re Denison Mines Ltd. and Ontario Securities Commission*.² In that case, Robins, J. stated (at pages 105-106):

... It [the Securities Act, 1978 (Ont.)] simply incorporates by reference the accounting and auditing standards and principles set by a professional governing body with responsibility in such matters to whose Handbook, practically speaking, auditors would in any event refer in order to ensure that [financial] statements to be certified by them were in accordance with GAAP requirements for the purposes of the Act or, indeed, for the other purposes served by the Handbook... (Emphasis added)

According to the principles enunciated in the CICA Handbook, a bad debt is defined as follows:

Because there are always some customers who cannot pay their debts, selling on credit necessarily involves credit losses. Such losses, as distinguished from amounts which are uncollectible because of damage to goods or failure to meet a specified quality or standard of performance, are "bad debt losses".

...

All businesses ... do not stop selling to a debtor as soon as there is a possibility, or even a probability, of loss. In some cases, to do so would force the customer into immediate bankruptcy with the resulting loss of the balance presently outstanding; whereas a continuation of credit on a restricted basis over a period of a year or more may give the customer an opportunity of restoring his financial solvency ... (Emphasis added)

The foregoing passages make it clear that, according to the CICA Handbook, a bad debt arises due to the inability, as opposed to the unwillingness, of the debtor to pay its debts.

Applying these principles to the facts of the case, the Tribunal can only conclude that Silvan did not receive monies on a portion of the mineral water purchased by National because National chose to set off mutually existing debts. Simply put, there is no evidence to suggest that National failed to pay the amount in issue because of financial difficulties. Rather, the evidence suggests that the defect in the purchased "Razz," and the associated costs incurred in its promotion, destruction, etc., form the basis of the set-off action taken by National which refuses to pay the debt, not because it is financially unable to do so, but because it considers the debt settled.

In view of the foregoing, the Tribunal therefore concludes that Silvan did not incur a bad debt within the meaning of subsection 68.21(2) of the Act and, consequently, is not entitled to a refund of the tax portion paid in respect of the \$13,422.77 worth of mineral water sold to National.

Silvan claimed that the service costs charged by National were, in part, unnecessary or excessive. This claim raises the question of the propriety of the amounts charged as opposed to the qualification of the debt as a bad debt under the applicable provisions of the Act. The

2. 122 D.L.R. (3d) 98.

appellant's concerns in this regard pertain to contract law and cannot be properly addressed by the Tribunal. There may be other recourses of a civil nature that the appellant could pursue, should it choose to do so.

There remains one final matter to consider. The appellant claims that it incurred bad debts regarding accounts with three distributors: Hasty Market, K. Frosch and R. Gaul. Neither Revenue Canada nor the Minister has made a determination in this matter because the claimed bad debts were not written off the appellant's books of account at the time that the appellant was audited. The appellant claims that the amounts were written off when it produced financial statements for the 1987 fiscal year.

The Tribunal is not empowered to consider the matter at this time because neither Revenue Canada nor the Minister has made a determination on whether the amounts constitute bad debts within the meaning of subsection 68.21(2) of the Act. However, pursuant to subsection 81.27(1) of the Act, the Tribunal can order the matter to be referred to the Minister for reconsideration.

CONCLUSION

Accordingly, the appeal is not allowed. The Tribunal concludes that Silvan did not incur a bad debt within the meaning of subsection 68.21(2) of the Act when the company was not paid for a portion (\$13,422.77) of the purchase price of mineral water which it sold to National. The Tribunal also orders that the question of claimed bad debts regarding sales by Silvan to Hasty Market, K. Frosch and R. Gaul be referred to the Minister for reconsideration.

Robert J. Bertrand, Q.C.
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