

Ottawa, Friday, February 14, 1997

Appeal No. AP-95-181

IN THE MATTER OF an appeal heard on November 5, 1996,
under section 81.19 of the *Excise Tax Act*, R.S.C. 1985, c. E-15;

AND IN THE MATTER OF a decision of the Minister of
National Revenue dated July 18, 1995, with respect to a notice of
objection served under section 81.15 of the *Excise Tax Act*.

BETWEEN

LAWTON'S DRUG STORES LIMITED

Appellant

AND

THE MINISTER OF NATIONAL REVENUE

Respondent

DECISION OF THE TRIBUNAL

The appeal is allowed.

Charles A. Gracey

Charles A. Gracey
Presiding Member

Arthur B. Trudeau

Arthur B. Trudeau
Member

Lyle M. Russell

Lyle M. Russell
Member

Michel P. Granger

Michel P. Granger
Secretary

UNOFFICIAL SUMMARY

Appeal No. AP-95-181

LAWTON'S DRUG STORES LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

The appellant filed its federal sales tax (FST) inventory rebate application on March 7, 1991, for over \$1 million. The rebate was calculated on the value of the appellant's inventory of FST-paid goods as of January 1, 1991. Subsequent to claiming and receiving the rebate, the appellant received certain volume discounts from its suppliers with respect to some of the merchandise held in inventory for which the FST inventory rebate was claimed. On June 7, 1995, the appellant was assessed on the basis that the FST inventory rebate should have been reduced as a result of the volume discounts. The issues in this appeal are: (1) whether the appellant was required to reduce the value of its inventory, for purposes of an FST inventory rebate, to account for the volume discounts received from its suppliers; and (2) if the value of the inventory should have been lowered to account for the volume discounts, whether the appellant is liable for interest and penalty on the amounts assessed against it.

HELD: The appeal is allowed. Pursuant to subsection 120(5) of the *Excise Tax Act*, the rebate payable to a person is determined by "a prescribed method using prescribed tax factors." That prescribed method is contained in section 4 of the *Federal Sales Tax Inventory Rebate Regulations*, which states that the value of the appellant's inventory was to be determined in the same manner as required for computing the appellant's income for purposes of the *Income Tax Act*. As the appellant did not reduce the value of its inventory to account for the volume discounts for purposes of the *Income Tax Act*, it was not required to do so for purposes of the FST inventory rebate.

Place of Hearing:	Ottawa, Ontario
Date of Hearing:	November 5, 1996
Date of Decision:	February 14, 1997
Tribunal Members:	Charles A. Gracey, Presiding Member Arthur B. Trudeau, Member Lyle M. Russell, Member
Counsel for the Tribunal:	David M. Attwater
Clerk of the Tribunal:	Anne Jamieson
Parties:	Maurice P. Chiasson, for the appellant Josephine A.L. Palumbo, for the respondent

Appeal No. AP-95-181

LAWTON'S DRUG STORES LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

TRIBUNAL: CHARLES A. GRACEY, Presiding Member
ARTHUR B. TRUDEAU, Member
LYLE M. RUSSELL, Member

REASONS FOR DECISION

This is an appeal under section 81.19 of the *Excise Tax Act*¹ (the Act) of an assessment of the Minister of National Revenue in respect of a federal sales tax (FST) inventory rebate application filed under section 120² of the Act. The appeal proceeded by way of the written record before the Tribunal, including an agreed statement of facts and written submissions by the parties.

The appellant filed its FST inventory rebate application on March 7, 1991, for over \$1 million. The rebate was calculated on the value of the appellant's inventory of FST-paid goods as of January 1, 1991. In calculating its entitlement to the inventory rebate, the appellant consulted GST-Memorandum 900,³ dated May 31, 1990 (the original Memorandum). The appellant received the rebate for which it applied.

Subsequent to claiming and receiving the rebate, the appellant received certain volume discounts from its suppliers with respect to some of the merchandise held in inventory for which the FST inventory rebate was claimed. Furthermore, GST-Memorandum 900 was revised and issued on March 25, 1991 (the revised Memorandum), indicating, in part, that an adjustment had to be made to the value of a person's inventory of tax-paid goods to account for volume discounts.

On June 7, 1995, the appellant was assessed on the basis that the FST inventory rebate should have been reduced as a result of the volume discounts that it received from its suppliers. The amount assessed was \$22,622.33, plus interest and penalty.

The issues in this appeal are:

- (1) whether the appellant was required to reduce the value of its inventory, for purposes of an FST inventory rebate, to account for the volume discounts received from its suppliers; and
- (2) if the value of the inventory should have been lowered to account for the volume discounts, whether the appellant is liable for interest and penalty on the amounts assessed against it.

1. R.S.C. 1985, c. E-15.

2. Added, S.C. 1990, c. 45, s. 12, as amended by S.C. 1993, c. 27, s. 6.

3. *Federal Sales Tax Inventory Rebates*, Department of National Revenue, Customs and Excise.

For purposes of this appeal, the relevant provisions of the Act are as follows:

[120](3) Subject to this section, where a person who, as of January 1, 1991, ... has any tax-paid goods in inventory at the beginning of that day,

(a) where the tax-paid goods are goods other than used goods, the Minister shall, on application made by the person, pay to that person a rebate in accordance with subsections (5) and (8);

“tax-paid goods” means

(a) new goods that are unused,

and on the sale price or on the volume sold of which tax (other than tax payable in accordance with subparagraph 50(1)(a)(ii)) was imposed under subsection 50(1), was paid and is not, but for this section, recoverable.

The relevant provisions of the revised Memorandum are as follows:

5. Goods that qualify for an FST rebate must be:

(b) in the hands of a GST registrant at the beginning of January 1, 1991:

(iv) licensed manufacturers or licensed wholesalers may continue to avail themselves of adjustments relating to sales made prior to 1991 that involve cash or volume discounts, even if the adjustments are refunded or credited to their customers after 1990. If the recipient of an adjustment claimed the FST inventory rebate, that person would be required to pay back to the Receiver General a portion of the FST inventory rebate, to the extent that the rebate was calculated on the gross value of the person’s inventory of tax-paid goods as of the beginning of January 1, 1991.

29. Applicants will use the same methods to value inventories for rebate purposes as they use to value inventories for income tax purposes. Income tax regulations provide two methods of valuing inventories:

(a) valuation at the lower of cost or fair market value for each item (or class of items if specific items are not readily distinguishable) in the inventory; and

(b) valuation of the entire inventory at fair market value.

Counsel for the appellant submitted that the appellant was assessed for moneys owing based on subparagraph 5(b)(iv) of the revised Memorandum. Counsel acknowledged that, if a taxpayer accounted for a volume discount by reducing the value of its inventory, then a subsequent adjustment to the FST inventory rebate would be sensible. However, the appellant has not historically accounted for the discounts in this way. Rather, these amounts have been treated as revenue items for income tax purposes. As the “gross value of the [appellant’s] inventory of tax-paid goods” did not change, the appellant was not required to pay back that portion of its rebate covered by the volume discounts. This is consistent with the wording of subparagraph 5(b)(iv) and section 29 the revised Memorandum.

To assist an applicant in valuing its inventory, the revised Memorandum refers to Interpretation Bulletin IT-473⁴ on “Inventory Valuation.” Counsel for the appellant claimed that the appellant’s treatment of volume discounts has been accepted by the respondent for income tax purposes and is consistent with the provisions of Interpretation Bulletin IT-473. As the appellant’s approach is consistent with income tax requirements, it should be accepted for FST rebate purposes.

4. Department of National Revenue, Taxation, March 17, 1981.

As to counsel for the respondent's argument that a portion of the appellant's inventory, equal to the volume discounts, does not constitute "tax-paid goods," counsel for the appellant argued that the word "recoverable" found in that definition must be interpreted with reference to the taxpayer. Under this interpretation, reference in the definition of "tax-paid goods" to "is not, but for this section, recoverable" is intended to prevent a taxpayer from valuing its inventory to include an FST rebate, which moneys can also be recovered under other provisions of the Act. This prevents an applicant from claiming its rebate twice.

Counsel for the appellant submitted that the assessment of interest and penalty should be waived if the appellant is unsuccessful in its appeal. Penalty and interest should not be payable if the appellant can establish that it exercised due diligence in remitting its FST inventory rebate.⁵ In this regard, counsel notes that the appellant filed its application on the basis of the original Memorandum that did not contain the provision found at subparagraph 5(b)(iv) of the revised Memorandum. Furthermore, the method of calculating its inventory, which had been accepted by the respondent for income tax purposes, should not be affected by a policy expressed in the revised Memorandum issued after the filing of the appellant's rebate application.

Counsel for the respondent argued that Parliament intended, pursuant to section 120 of the Act, to pay rebates on the actual cost of goods held in inventory. As a result of the contractual commercial relations with its suppliers, the bottom-line cost to the appellant of the goods in inventory on January 1, 1991, was lower than that declared on the FST rebate application. The volume discounts relate to purchases from its suppliers; they do not come from sales to customers or other business activities. As such, the volume discounts are reductions in the cost of goods sold and not income.

Counsel for the respondent submitted that it is irrelevant that the appellant has not reduced the inventory values in its records to account for the volume discounts. The discounts are found in the appellant's financial statements as "[e]arned cost reductions and purchase discounts," which effectively result in reduced inventory costs.

It was submitted that, until the value of the volume discounts is taken into account, the goods in issue do not satisfy the definition of "tax-paid goods," as there is still within them an FST component that is otherwise recoverable. Under ordinary circumstances, the supplier (licensed manufacturer or licensed wholesaler) would apply for a refund of tax paid in respect of the value of the volume discounts. This is further clarified at subparagraph 5(b)(iv) of the revised Memorandum.

As to section 29 of the revised Memorandum, counsel for the respondent submitted that, though this does not address the appellant's situation, the intent of the statute cannot be ignored. That the respondent has not challenged the appellant's treatment of volume discounts for income tax purposes is merely a reflection of the fact that it is irrelevant under the *Income Tax Act*.⁶

Counsel for the respondent asserted that there is no authority under the Act to waive the assessment of interest and penalty. The cases in support of the due diligence defence are not binding on the Tribunal and

5. See *Pillar Oilfield Projects Ltd. v. The Queen*, 2 G.T.C. 1005, Tax Court of Canada, Court File No. 93-614(GST)I, November 19, 1993; *Kyrkos Enterprises Limited v. The Queen*, 3 G.T.C. 2049, Tax Court of Canada, Court File No. 94-2310(GST)I, March 13, 1995; and *620247 Ontario Limited v. The Queen*, 3 G.T.C. 2065, Tax Court of Canada, Court File Nos. 94-2400(GST)I, 94-2401(GST)I and 94-2399(GST)I, April 18, 1995.

6. R.S.C. 1985 (5th Supp.).

of little precedential value. In the alternative, the appellant has failed to meet the due diligence standard, as there is no evidence that the appellant did more than consult the original Memorandum.

This appeal has its origins in the appellant's reliance on section 28 of the original Memorandum, which was prepared by the Department of National Revenue.⁷ Section 28 provides that "[a]pplicants will use the same methods to value inventories for rebate purposes as they use to value inventories for income tax purposes." The appellant relied on the original Memorandum when applying for its FST inventory rebate.

Several weeks after the appellant filed its application for the rebate, the revised Memorandum was issued and included, for the first time, subparagraph 5(b)(iv). Relying on its interpretation of the definition of "tax-paid goods," which counsel for the respondent said was clarified in subparagraph 5(b)(iv) of the revised Memorandum, the appellant was assessed because its FST inventory rebate "was originally overclaimed due to the value of the tax paid inventory not being reduced to reflect volume rebates receivable." The amount found to be overclaimed was \$22,622.33. As of June 7, 1995, the interest and penalty assessed against the appellant amounted to \$11,561.73. In support of the assessment, counsel argued that the valuation of the appellant's inventory for income tax purposes is irrelevant for purposes of the FST inventory rebate.

The Tribunal does not agree with counsel for the respondent that the appellant's treatment of the volume discounts for purposes of the *Income Tax Act* is irrelevant for purposes of calculating its FST inventory rebate. Pursuant to subsection 120(5) of the Act, the rebate payable to a person is determined by "a prescribed method using prescribed tax factors." That prescribed method is contained in section 4 of the *Federal Sales Tax Inventory Rebate Regulations*⁸ (the Regulations).

For purposes of subsection 120(5) of the Act, the rebate in respect of a class of goods that forms part of a person's inventory may be calculated by multiplying a prescribed tax factor for the class of goods by the total value of goods in that class. With respect to the class of goods in issue, section 4 of the Regulations provides that the value of the class of goods must be determined "as that total value would be required to be determined at the beginning of January 1, 1991 for the purpose of computing the person's income from a business for the purposes of the *Income Tax Act*." This provision is reflected in section 29 of the revised Memorandum and section 28 of the original Memorandum.

Counsel for the appellant reported that, for purposes of the *Income Tax Act*, the appellant does not reduce the value of its inventory to account for volume discounts. Rather, a discount is recorded as income. As proof, counsel filed copies of the appellant's audited financial statements reflecting the financial position of the appellant as at April 27, 1991.

As the value of the appellant's inventory was not reduced to reflect volume discounts for purposes of the *Income Tax Act*, the appellant did not reduce the value of its inventory for purposes of calculating its FST inventory rebate. In the Tribunal's view, this method of valuation is prescribed by section 4 of the Regulations and supported by section 29 of the revised Memorandum.

In addressing this argument, counsel for the respondent advocates ignoring section 29, while enforcing subparagraph 5(b)(iv), of the revised Memorandum. Without being explicit, subparagraph 5(b)(iv) implies that an FST inventory rebate must be calculated on the net value of a person's inventory after adjusting the gross value to account for volume discounts. However, the Tribunal agrees with the arguments

7. A provision similar to section 28 is contained in section 29 of the revised Memorandum.

8. SOR/91-52, December 18, 1990, *Canada Gazette* Part II, Vol. 125, No. 2 at 265.

of counsel for the appellant to the effect that, because the value of the appellant's inventory was not adjusted to account for volume discounts for purposes of the *Income Tax Act*, the appellant was not required to adjust the value of its inventory of tax-paid goods for purposes of the FST inventory rebate. Under other circumstances, the Tribunal would expect that the value of a person's inventory be adjusted to reflect a volume discount. However, under the particular circumstances of this case, the Tribunal finds that the appellant's position is fully justified.

Accordingly, the appeal is allowed.

Charles A. Gracey

Charles A. Gracey
Presiding Member

Arthur B. Trudeau

Arthur B. Trudeau
Member

Lyle M. Russell

Lyle M. Russell
Member