

Docket: 2002-2173(GST)G

BETWEEN:

JILLY CREATIONS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on November 4, 2004, at Montréal, Quebec

Before: The Honourable Justice Louise Lamarre Proulx

Appearances:

Counsel for the Appellant: Louis-Frédéric Côté
Josée Massicotte

Counsel for the Respondent: Gérald Danis

JUDGMENT

The appeal from the assessment made under the *Excise Tax Act*, notice of which bears number 03110197 and is dated May 10, 2002, is dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 8th day of February 2005.

"Louise Lamarre Proulx"

Lamarre Proulx J.

Citation: 2005TCC77
Date: 20050208
Docket: 2002-2173(GST)G

BETWEEN:

JILLY CREATIONS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Lamarre Proulx, J.

[1] This appeal concerns an assessment made under the *Excise Tax Act* (the "Act") for the period from November 1-30, 1999. The assessment is dated May 10, 2002, and the notice thereof bears number 03110197 (Exhibit I-1, Tab 8).

[2] The dispute is about the deduction, in the calculation of net tax, of an amount of \$59,786.62 by reason of a bad debt expense incurred by the Appellant. The deduction was made pursuant to section 231 of the *Act*.

[3] A reassessment dated January 26, 2001, had denied a claim for a deduction of \$88,194.73 (Exhibit I-1, Tab 2). At the objection stage, a deduction of \$20,150.92 was allowed by the assessment dated May 10, 2002. Subsequent to this assessment, an additional deduction of \$8,257.19 was allowed (Exhibit A-3), which explains the current amount at issue.

[4] The Appellant maintains that the bad debts came about through a fraud perpetrated against it by an employee.

[5] According to the Respondent, the Appellant has not demonstrated by way of supporting documentation the quantum and identity of the bad debts, in accordance with section 231 of the *Act*.

[6] Berny Fersten, president of the Appellant, explained that the Appellant was part of a group of nine companies operating in the textile industry. The Appellant manufactures women's and children's clothing. Each company keeps its own records. The Fersten Group began doing business around 1967. In 1990, the Group's annual sales totalled approximately 40 million dollars. The Appellant's sales were in the neighbourhood of six to eight million. It had more than 200 employees; however, most of these employees also worked for the other companies. There were inter-company expenses.

[7] Around nine or ten individuals, including the comptroller, the accounts receivable and accounts payable clerks, the payroll clerk and the computer technician, took care of the administrative side of things.

[8] Mr. Fersten explained that in 1999 he received a telephone call from his banker, who expressed some uneasiness about the accounts receivable. The bank was asking why companies like Zellers, Kmart and Eaton, which usually pay within 30 or 40 days, still owed money after two or three months.

[9] Initially, Mr. Fersten asked his outside accountant to try to find an explanation for this state of affairs; however, the accountant was unable to do so.

[10] At the bank's insistence that the Appellant bring in an expert in forensic audits of records, Mr. Fersten contacted Bessner Gallay Schapira Kreisman. Philip Levi and Brian Kreisman conducted the investigation.

[11] Their report was produced as the seventh document in Exhibit A-1. It is dated December 1999. The report concludes as follows:

On the basis of the evidence examined by us and the confession made by Louise Bennett, we are of the opinion that the total amount embezzled by the Bennetts amounted to the total purchased by them, which we have calculated to be \$496,924.69.

[12] A confession signed by Louise Bennett is attached to the report. She admits to embezzling funds totalling approximately \$250,000 by directing customer payments and applying them against her own account and her husband's. Mrs. Bennett was responsible for accounts receivable.

[13] Mr. Fersten stated that Irving Zwirek, the comptroller, supervised Mrs. Bennett. Mr. Zwirek apparently retired one year before the fraud was

discovered. Mr. Gold replaced him. Mr. Fersten explained as well that Mr. Pace, who had met with the auditor from Revenu Québec, was only in charge of computer systems. He was in no way responsible for accounts receivable.

[14] Counsel for the Appellant referred to document 8 in Exhibit A-1, entitled "Jilly Originals Receivables as at October 31st, 1999 over 180 days to be written off." It is on this 137-page document, apparently compiled by Mr. Levi, that the claim in this appeal is based.

[15] According to Mr. Fersten, the document reveals the unpaid amounts. The total of these amounts, which appears on page 137, is \$1,259,422.28. This amount was deducted as bad debts in computing the Appellant's income. Mr. Fersten says that the Appellant claimed the deduction on the advice of its accountants and at the bank's request.

[16] According to the witness, this is a case of bad debts because, if the Appellant requests payment of these debts from the companies indicated in connection with the amounts due, these companies reply that they have already paid the amounts in question and they provide proof thereof. The amount of tax on the \$1,259,422.28 was \$82,392.11.

[17] Document 9 is a letter from the office of Quebec Attorney General's prosecutors, to which are attached the minutes of a judge's decision and an indictment. The letter is dated September 23, 2004; the indictment and plea are dated May 3, 2004. The indictment is against Louise Bennett and states in particular that between December 4, 1992, and June 21, 1999, she fraudulently appropriated a sum in excess of \$5,000. She pleaded guilty to that charge.

[18] With regard to the Appellant, Jilly Originals Inc., Mrs. Bennett was charged with theft of \$5,000. She pleaded guilty to that charge.

[19] On cross-examination, the witness acknowledged that, as president, he received monthly reports from Mr. Zwirek, the comptroller of the companies in the Group. Counsel for the Respondent referred him to the auditor's report, produced at Tab 6 of Exhibit I-1, and more particularly to the passage in which the auditor reports the words of Richard Pace, the person who met with her at the Appellant's office:

[TRANSLATION]

We told Mr. Pace that there are written-off debts for which GST has been claimed, although, at the time, the ETA had not even come into effect yet. The net amount would represent approximately \$753.06 in GST claims to be disallowed. For the rest, we pointed out to him that the companies shown in the document are large store chains, the majority of which are still operating. We asked him what steps Jilly Creations Inc. takes to recover its accounts receivable dating back a number of weeks. He told us that there are no measures taken for collecting overdue accounts. No one is assigned to that duty; at most, customers behind in their payments may be telephoned; however, no follow-up takes place. For questions relating to the submitted document, he referred us to his outside firm, as he was unable to answer our questions on that subject.

[20] Mr. Fersten repeated that Mr. Pace was not the appropriate person to answer questions concerning internal collection procedures. Counsel asked him whether he had any examples of attempts that were made to collect bad debts. Mr. Fersten referred to Exhibit A-2, which is a copy of Mr. Fersten's affidavit in support of a motion to extend the time for filing a claim in the context of a proposed arrangement with regard to Eaton. A law office was handling this motion. Paragraph 5 of this affidavit reads as follows:

5. Jilly sold and delivered children's clothing to Eaton's from time to time. Eaton's is indebted to Jilly for the children's clothes in the amount of \$30,682.65. Attached hereto to this my Affidavit and marked collectively as Exhibit "B" are true copies of the invoices rendered by Jilly to Eaton's, which remain unpaid.

[21] This paragraph indicates that Mr. Fersten attached to his affidavit copies of invoices totalling \$30,682.65 which remain unpaid. These invoices were not attached to Exhibit A-2. The Appellant or counsel for the Appellant said that these documents would be sent to the Court but they were not.

[22] Mr. Kreisman is a chartered accountant. He stated that in 1999 Philip Levi received a request from Mr. Fersten concerning a problem with the accounts receivable. Mr. Levi asked Mr. Kreisman to help him with the investigation. They co-authored the report that was produced as document 7 in Exhibit A-1 and is entitled "The Fersten Group — Special Report".

[23] They came to the conclusion that the employee responsible for accounts receivable had succeeded, over a number of years, in defrauding the company of a

total amount of some \$500,000. She apparently took monies received from other customers and applied them against her personal account and her husband's account. No one ever saw any cheques written by the employee or her husband in payment of their invoices, and these totalled \$500,000. Neither did Mr. Levi and Mr. Kreisman trace any cheques.

[24] On page 11 of their report they established that the employee had definitely embezzled a sum of \$43,855.14. Based on this proof of embezzlement, since there was no indication of any payments by Mr. and Mrs. Bennett themselves, it was logical to conclude that their accounts were paid with monies embezzled by the employee, Mrs. Bennett. As indicated on page 9 of the report, the amount involved totals \$496,924.69. This is the amount of fraud they were to some extent able to substantiate. Of this amount, \$446,058.46 was attributable to the Appellant, \$34,509.15 to Tops "R" Us Inc. and \$16,357.08 to Fersten Headwear Inc. Mrs. Bennett used a defrauding technique called "kiting", which apparently consists in taking money from one account and placing it in another account. She did not actually take any money; however, she did obtain merchandise without having to pay for it.

[25] The financial statements for the year ending on November 30, 1999, were filed as document 10 in Exhibit A-1. Page 4 shows a deduction for bad debts in the amount of \$740,004 for 1999 and of \$403,444 for 1998. The witness stated that he was not involved in the preparation of the financial statements; it was, however, their firm that had prepared them. Mr. Kreisman had the opportunity to review the relevant files at his office the day before the hearing. The amount of \$740,004 includes a deduction of \$645,000 relating to the alleged bad debts concerned in this appeal. For 1998, the amount of \$403,444 includes a deduction of \$330,000. Thus, the amount of \$1,300,000 was split over the two years 1998 and 1999, and there is another charge somewhere in the 1998 financial statements.

[26] With regard to document 8 in Exhibit A-1, on which the claim herein is based, the witness clearly stated that no one could find a semblance of logic to this document. He was unable to explain it.

[27] Auditor Sylvie Dontigny, whose report appears in Tab 6 of Exhibit I-1, explained that the audit period was from November 1, 1999, to November 30, 1999, because the deduction claim at issue fell within that period. Her audit began on April 4, 2000.

[28] She telephoned the Appellant to make an appointment with the individual who was responsible for the accounting and who would be able to provide her with information concerning the Appellant's return for November. It was Richard Pace who met with her.

[29] The deduction claimed following the write-off of some bad debts was \$88,000. The auditor asked to see proof of those bad debts. Mr. Pace provided her with document 8 in Exhibit A-1, the 137-page document. He told her that, to obtain answers to her questions, she would need to call the outside accountants who prepared the document.

[30] She was surprised by the fact that, on the face of the document, the companies whose debts were written off were still in business, with the exception of Eaton. Even for Eaton, no claim was included on the list of creditors. She wondered how bad debts could be claimed for companies that were still in existence and reputed to be good payers. Furthermore, in the document, there were amounts that predated the coming into effect of the GST. In addition, a number of the amounts were statute-barred given the dates on which the claims therefor arose.

[31] Even so, the auditor attempted to understand the document. She asked the accountants to provide her with the vouchers that gave rise to the entries. She proceeded by way of a sampling. What was provided to her did not prove anything. The invoices had been paid. She asked for the registers of accounts receivable by customers. That information was not located or else simply not provided to her.

[32] The auditor was given no evidence of any collection measures having been taken concerning these supposedly outstanding debts.

[33] At the objection stage, the Minister accepted the report produced as document 7 in Exhibit A-1. He considered the debts of Louise Bennett and those of her husband to be bad debts, as determined in the report.

Analysis and conclusion

[34] In the present case, document 8 in Exhibit A-1 forms the basis for the claim for a deduction for bad debts in the computation of net tax. Mr. Kreisman, a chartered accountant, stated that document 8 made no sense and he refused to comment on it. He was not the person who prepared it. In the case of the 1998 and 1999 financial statements, however, while it was not he who had prepared them, he was able to explain their content, as he had informed himself on the subject at his

office the day before. Nor is there anything in writing by the person who prepared document 8 that explains its nature as being that suggested by the Appellant. Furthermore, the document turned out to be incomprehensible to the auditor as well, in spite of all her efforts.

[35] In addition, various strange facts are noteworthy in this case. Mr. Fersten stated that Mr. Pace, who met with the auditor, knew nothing about the Appellant's accounting. Why then did the comptroller not see the auditor? It should also be noted that neither of the two comptrollers was in Court to testify and explain the absence of information regarding the accounts receivable. There is no evidence that an effort was made to collect the bad debts. The motion for an extension of the time for filing a claim in the Eaton case, in Exhibit A-2, is dated February 9, 2001, which is two years after the deduction claim at issue.

[36] Subsection 231(1) of the *Act* reads as follows:

231(1) **Bad debts** — Where a person has made a taxable supply (other than a zero-rated supply) for consideration to a recipient with whom the person was dealing at arm's length, to the extent that it is established that the consideration and tax payable in respect of the supply have become in whole or in part a bad debt, the person may, in determining the net tax for the person's reporting period in which the bad debt is written off in the person's books of account or for a subsequent reporting period, deduct the amount determined by the formula

$$A \times B/C$$

where

- A is the tax payable in respect of the supply,
- B is the total of the consideration, tax and any amount that can reasonably be attributed to a tax imposed under an Act of the legislature of a province that is a prescribed tax for the purposes of section 154 (referred to in this section as "applicable provincial tax") remaining unpaid in respect of the supply that was written off as a bad debt, and
- C is the total of the consideration, tax and applicable provincial tax payable in respect of the supply,

provided the person reports the tax collectible in respect of the supply in the person's return under this Division for the reporting period in which the tax became collectible and remits all net tax, if any, remittable as reported in that return.

[37] Subsection 231(1) of the *Act* provides that where a person has made a taxable supply for a consideration, to the extent that it is established that the consideration and tax payable have become in whole or in part a bad debt, the person may, in determining the net tax, deduct the tax payable but not paid. That subsection sets out the conditions to which a claim for such a deduction is subject.

[38] A supplier of goods and services is required first of all to refer the Minister to an invoice or to any satisfactory evidence establishing that an amount of tax billed to a recipient was not paid by that recipient. On the evidence in this appeal, the Appellant failed to get beyond this initial step.

[39] Second, the deduction may be claimed for the reporting period in which the supplier wrote the debt off in the supplier's books because it had become a bad debt. The Minister may require proof that it was in fact a bad debt.

[40] A third condition is that the supplier have reported the tax collectible in a return filed for the reporting period in which the tax became collectible and have remitted all net tax reported in that return.

[41] In *Equinox Realty Ltd. v. Canada*, [1997] T.C.J. No. 1210 (Q.L.), Judge Mogan of this Court made the following statement:

7 In my opinion, the Appellant cannot succeed in this appeal because the Appellant did not satisfy the basic condition in subsection 231(1) which might otherwise permit the deduction. That basic condition is expressed in the last few lines of the subsection immediately following the formula; and the important words are:

... provided that the person reports the tax collectible in respect of the supply in the person's return under this Division for the reporting period in which the tax became collectible and remits all net tax, if any, remittable as reported in that return.

[42] In *Ciriello v. Canada*, [2000] T.C.J. No. 829 (Q.L.), Judge Rip of this Court said the following:

3 Mr. Ciriello also claims that the Minister did not give credit to R&V for bad debts. No evidence was led by the appellant with respect to the bad debts. For R&V to receive a refund or adjustment of tax subsection 231(1) of the *Act* requires that not only must the taxpayer have made a taxable supply in the course of a commercial activity and for consideration, but also that the taxpayer have filed a return accounting for and remitting tax under Division II in respect of that supply; finally, the consideration and

[43] As previously mentioned, subsection 231(1) of the *Act* allows the recovery of amounts of tax that a recipient was charged but did not pay. Such amounts must however be proven. In the present case, not only are there no relevant invoices, there are no registers of accounts receivable by customers either. We do not know who the debtors are or the amounts of their respective bad debts. The Appellant's president said that requests for payment had been made but the recipients' response was that they had already paid. He complained of a fraud scheme set up by an employee.

[44] It must be understood that the purpose of section 231 of the *Act* is, unfortunately, not to refund a supplier of goods and services amounts of tax that were paid to the supplier by recipients and subsequently apparently stolen on the supplier's premises.

[45] Reference must also be made to section 286 of the *Act*, which obliges every person who is required to file a return and every person who applies for a rebate or refund to keep records in such form and containing such information as will enable the establishment and determination of the person's obligations and of any rebate or refund to which the person may be entitled.

[46] For all these reasons, the appeal must be dismissed with costs.

Signed at Ottawa, Canada, this 8th day of February 2005.

"Louise Lamarre Proulx"

Lamarre Proulx J.

CITATION: 2005TCC77

COURT FILE NO.: 2002-2173(GST)G

STYLE OF CAUSE: Jilly Créations Inc. and
Her Majesty the Queen

PLACE OF HEARING: Montréal, Quebec

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REASONS FOR JUDGMENT BY: The Hon. Justice Louise Lamarre Proulx

DATE OF JUDGMENT: February 8, 2005

APPEARANCES:

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