

Docket: 2010-1572(IT)I

BETWEEN:

THIS IS IT DESIGN INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on November 26, 2010 at Vancouver, British Columbia

Before: The Honourable Justice Wyman Webb

Appearances:

Agents for the Appellant: Elizabeth (Beth) Hawthorn and
Robert Studer
Counsel for the Respondent: Jonathan Wittig

JUDGMENT

The Appellant's appeals in relation to the reassessment of its 2006 and 2007 taxation years are allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to the deductions claimed by the Appellant for an inventory write-down in 2006 of \$21,981 and in 2007 of \$21,980.56. The Appellant is entitled to costs which are fixed in the amount of \$750.

Signed at Halifax, Nova Scotia, this 22nd day of December, 2010.

“Wyman W. Webb”

Webb, J.

Citation: 2010TCC652
Date: 20101222
Docket: 2010-1572(IT)I

BETWEEN:

THIS IS IT DESIGN INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Webb, J.

[1] The issue in these appeals is whether the Appellant is entitled to claim the inventory write-downs that it deducted in determining its income for 2006 and 2007 for the purposes of the *Income Tax Act* (the “Act”). The amount of the write-down claimed for each year was \$21,981 (rounded to the nearest dollar).

[2] In 1996 the Appellant started carrying on a business of designing, producing and selling quality giftware products made of glass, steel and wood. In the company profile prepared early in 2002, the Appellant’s products are described as “Focus based products, produced in glass, stainless steel and wood”. It is stated that the Appellant then had 48 products. Six new products had been added in 2001 and there were 8 new products for 2002. They would sell their products to distributors. Most of their market was outside Canada.

[3] The Appellant had been successful in building its sales. However as a result of different events that were beyond the control of the Appellant, sales of the Appellant’s products started dropping after September 11, 2001 and continued to decline for the next few years. As a result the Appellant decided to shift the focus of its business from selling giftware products to custom design work. One such custom work project was for a residential dwelling for which the Appellant did four custom ceilings. Three of the ceilings were shown in pictures submitted by the Appellant. Attached to one ceiling was a “40 foot long fused glass suspended and illuminated sculpture”. Another example of the custom art work was a 6,000 pound glass

sculpture that was seven feet tall and thirteen feet wide. The custom work was not the same as the giftware product business and by 2005 – 2006 the Appellant had stopped marketing the products so that it could focus on the custom work.

[4] The Appellant would still produce some products as gifts for clients or if it received an unsolicited order that it chose to fill. However clearly the focus had changed as illustrated by the decline in product sales and the increase in commission work:

Year	Product Sales	Commission Sales	Total Sales	Product Sales as a % of Total Sales
2001	\$168,799	\$78,647	\$247,446	68%
2002	\$161,133	\$83,140	\$244,273 ¹	66%
2003	\$137,370	\$75,086	\$212,456	65%
2004	\$42,000	\$129,232	\$171,232	25%
2005	\$7,000	\$120,916	\$127,916	5.5%
2006	\$5,420	\$189,004	\$194,424	2.8%
2007	\$3,000	\$223,517	\$226,517	1.3%

[5] It is clear that by 2006 (the first taxation year under appeal) the sale of products was a very minor component of the Appellant’s business. The Appellant had a significant quantity of components for the products that were stored in an open area that was covered but was otherwise exposed to the elements. The components consisted of pieces of glass cut to the required specifications to produce certain products, metal pieces, and other component parts. By 2006 some of the components had been stored for a few years.

[6] Inventory is relevant in determining income. The cost of goods sold would generally be determined by the following formula:

$$\begin{array}{r}
 \text{opening inventory} \\
 + \text{ purchases} \\
 - \text{ closing inventory} \\
 = \text{ cost of goods sold}
 \end{array}$$

[7] Subsection 10(1) of the *Act* provides that:

¹ In the table submitted by the Appellant the total sales for 2002 were stated to be \$224,273 but the sum of \$161,132.76 and \$83,140.24 is \$244,273.

10. (1) For the purpose of computing a taxpayer's income for a taxation year from a business that is not an adventure or concern in the nature of trade, property described in an inventory shall be valued at the end of the year at the cost at which the taxpayer acquired the property or its fair market value at the end of the year, whichever is lower, or in a prescribed manner.

[8] If no purchases are made during the year and the fair market value of the inventory has decreased, the taxpayer will be entitled to a deduction even if no goods were sold and the taxpayer still has the inventory.

[9] In determining the Appellant's income for 2006 two deductions were claimed in relation to the inventory – a deduction in the amount of \$16,000 (which is not in dispute) and another deduction in the amount of \$21,981 (which is in dispute). The first amount (\$16,000) is simply the difference between the closing inventory for 2005 (based on cost) and the closing inventory for 2006 (based on cost):

Closing inventory 2005:	\$71,962
Closing inventory 2006:	\$55,962
Difference:	\$16,000

[10] The amount deducted of \$16,000 simply reflects a reduction in the inventory of \$16,000 and this deduction has been accepted by the Canada Revenue Agency. It is not clear, however, how the Appellant accounted for purchases. If the Appellant had, for example, \$5,000 of purchases in 2006 and the amount incurred in relation to the purchases was added to inventory, then it would seem that the cost of goods sold would have been:

Opening inventory 2006:	\$71,962
+ Purchases:	\$5,000
- Closing inventory 2006:	\$55,962
= Cost of goods sold:	\$21,000

[11] There was no evidence to show how the Appellant accounted for purchases. Since “custom work in progress” is included in inventory at the end of 2006 (in the amount of \$3,404) it appears that purchases were added to inventory. If however purchases were not included in determining the cost of goods sold then the Appellant may have missed a deduction that could have been claimed. Whether this is correct could, however, only be determined by a review of how the Appellant determined its income and how it accounted for purchases.

[12] The second deduction claimed by the Appellant for 2006 was in relation to various items of inventory that the Appellant claimed were obsolete. Part of Robert Studer's testimony in relation to the inventory items that are in question was as follows:

The next page you can see a good portion of our inventory also, in the sense that this is an outside shelter that we have on our property, and basically that we just unloaded the products there, just underneath, kept them sheltered so that they were not in the rain. But you can obviously see it is an exposed building, it is not a warehouse by any means. And we have shots. From here we have close up shots of different components and products.

Next one over is a crate of glass that is cut to size, specifically for products that we were producing. So these -- a variety of different sizes, would be for different things like trays, mainly the serving trays or the bottoms of the Petra lights.

The next page over you can see more boxes with components. There it's obvious in the sense of the stainless steel, there's about 50 to 60 pieces of stainless steel there. You can see that some of them are in a variety of different modes, some of them were painted and finished or *[sic]* you could be considered finished. However once again, they are not stored in a manner that they could be resold. Other ones you can see they have rippled patterns in them, which we would form the metal in our studio, and produce those patterns, and if you were to turn to M, on the second page, you could see the nature of those products, how they were finished and presented to the retailers. Once again they would have a ripple placed into the metal and then one side would be painted with an automotive paint.

The next page after that is showing it further over and seeing that there is more metal and there you can see bundles, several bundles of metal that are wrapped up with tape. So those are raw materials that we had purchased from our metal supplier. What we would typically do is we would order glass and metal cut to the size of our product and then from there we would take those cut metal pieces and we would form the pattern into them, put the wooden handles on the sides. Or form the metal, have them painted, bring them back, put the wooden handles on the sides, package them and have them ready for product.

The challenge with these metal pieces are not only that they are cut to size, there was a plastic membrane that was on it to protect the metal, and over the years those pieces have -- the plastic membrane, it's like a sticker. If one tries to peel it off now it just peels off in little slivers. They can't really be -- they're not even usable for making trays anymore.

[13] The Appellant moved to a new location in 2005 and the items were stored in the shelter described above by Robert Studer at that time. It seems obvious from the

photographs that were introduced into evidence and from the testimony of Robert Studer that the items were not being stored in a manner that would allow the items to be readily found and accessed to produce products but were being stored as items that were no longer being used. I find that the inventory items related to the products that the Appellant had previously been producing and selling were obsolete as the Appellant was no longer marketing the products to which these inventory components were related and only sold a few wood steel trays to fill unsolicited orders that it chose to fill.

[14] The witnesses for the Appellant were unable to quantify the number of products that were sold in 2006. It appears that the only products that the Appellant was still selling (when it received unsolicited orders that it chose to fill) were the wood steel trays. These were sold at retail prices of \$150 to \$300. With \$5,420 in product sales in 2006 this would mean that 18 – 36 products were sold in 2006. With \$3,000 in product sales in 2007 this would mean that 10 – 20 products were sold in 2007.

[15] In the inventory counts prepared for 2006 and 2007, approximately 80 different items were marked as obsolete² (other than the 6 items for 2006 and the 7 items for 2007 that were listed under “other”). These approximately 80 items appear to be the parts and packing materials for the products that the Appellant had previously been actively selling. Of these obsolete items, the inventory counts as of the end of 2006 and the end of 2007 only indicate a decrease in the following parts, all of which were grouped under the heading “Wood Steel Trays”:

Item	Quantity 2006	Quantity 2007	Decrease
LG1	25	16	9
LG2	28	20	8
LG3	11	9	2
Total:			19

[16] Assuming that the parts were for different trays, this supports the conclusion (based on the revenue) that only a small number of trays were sold in 2007. The inventory count also supports a finding that the Appellant clearly was not selling the full product line of 48 products (that according to the information sheet the Appellant

² There was one item (64W/64T Glass Complete) that was not marked as obsolete in the 2006 inventory listing but that was marked as obsolete in the 2007 listing. Beth Hawthorn confirmed that this should also have been marked as obsolete in the 2006 inventory listing.

had in 2002). It appears that at most, the Appellant was selling only 3 of the 48 products in 2007 and therefore clearly the parts for the other 45 products would be obsolete as of the end of 2006.

[17] The total cost of all of the items included in inventory as of the end of 2006 was \$55,962. The total cost of all items marked as obsolete as of the end of 2006 was \$52,038.26. If the items for the products that were sold in 2007 are not included as obsolete, this will reduce the cost of the obsolete items as of the end of 2006 to:

Cost of Obsolete items (including LG1, LG2 and LG3):	\$52,038.26
- Cost of LG1:	\$250
- Cost of LG2:	\$336
- Cost of LG3:	\$187
Revised cost of obsolete items:	\$51,265.26

[18] The amount claimed as an inventory write-down was therefore \$21,981 / \$51,265.26 = 43% of the revised amount determined as the cost of the obsolete items. Therefore, effectively, the Appellant's position is that the fair market value of the obsolete items (not including the items identified as LG1, LG2 and LG3) was \$29,284.26 as of the end of 2006.

[19] The obsolete items included pieces of glass and metal cut to certain specifications and other parts that were unique to the products that the Appellant had previously been actively selling. In my opinion, it is more likely than not that the fair market value of these parts would decrease once the Appellant was no longer selling the products that incorporated these parts and I find that the write-down of 43% claimed by the Appellant in 2006 was therefore reasonable and the Appellant is allowed a deduction in computing its income for 2006 in the amount of \$21,981 on the basis that the fair market value of the obsolete items included in inventory as of the end of 2006 was \$21,981 less than the cost of the same items of inventory.

[20] Since the inventory of the Appellant was valued (as of the end of 2006) at an amount that was \$21,981 less than its cost, the opening inventory for 2007 should have been valued at the same amount. Subsection 10(2) of the *Act* provides that:

(2) Notwithstanding subsection (1), for the purpose of computing income for a taxation year from a business, the inventory at the commencement of the year shall be valued at the same amount as the amount at which it was valued at the end of the preceding taxation year for the purpose of computing income for that preceding year.

[21] Therefore the opening inventory for 2007 should have been valued at the following amount:

Closing inventory for 2006 before write-down:	\$55,962
Write-down amount:	\$21,981
Value as of the end of 2006 / commencement of 2007:	\$33,981

[22] How the inventory amount that was determined as of the end of 2007 was used in determining the income of the Appellant is a mystery. Unfortunately the evidence presented at the hearing did not help to solve this mystery.

[23] The inventory schedule for each year (2006 and 2007) is three pages long and each schedule was prepared using the original cost of the various items. The schedule for 2007 did not reflect the write-down of \$21,981 claimed in 2006.

[24] The first two pages list the items that the Appellant states were obsolete and included on the second page are the items identified as LG1, LG2 and LG3. As indicated above, the inventory count as of the end of 2007 indicates a decrease in the quantity of each of these items. Since the Appellant was only selling wood steel trays and then only selling those if it received an unsolicited order that it chose to fill, it seems obvious that no purchases were made in 2006 or in 2007 of any of the items of inventory included on the first two pages of the inventory schedules. It also appears that for several of the categories that the cost of the last item listed in the category as of the end of 2007 was not included in determining the total cost of the items in that category. The following is a list of the categories where the amount indicated as the total cost does not include the last item listed:

Category	Total cost 2006	Total cost 2007	Difference	Cost of the last item listed
Raw stainless steel	\$1,108.05	\$976.05	\$132.00	\$132.00
Glass items	\$1,815.30	\$1,665.30	\$150.00	\$150.00
Metal brackets	\$3,832.45	\$3,045.95	\$786.50	\$786.50
Square ware-glass	\$751.21	\$631.21	\$120.00	\$120.00

Category	Total cost 2006	Total cost 2007	Difference	Cost of the last item listed
Stainless items	\$1,963.65	\$1,926.15	\$37.50	\$37.50
TV Dinner trays - glass	\$612.90	\$417.90	\$195.00	\$195.00
Wood Steel Trays (excluding LG1, LG2 and LG3)	\$2,359.00	\$1,959.00	\$400.00	\$400.00
Total:			\$1,821.00	\$1,821.00

[25] For each of these categories the number of individual items included in the categories did not change from 2006 to 2007 and therefore the total amount of the original cost of the items in these categories should have been the same at the end of 2007 as it was at the end of 2006. As noted, the cost of the items does not reflect the adjustment made to the value of the items as of the end of 2006. The witnesses for the Appellant were unable to explain this discrepancy and it appears that it was simply an arithmetic error that could have been caused by the formula in Excel simply not including the last item listed in determining the total for the category. As a result it seems to me that the total value of the inventory as of the end of 2007 (before any adjustment for the obsolete items in 2007) would be:

Cost of inventory based on the schedule:	\$69,886.15
+ Amounts not included (arithmetic error):	\$1,821.00
- 2006 write-down amount:	\$21,981.00
= Revised inventory value:	\$49,726.15

[26] The Appellant claimed a deduction of \$21,980.56 in 2007 for obsolete items. As a result the revised closing inventory for 2007 should have been:

Revised inventory value (before write-down):	\$49,726.15
- Write-down amount claimed in 2007:	\$21,980.56
= Value of inventory as of the end of 2007:	\$27,745.59

[27] However, the amount that the Appellant indicates as the value of the closing inventory as of the end of 2007 is \$12,000. Claiming a deduction of \$21,980.56 in

2007 does not reduce the value of the inventory to \$12,000. The tax return for the Appellant that was filed for 2007 was not introduced into evidence and there was no evidence of how, if at all, the valuation of the inventory at \$12,000 factored into the determination of the Appellant's income for 2007.

[28] The cost of the items listed in the 2007 inventory listing that are not marked as obsolete was \$14,665.96 of which \$14,145.91 was custom work in progress. Therefore it appears clear that the value of the inventory as of the end of 2007 was more than \$12,000. With a write-down of \$21,980.56 the value of the inventory would be, as noted above, \$27,745.59. The only adjustment that was denied by the Canada Revenue Agency was the deduction of \$21,980.56. A reduction in the inventory from \$27,745.59 to \$12,000 would have required a further deduction of \$15,745.59 which presumably would have been made by another adjusting journal entry.

[29] The auditor for the Canada Revenue Agency testified during the hearing. He stated that:

Q I'm just wondering what you based your -- or what information you had before you when you worked on it.

A The information I had before me was -- well, we reviewed -- well, I reviewed and traced the inventory amounts to what was recorded and what was reported. We also -- a standard operating -- or a standard audit step that I also do is to check for the adjusting journal entries that were done for the year-end, fiscal years. One curious note that I had when I [*sic*] reviewing the adjusting journal entries were two journal entries affecting the inventory, which there was a write-down for both years, of peculiarly the same amount, roughly around \$21,000 each year.

[30] Therefore it seems more likely than not that this additional deduction of \$15,745.59 was not claimed by the Appellant in computing its income for 2007. No assumption was made in the Reply in relation to this and it seems clear from the testimony of the auditor for the Canada Revenue Agency that the auditor reviewed the year-end adjusting journal entries. Therefore if the Appellant would have made another adjusting journal entry to reduce the inventory by another \$15,745.59 (and to claim a deduction in computing income), it seems more likely than not that such adjusting entry would have been identified by the auditor and also denied as a deduction by the Canada Revenue Agency.

[31] In the inventory listings for 2006 and 2007, the Appellant listed the following as obsolete under the heading “other”:

Item	2006	2007	Increase (Decrease)
World clock 2001	\$6,000.00	\$6,000.00	0
World clock 2002	\$8,000.00	\$8,000.00	0
Vinyl for 2003	\$1,000.00	\$1,000.00	0
Other / misc. raw materials	\$3,213.85	\$3,000.00	(\$213.85)
Cast glass panels/table tops	\$7,692.53	\$10,000.00	\$2,307.47
Seconds room	\$5,000.00	\$4,109.21	(\$890.79)
Glass panels / art		\$4,000.00	\$4,000.00
Total:			\$5,202.83

[32] There was a net increase in the last four items of \$5,202.83 from 2006 to 2007. It is not clear why there was an increase in these items, however the Appellant was still carrying on business and since a new category was added it appears that these were related to the custom art work and presumably were now obsolete because they are scrap pieces that did not get included in the final work of art.

[33] As noted above, the position of the Appellant is that as of the end of 2006 the fair market value of the obsolete items (not including the items identified as LG1, LG2 and LG3) was \$29,284.26. There was a decrease from the end of 2006 to the end of 2007 of \$1,104.64 (\$213.85 + \$890.79) in two of the categories identified as obsolete (under the heading “other”). Assuming that the fair market value of these items was equal to the cost of these items³, this would reduce the fair market value of the obsolete items on hand as of the end of 2006 and still on hand as of the end of 2007 to \$29,284.26 - \$1,104.64 = \$28,179.62, before any adjustment is made for 2007. As of the end of 2007 these items were another year older and the Appellant was clearly no longer selling at least 45 of the 48 products that it had in 2002. A further reduction of \$21,980.56 in 2007 would reduce the value of the obsolete items that were on hand at the end of 2006 and still on hand at the end of 2007 (not including the items identified as LG1, LG2 and LG3) to \$6,199.06 (\$28,179.62 - \$21,980.56). It seems to me that it is more likely than not that the value of the

³ It seems to me that the only realistic possibilities were that fair market value of these items was equal to or less than the cost of these items. If the fair market value was less than the cost and reflected the write-down of 43% claimed in 2006 the value of these items would be \$629.64 (57% of \$1,104.64). The revised value of the items still on hand at the end of 2007 (before any write-down for 2007) would then be \$29,284.26 - 629.64 = \$28,654.62.

component parts, packaging material and other scrap pieces still on hand as of the end of 2007 would have decreased further in 2007 and would be a minimal amount. In my opinion the write-down of \$21,980.56 claimed by the Appellant in 2007 was reasonable. As a result the Appellant is entitled to the deduction of \$21,980.56 claimed in 2007.

[34] As a result the Appellant's appeals in relation to the reassessment of its 2006 and 2007 taxation years are allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to the deductions claimed by the Appellant for an inventory write-down in 2006 of \$21,981 and in 2007 of \$21,980.56. The Appellant is entitled to costs which are fixed in the amount of \$750.

Signed at Halifax, Nova Scotia, this 22nd day of December, 2010.

“Wyman W. Webb”

Webb, J.

CITATION: 2010TCC652
COURT FILE NO.: 2010-1572(IT)I
STYLE OF CAUSE: THIS IS IT DESIGN INC. AND
HER MAJESTY THE QUEEN
PLACE OF HEARING: Vancouver, British Columbia
DATE OF HEARING: November 26, 2010
REASONS FOR JUDGMENT BY: The Honourable Justice Wyman W. Webb
DATE OF JUDGMENT: December 22, 2010

APPEARANCES:

Agents for the Appellant: Elizabeth (Beth) Hawthorn and
Robert Studer
Counsel for the Respondent: Jonathan Wittig

COUNSEL OF RECORD:

For the Appellant:

Name:

Firm:

For the Respondent:

Myles J. Kirvan
Deputy Attorney General of Canada
Ottawa, Canada