

THE TAXATION OF IMPUTED INCOME AND THE RULE IN *SHARKEY v. WERNHER*

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I have a suspicion that the difficulties of this subject have not been eased by the philosophizing of economists and the practises of accountants. In a matter of this kind the issue should be decided by realities.

Danckwerts L. J.

Economists generally agree that the present concept of taxable income is too narrow. For these theoreticians, the ideal definition of income for tax purposes is the comprehensive tax base; that is, a taxpayer's "consumption plus (or minus) the net increase (or decrease) in value of [his or her] assets during the taxable period".¹ Furthermore, it is generally accepted that the current tax base excludes imputed income and that the ideal concept would include it. The purpose of this article is to examine the assumption that the tax base excludes imputed income and to consider the extent to which Parliament and the courts have attained the theoretical ideal of bringing imputed income within the definition of taxable income.

I. *Definition of Imputed Income.*²

The two salient qualities of imputed income are: (1) it is non-cash income or, income in kind, and (2) it arises outside the market place. Some examples will help to clarify the definition of imputed income. A taxpayer who occupies his own home instead of deriving rental income from letting it to a tenant enjoys imputed income to the extent of the rent foregone. The owner-occupant enjoys a benefit, which increases his economic power, and

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¹ Pechman, What Would a Comprehensive Individual Income Tax Yield?, House Ways and Means Committee, Tax Revision Compendium (1959), Vol. 1, p. 251, at p. 259.

² A leading article on the subject is Marsh, The Taxation of Imputed Income (1943), 58 Pol. Sc. Q. 514.

the value of which is imputed income to him. However, a landlord who receives rent in kind from his tenant does not thereby gain imputed income because the transaction is an exchange in the market, albeit without cash. Although such barter transactions give rise to income in kind, they do not involve imputed income. Further, when a farmer consumes his own produce instead of selling it and buying groceries with the proceeds, the value of this benefit is imputed income. Similarly, when a taxpayer cuts his own lawn instead of hiring a gardener, he thereby enjoys a benefit which can be measured by the going wages of gardeners.³ Thus, broadly, imputed income "includes any gain, benefit or satisfaction from a non-market transaction or event".⁴

The argument for taxing imputed income begins with the premise that income, in its most sweeping sense, is a flow of satisfactions over a period of time. Although the government imposes tax when the taxpayer receives either money or money's worth, this is primarily for administrative convenience, because money reflects only the taxpayer's "power to command these satisfactions",⁵ and tax should in theory be imposed when the taxpayer is "enjoying the satisfactions provided by the goods and services which were purchased with the money income".⁶ Imputed income arises when a taxpayer bypasses the money (or market) transaction and supplies himself directly with the property, goods or services from which he derives satisfactions. Thus, the argument concludes, since these satisfactions are as real as any other, both Equity and Neutrality require the taxation of imputed income.

Against the theoretical argument in favour of taxing imputed income, certain objections have been made. As will be discussed in more detail in the pages that follow, the relevancy of these countervailing factors varies with different kinds of imputed income.

The first problem is valuation. In order to measure imputed income, the government or the taxpayer must determine the monetary value of the equivalent item in the market place. For some types of imputed income, the measurement problem is insurmountable. Second, the inclusion of certain kinds of imputed income in the tax base may produce enough tax revenue neither to accomplish

³ But see, Hartle, *Taxation of the Incomes of Married Women*, Studies of the Royal Commission on the Status of Women in Canada, No. 5 (1969), p. 27: "Imputed incomes from providing services for oneself are valued as the cash income foregone by not devoting the same time and effort to a job."

⁴ McNulty, *Federal Income Taxation of Individuals in a Nutshell* (1972), p. 27.

⁵ Haskell and Kauffman, *Taxation of Imputed Income—The Bargain-Purchase Problem* (1964), 17 Nat. Tax J. 232, at p. 233.

⁶ *Ibid.*

any fiscal purpose nor to justify the concomitant problems of valuation. Third, if imputed income which accrues to lower income classes, such as imputed income from services to oneself and one's family is included in the tax base, then an undesirable result is an increase in economic disparity. And, of course, the amount of tax revenue may be derisory. Fourth, the taxation of some forms of imputed income is objectionable for other social reasons. For example, while the definition of imputed income includes the satisfactions of leisure, such taxation of leisure time would be not only impractical but also oppressive. Finally, the taxation of any form of income in kind creates liquidity problems for the taxpayer who is assessed to tax on non-cash items but must discharge the liability with cash.

Perhaps with these considerations in mind, judges have occasionally contorted in sweeping terms the taxation of imputed income. Thus Palles C. B., said: "No man, in my opinion, can trade with himself; he cannot, in my opinion, make, in what is its true sense or meaning, taxable profit by dealing with himself . . .".⁷ And a distinguished tax judge, Rowlatt J., denied very clearly that imputed income was taxable: "It is true to say that a person cannot make a profit out of himself, if what is meant is that he may provide himself with something at a less cost than that at which he could buy it, or if he does something for himself instead of employing some one to do it. He saves money in those circumstances, but he does not make a profit".⁸ In a leading tax case, Lord Macnaghten said: "But a person is chargeable for income tax . . . not on what saves his pocket, but on what goes into his pocket".⁹ And Viscount Simon has written: "The identity of the source with the recipient prevents any question of profits arising . . .".¹⁰ However, when the various kinds of imputed income are considered, it will be seen that these quotations are misleading and that the courts and Parliament have broadened the tax base to encompass some imputed income. We will consider the following types of imputed income: (1) imputed rent and interest (2) self-supply of goods (3) self-supply of services (4) housewives' services and (5) mutual trading.

⁷ *Dublin Corporation v. M'Adam* (1887), 2 Tax Cas. 387, at p. 397 (Ir. Ex. Ct.).

⁸ *Thomas v. Richard Evans & Co. Ltd.*, [1927] 1 K.B. 33, at p. 46, (1926), 11 Tax Cas. 790, at p. 822 (Eng. K.B.). There are minor differences in the wording of the two passages cited. The King's Bench Report is regarded as more authoritative and the quoted passage in the text is from that report.

⁹ *Tennant v. Smith*, [1892] A.C. 150, at p. 164, 3 Tax Cas. 158, at p. 171 (H.L.).

¹⁰ *Ostime v. Pontypridd and Rhondda Joint Water Board* (1946), 28 Tax Cas. 261, at p. 278 (H.L.).

II. *Imputed Rent and Interest.*

The tax system aids those taxpayers who own and occupy their own homes in three ways: (1) by exempting the principal residence from capital gains (2) by exempting the family home from provincial succession duties, and (3) by excluding from the tax base the rental value of owner-occupied homes.

How does imputed rent arise from owner-occupied homes? Suppose that two taxpayers have equal money incomes, family sizes, and consumption patterns, and that each taxpayer was furnished with \$40,000.00. One bought a home for \$30,000.00 and invested the other \$10,000.00 using the \$500.00 income (after income tax) to defray property taxes, maintenance and so on. The other invested the \$40,000.00, became a tenant and used the \$2,000.00 income (after income tax) to pay rent. While both taxpayers are in the same financial position, the owner-occupier's taxable income is increased by only \$500.00 and the renter's taxable income includes the \$2,000.00.¹¹ Thus, the renter bears a greater tax burden than does the owner-occupier, because the rental value of owner-occupied homes is excluded from taxable income. Moreover, the renter will be liable to capital gains on his investments¹² and succession duties may be eligible on his death.

Many critics have elaborated on the drawbacks of excluding imputed rent. As the example indicates, by imposing a heavier tax burden on the renter, such an exclusion violates horizontal equity. Further, it contravenes the principle of neutrality by influencing those taxpayers who can do so, to purchase a home. As a subsidy to homeowners, it is inefficient, for its benefit increases directly with the size of the taxpayer's home and with his marginal rate of tax. The subsidy provides the greatest benefit where it is needed the least. Thus, even if one accepts that tax incentives should encourage home ownership, the exclusion of imputed rent is "an upside down subsidy".¹³ And, it is argued, the exclusion substantially reduces revenue yield and cuts down the progressive effect of the personal income tax.

Two solutions have been advanced: (1) to impose tax on "net imputed rent",¹⁴ that is, "gross imputed rent minus the expenses of home ownership"¹⁵ and (2) to allow renters to deduct

¹¹ Derived from, Vickrey, *Agenda for Progressive Taxation* (1947), (reprinted 1972), pp. 18-19.

¹² See Wolff, *The White Paper: Tax Treatment of Principal Residences* (1970), 18 Can. Tax. J. 263; cf., Kitchen, *Imputed Rent on Owner-Occupied Dwellings* (1967), 15 Can. Tax J. 482, and authorities cited therein; Aaron, *Income Taxes and Housing* (1970), 60 Am. Econ. Rev. 789.

¹³ Merz, *The Income Tax Treatment of Owner-Occupied Housing* (1965), 41 Land Economics 247, at p. 255.

¹⁴ Kitchen, *op. cit.*, footnote 12, at p. 483.

¹⁵ *Ibid.*

rent from their incomes for tax purposes.¹⁶ Because of the drastic loss of tax revenue which would follow from allowing taxpayers to deduct their rent, the second alternative is not very promising.

While the present definition of taxable income excludes rental income on owner-occupied dwellings, it does catch housing benefits furnished to employees or shareholders.¹⁷ Although such benefits are not, of course, imputed income, they can approach it. For example, where a corporation supplies housing to its controlling shareholder, in a sense the shareholder becomes an owner-occupier. The value of this housing would be a taxable benefit.¹⁸

Paradoxically, rental value has been allowed as a deduction in computing business income. In *Usher's Wiltshire Brewery, Ltd. v. Bruce*,¹⁹ the taxpayer was a brewer and a landlord of certain tied houses. In consideration of the tie, the tenants of these tied houses paid less than the full annual rental value. The House of Lords allowed the taxpayer to deduct such foregone rent. In a subsequent case, Lord Radcliffe said that the speeches were "only consistent with the hypothesis that it was a notional expenditure equivalent to the 'loss' that [their Lordships] proposed to allow to the trader . . . even if the conception upon which the *Usher* decision rests is ambiguous in origin and exceptional in practice; I think that it does both involve and establish the proposition that a trader who owns such assets as tied houses and uses them as tied houses are used may charge his trading profits with a sum equivalent to the part of the annual value of those assets that he has 'forgone' by such use".²⁰

In Canada, section 18(1)(d) of the Income Tax Act prohibits

¹⁶ Harmelink and Krause, Reduction of Tax Inequity to Renters of Dwellings: A Recommendation (1973), 51 Taxes 204.

¹⁷ E.g., *Cockerill v. M.N.R.* (1965), 38 Tax A.B.C. 446, 65 D.T.C. 525, where the taxpayer was shareholder and president of a company which paid his rent. At pp. 448 (Tax A.B.C.) 526 (D.T.C.), Fordham Q.C., said: "The payment of his rent by the Company was a saving to him *pro tanto* in personal or living expenses and clearly a benefit." See also: *Williams v. M.N.R.*, [1955] C.T.C. 1, 55 D.T.C. 1006; and, Employees' Fringe Benefits, Interpretation Bulletin No. IT-71.

¹⁸ See *Chandler v. Commissioner* (1941), 119 F.2d 623 (U.S.C.A., 3rd Cir.); in the United States, it has been suggested that the taxation of imputed rental income is unconstitutional: *Helvering v. Independent Life Insurance Co.* (1934), 292 U.S. 371, at p. 379.

¹⁹ [1915] A.C. 433, 6 Tax Cas. 399 (H.L.); and see Royal Commission on the Taxation of Profits and Income, Cmnd. 9474/55, at p. 250: "The owner-occupier of business premises is charged under Schedule A for the net annual value and under Schedule D for the balance of the profits of his trade, i.e., he is permitted, when arriving at the trade profit for assessment purposes, to deduct the rent he might be supposed pay [sic] to himself for the use of his own property." Rent-free or low rent housing supplied to an employee is a taxable benefit: Employees' Fringe Benefits, Interpretation Bulletin, No. IT-71.

²⁰ *Tamplin and Son's Brewery (Brighton), Ltd. v. Nash*, [1952] A.C. 231, at pp. 259-260, 32 Tax Cas. 415, at pp. 480-481 (H.L.).

the deduction of rent foregone in computing business or property income.

However, the principle that income foregone may be deducted might perhaps be applied to income other than rent.²¹ The rationale for permitting a trader to deduct a profit which he chose not to earn is, to say the least, dubious. The brewer who decides to lower the rent to his tenants below the market rate in order to increase his profits from the sale of beer to them should be prohibited from offsetting the rent foregone against those profits. Similarly, a supplier who charges his customer higher prices for his stock-in-trade in exchange for a loan at less than the market rate of interest should not be able to offset the profits on the sale of goods against the notional loss in the amount of the abated interest on the loan.²² In any event, because such transactions take place in the market, they do not involve imputed income.

As the ownership and occupation of dwellings give rise to imputed income, so, in theory, do the ownership and personal use of consumer durable goods. The taxpayer who owns and uses his own washing machine, automobile, airplane, television set or furniture is said to derive income thereby.²³ The amount of such imputed income is the cash rental for the equivalent item in the market place. However, the taxation of imputed income arising from investments in consumer durable goods other than real estate causes difficult problems of valuation, audit and enforcement. Moreover, it would probably produce less tax revenue than the taxation of imputed income from owner-occupied dwellings and would affect lower income classes more seriously. Thus, the advocates of taxing imputed income are less certain about the desirability of taxing imputed income from investment in consumer durable goods.²⁴ The problems which occur in attempting to tax

²¹ Cf. *Lowry v. Consolidated African Selection Trust, Ltd.*, [1940] A.C. 648, [1940] 2 All E.R. 545, 23 Tax Cas. 259 (H.L.).

²² The Revenue practice is not to assess interest-free loans to employees as taxable fringe benefits: Employees' Fringe Benefits, Interpretation Bulletin, No. IT-71; accord: *No. 359 v. M.N.R.* (1956), 16 Tax A.B.C. 24, 56 D.T.C. 475; where the taxpayer, who was a minority shareholder in a company, borrowed money, without interest, Fisher Q.C., held that the failure to charge interest was not a taxable benefit; cf., *J. Simpson Dean* (1961), 35 T.C. 1083 (Tax Court of the United States), noted in (1966), 33 U. Chi. L. Rev. 346. Section 17(1) of the Income Tax does impute interest on loans to non-residents at less than a reasonable rate of interest.

²³ Marsh, *op. cit.*, footnote 2, at pp. 520-521.

²⁴ E.g., Haskell and Kauffman, *op. cit.*, footnote 5, at p. 234; Royal Commission on the Taxation of Profits and Income, Cmnd. 9474/55, at p. 250: "Theoretically an income can be attributed to the possessors of many forms of chattels. Failure to tax such income from movable possessions rests on practical and administrative considerations. The task of valuing and revaluing the chattels of taxpayers, of assessing the annual value of their enjoyment and of fairly and efficiently collecting tax upon them is an impossible one. Speaking generally, a man's house is of much

the value of an employee's (or shareholder's) personal use of an automobile which has been supplied by his employer (or corporation) are similar.²⁵ But it is unlikely that the taxation of such benefits points the way towards the taxation of similar kinds of imputed income. One reason is that the rules do not apply to the self-employed.

III. *Self-Supply of Goods.*

The value of stock-in-trade which a taxpayer appropriates from his business for his own and his family's personal consumption is imputed income. Examples include farmers who eat their home-grown produce, and retail-clothing-store proprietors who outfit themselves and their families out of inventory.²⁶

The leading case on the question whether taxable income should be imputed to a businessman who appropriates stock-in-trade for his personal consumption is *Sharkey v. Wernher*.²⁷

However, the Supreme Court of India has also considered the question. In *Kikabhai Premchand v. Commissioner of Income-Tax*,²⁸ the taxpayer was the sole proprietor of a business which consisted of dealing in silver and shares. He kept his books on the accrual method. He withdrew some silver bars and shares from the business and settled them upon trusts, of which he was the "managing trustee", with equitable life interests for his wife and for himself and with the equitable remainder to charity. In computing his business profits, he credited his accounts with the cost of the appropriated stock-in-trade. The tax authority contended that he should have credited his accounts with the market value of the appropriated trading stock when he withdrew it from the business. While the market value in this case was greater than the cost, the tax authority was prepared to concede that the same rule should apply even if the market value were less than cost. The majority of the Supreme Court held that cost was the correct amount, for the following reasons: (1) since the transaction was not in the course of business (2) the business did not realize any

greater value than his chattels." Blum, Federal Income Tax Reform-Twenty Questions (1963), 41 Taxes 672, at pp. 680-682.

²⁵ Employee's Personal Use of Automobile Supplied by Employer, Interpretation Bulletin, No. IT-63.

²⁶ Heller, Limitations of the Federal Individual Income Tax (1952), 7 J. Finance 185, at pp. 193, 195; Goffman, An Economic Analysis of the Preferential Tax Treatment of Personal Income in Canada and the United States (1961-62), 17 Tax L. Rev. 77, at p. 89. Somewhat related to the self-supply of goods is the benefit to employees of discounts on merchandise. According to Revenue practice, such discounts are not taxable benefits: Employees' Fringe Benefits, Interpretation Bulletin, No. IT-71.

²⁷ [1956] A.C. 58, [1955] 3 All E.R. 493, 36 Tax Cas. 275 (H.L.); Potter, Reflections on *Sharkey v. Wernher*, [1966] British Tax Rev. 438.

²⁸ [1953] 24 Income Tax R. 506.

profit (3) and the only result was that a potential profit had been foregone; (4) it was wrong to distinguish the business of a sole proprietorship from its owner and finally, (5) both the sale and the profit were fictional. In the course of delivering judgment for the majority, Bose J., drew an analogy of the man who trades in rice and who uses it for family consumption:

The bags are all stored in one godown and he draws upon his stock as and when he finds it necessary to do so, now for his business, now for his own use . . . How can he be said to have made an income personally or his business a profit, because he uses ten bags out of his godown for a feast for the marriage of his daughter? How can it make any difference whether the bags are shifted directly from the godown to the kitchen or from the godown to the shop and from the shop to the kitchen, or from the shop back to the godown and from there to the kitchen? And yet, when the reasoning of the learned Attorney-General [for the tax authority] is pushed to its logical conclusion, the form of the transaction is of its essence and it is taxable or not according to the route the rice takes from the godown to the wedding feast. In our opinion, it would make no difference if the man instead of giving the feast himself hands over the rice to his daughter as a gift for the marriage festivities of her son.²⁹

On the other hand, in *Sharkey v. Wernher*,³⁰ a majority in the House of Lords reached the opposite conclusion, namely, that when a taxpayer appropriates stock-in-trade from his business for his personal use, enjoyment or recreation, he must credit his trading account with the fair market value of the stock so withdrawn, and accordingly, to the extent that market value exceeds cost, a profit is imputed to him and is taxable. The taxpayer's wife, Lady Zia Wernher carried on (1) a stud farm, which was, admittedly, a business for tax purposes and (2) racing stables, which were recreational and therefore not taxable.³¹ The horses, which were bred at the stud farm, were either sold to third parties or transferred to her racing stables. In the relevant year, she transferred five horses from the stud farm to the racing stables and credited the trading account for tax purposes with the cost of breeding the horses. A majority of the Law Lords held that the fair market value of the horses at the time of their transfer was the correct entry. Thus the House of Lords approved the taxation of imputed income to the trader who appropriates stock-in-trade for his per-

²⁹ *Ibid.*, at p. 510. A "godown" is a warehouse or store for goods.

³⁰ *Supra*, footnote 27. Their Lordships' judgments did not refer to the *Kikabhai Premchand* case.

³¹ In Canada, raising and breeding race horses may be either a business or a recreation (hobby farm): *Garrard v. M.N.R.*, 72 D.T.C. 1307, [1972] C.T.C. 2362 (T.R.B., per A. J. Frost); *Keirstead v. M.N.R.*, 71 D.T.C. 226, [1971] Tax A.B.C. 264, (T.R.B., per Boisvert, Q.C.). And, the winnings of a racehorse may not constitute the income of a business and may therefore be a non-taxable windfall: *Filion v. M.N.R.*, 73 D.T.C. 56, [1973] C.T.C. 2067 (T.R.B., per St.-Onge); *Hammond v. M.N.R.*, [1971] 1 F.C. 341, 71 D.T.C. 5389; [1971] C.T.C. 663 (per Pratte J.).

sonal use or consumption. As Viscount Simonds pointed out: "The same problem arises whether the owner of a stud farm diverts the produce of his farm to his own enjoyment, or a diamond merchant, neglecting profitable sales, uses his choicest jewels for the adornment of his wife, or a caterer provides lavish entertainment for a daughter's wedding breakfast. Are the horses, the jewels, the cakes and ale to be treated for the purpose of income tax as disposed of for nothing or for their market value or for the cost of their production?"³²

Thus, the majority's reasoning began with the premise that the amount to be credited to the trading account must be chosen from: (1) nil, (2) cost of production of the horses, or (3) their fair market value.

First, the majority rejected the suggestion that the accounts should be credited with nil. Both Viscount Simonds and Lord Radcliffe, who wrote the majority's reasons, recognized that since Lady Zia had not received any consideration on the transfer, it could be argued with some logical force that the proper figure to be brought in was nil. However, their Lordships dismissed that line of reasoning on two grounds: (1) since the parties had joined issue on whether cost or market value was the appropriate alternative, the "nil" possibility had not been argued and (2) it was wrong in principle, "because of the absurd anomalies that [the nil figure] would produce as between one taxpayer and another. It would give the self-supplier a quite unfair tax advantage".³³ In other words, if the taxpayer were allowed to enter nil into his books, he would for tax purposes be able to deduct a trading loss even though such a loss had not in fact been realized. The inequity of this result and the possibilities for tax avoidance fell foul of their Lordships.

Second, the majority considered the taxpayer's contention that the cost of production should be credited to the trading account, thus, it was argued, producing neither a gain nor a loss on the transaction. The dissenting judge, Lord Oaksey, accepted the argument that trading profits for tax purposes must be computed by deducting from gross income the expenses incurred to earn the profits, and that according to accounting practice, the cost of trading assets withdrawn from the trade should not be deducted because such expenses were not incurred for the purpose of earning income. On the other hand, the majority rejected this reasoning

³² *Supra*, footnote 27, at pp. 69-70 (A.C.), 496 (All E.R.), 297 (Tax Cas.).

³³ *Ibid.*, at pp. 83 (A.C.), 505 (All E.R.), 306 (Tax Cas.), per Lord Radcliffe.

because it was (1) "pure fiction"³⁴ and (2) an *ex post facto*³⁵ argument. Because when such expenses were incurred, they were properly deductible, the subsequent appropriation did not retrospectively vitiate those deductions.

Furthermore, an equally persuasive argument against the use of cost has been advanced.³⁶ Their Lordships and other writers have overlooked the fact that crediting cost to the trading account may not, in fact, effect a break-even on the transaction. If the market value of the stock-in-trade had fallen below cost, the taxpayer may have written it down to the lower market value for tax purposes, since the Income Tax Act permits him thus to anticipate his loss. When the goods had thus depreciated in value and the taxpayer had written them down to market value, why should he credit the trading account with cost, to produce a profit on the transaction? Conversely, if the cost figure were adopted as the proper entry when a taxpayer withdraws stock-in-trade for personal use, taxpayers could underestimate their income by withdrawing stock-in-trade which had appreciated in value instead of selling such goods in the market.

In the result, their Lordships approved the third possibility, namely, the crediting of fair market value to the trading account. Lord Radcliffe did so because he regarded this result as most consistent with what are sometimes referred to as *Equity* and *Neutrality*:³⁷

The realizable [or market] value figure is neither more nor less "real" than the cost figure, and, in my opinion, it is to be preferred for two reasons. First, it gives a fairer measure of assessable trading profit as between one taxpayer and another, for it eliminates variations which are due to no other cause than any one taxpayer's decision as to what proportion of his total product he will supply to himself. A formula which achieves this makes for a more equitable distribution of the burden of tax, and is to be preferred on that account. Secondly, it seems to me better economics to credit the trading owner with the current realizable value of any stock which he has chosen to dispose of without commercial disposal than to credit him with an amount equivalent to the accumulated expenses in respect of that stock. In that sense, the trader's choice is itself the receipt, in that he appropriates value to him-

³⁴ *Ibid.*, at pp. 69 (A.C.), 496 (All E.R.), 296 (Tax Cas.), per Viscount Simonds.

³⁵ *Ibid.*

³⁶ See the judgment of Bhagwati J., dissenting, in the *Kikabhai Premchand* case, *supra*, footnote 28.

³⁷ It has, of course, been frequently contended that the taxation of imputed income would advance the policy goals of: (1) greater equity, i.e., a fairer distribution of the tax burden in accordance with ability to pay and (2) greater neutrality, i.e., less interference with a competitive free market, which in theory produces the optimum allocation of resources: Sneed, *The Criteria of Federal Income Tax Policy* (1965), 17 Stanford L. Rev. 567 and *The Configurations of Gross Income* (1967).

self or his donee direct, instead of adopting the alternative method of a commercial sale and the subsequent appropriation of the proceeds.³⁸

Several Canadian writers³⁹ contend that our courts would follow *Sharkey v. Wernher*, by taxing the imputed income which arises on appropriations of stock-in-trade. However, the 1972 Income Tax Return (long form) clearly indicates that the Department of National Revenue does not apply the *Sharkey* decision. According to Schedule 8, in computing income from business, after deducting expenses, the taxpayer is instructed to add back to income, the "cost of goods taken from stock or saleable products consumed in your home".⁴⁰ Since this rule of practice is favourable to taxpayers whose stock-in-trade has appreciated in value, Canadian courts will most likely be squarely faced with the question only when a taxpayer, whose stock-in-trade had depreciated in value and had been written down accordingly, appropriates those goods for personal consumption and objects to recognizing a profit for tax purposes on the transaction.

In cases throughout the Commonwealth, both taxpayers and fiscal authorities have espoused the principle in *Sharkey v. Wernher*. Paradoxically, while the courts have resiled from the *Sharkey* case as authority for taxing imputed income,⁴¹ they have embraced and extended the case in other contexts. Thus, in *J. Bert Macdonald and Sons Limited v. M.N.R.*,⁴² the taxpayer company had three shareholders, a father and his two sons. Intending to give part of the value of some land to his sons, the father had trans-

³⁸ *Supra*, footnote 27, at pp. 84-85 (A.C.), 505-506 (All E.R.), 307 (Tax Cas.). This passage is a major part of the argument in favour of taxing imputed income: see text at footnote 2, *supra*.

³⁹ E.g., Canada Tax Service, at 9-136C, contends that the Income Tax Act, ss. 13(7)(a) and (b) and ss. 69(1)(b) (ii) and (c) have put "to rest" the controversy. However, s. 13 deals with depreciable property and s. 69 contemplates a disposition between the taxpayer and another person and not a self-supply. Scace, *The Income Tax Law of Canada* (1972), pp. 30-31, does not classify *Sharkey v. Wernher* as an imputed income case. Instead it is regarded as an example of the "constructive receipt of income". At p. 31, Scace argues that Canadian courts would follow *Sharkey* because of s. 69(1)(b). As will be explained, *infra*, the Department of National Revenue does not seem to share this view: *Conversion of Property From or To Inventory*, Interpretation Bulletin No. IT-102.

⁴⁰ In 1947 and 1948, Revenue practice required farmers to include in income the fair market value of stock and produce withdrawn for personal consumption: Gordon, *The Taxation of Farmers* (1949), 27 Can. Bar Rev. 898, at pp. 898-899. In Australia, taxpayers who dispose of trading stock otherwise than in the ordinary course of trade must bring its value into income: *Australian Income Tax Guide*, pp. 842-843; but where stock-in-trade is appropriated for domestic consumption, cost is the proper entry: Bock and Mannix, *Australian Income Tax Law and Practice* (1973), Vol. 1, p. 1515.

⁴¹ *Mason v. Inries*, [1967] Ch. 1079, [1967] 2 All E.R. 926, 44 Tax Cas. 326, discussed, *infra*.

⁴² [1970] 1 Ex.C.R. 230, [1970] C.T.C. 17, 70 D.T.C. 6032 (Ex.Ct).

ferred it to the company at a bargain price of \$1,000.00 per acre when its fair market value, as found by the learned judge, Thurlow J., was \$2,200.00 per acre. Subsequently, the company sold the land and conceded that the sale was a trading transaction. The question was whether the profit for tax purposes was the difference between the actual cost of \$1,000.00 and the sale price or the fair market value of \$2,200.00 and the sale price. Extending the reasoning of the *Sharkey* case, the learned judge held that since the company, on the facts, had not acquired the land in the course of business,⁴³ the proper amount was fair market value: "When a trader acquires something by some means or transaction unrelated to his business (e.g., by inheritance or gift, by purchase for personal use or even by purchase as a capital asset of some other undertaking) and then, having subsequently taken it into his business, sells it in the course of that business, it is only the profit from his business that is taxable and, to arrive at that profit, what must be deducted from the sale price in respect of the cost of inventory is the value of the thing sold at the time it was taken into the inventory of that business (because that is the cost to him of putting that thing into the business)."⁴⁴ In the present Income Tax Act, section 69 may cover the problem of the cost of bargain sales with a gift element. But since the interpretation of section 69 on this point is arguable,⁴⁵ the *Bert Macdonald* case may either complement section 69 or differ from it. If section 69 is interpreted to require actual cost in these circumstances, then it would, of course, overrule the *Bert Macdonald* case.

However, it is clear that a taxpayer who acquires stock-in-trade at a bargain price *in the course of trade* may not apply *Sharkey v. Wernher* to substitute, for the actual cost, fair market value at the time of acquisition.⁴⁶ As recent dividend-stripping

⁴³ Primarily because of the following factors: (1) the family relationship among the shareholders (2) evidence of the father's intention to give part of the value of the land to his sons and (3) the element of bounty or gift in the price.

⁴⁴ *Supra*, footnote 42, at pp. 246 (Ex.C.R.), 26 (C.T.C.), 6038 (D.T.C.); *contra, Reade v. M.N.R.* (1963), 34 Tax A.B.C. 313, 64 D.T.C. 95, per Fordham, Q.C. (not referred to in the *Bert Macdonald* judgment); *Johnston v. Heath*, [1970] 3 All E.R. 915, 46 Tax Cas. 463 (Ch.D.) where Goff J. rejected the argument because: (1) it had neither been raised below nor had notice been given to the Revenue and (2) there were no findings of fact as to whether the sale was partly a gift, or at arm's length or in the ordinary course of business; accord: *Petrotim Securities Ltd. v. Ayres*, [1964] 1 W.L.R. 190, [1964] 1 All E.R. 269, 41 Tax Cas. 389 (Eng. C.A., *obiter* dictum per Lord Denning M.R.); *Ridge Securities, Ltd. v. I.R.C.*, [1964] 1 All E.R. 275, 44 Tax Cas. 373 (Ch.D.); cf. *C Bar C Ranch Limited v. M.N.R.* (1963), 33 Tax A.B.C. 345, 63 D.T.C. 872.

⁴⁵ E.g., London, Depreciation, Canadian Bar Papers on Tax Reform (1971), p. 71, at p. 82; see, *Allfine Bowlerama Limited v. M.N.R.*, [1972] C.T.C. 2603, 72 D.T.C. 1502 (T.R.B., per A. J. Frost).

⁴⁶ *Jacgilden (Weston Hall), Ltd. v. Castle*, [1969] 3 W.L.R. 839, [1969]

cases indicate, the courts have great difficulty in deciding whether or not a transaction took place in the course of the trade.⁴⁷

Moreover, if the bargain element is included in the purchaser's income, then he can increase the cost of the asset for capital gains purposes according to section 52(1).

The principle in *Sharkey v. Wernher* has been useful in counteracting surplus-stripping transactions. In *Petrotim Securities Ltd. v. Ayres*,⁴⁸ the company, a dealer in securities, purchased securities and War Loan in the course of trade and resold them to associated companies at a price below cost and fair market value in order to create a trading loss. Because the sale was not in the course of trade, the Court of Appeal held that the company's trading account should be credited with fair market value at the time of sale rather than with the actual sale price.

Depending on the circumstances, such transactions in Canada could be dealt with by section 69 or section 245, and, if the loss were a capital loss, by section 40(2)(e) and section 55. To this formidable arsenal, sections 112(3) and (4) must also be added. Because of this array of statutory provisions, recourse to the *Petrotim* case in similar situations is probably unnecessary in Canada.

However, in the United Kingdom, the *Petrotim* principle has been extended beyond sales at a loss to sales at an undervalue, which are not in the course of trade. In *Skinner v. Berry Head Lands, Ltd.*,⁴⁹ the taxpayer company, a dealer in land, purchased land and agreed to sell it to its parent company for a small profit (rather than a loss) at less than fair market value, and the parent company agreed to sell the land to a third person at arm's length at a large profit. Because the sale to the parent company took place within a corporate group, within a day after the subsidiary had bought the land and the price was less than fair market value, Goff J., was of the opinion that the transaction was "an appropriation by the subsidiary to its parent of this profit"⁵⁰ and therefore not in the course of trade. Applying the principle in *Sharkey v. Wernher*, the learned judge held that the taxpayer was deemed to sell the land at fair market value. In Canada, section 69 would seem to cover this situation.

The *Sharkey* case dealt with the trader who appropriates stock-in-trade from his business for his own use, recreation or consumption. A closely related problem concerns the trader who converts

⁴⁷ All E.R. 1110, 45 Tax Cas. 685 (Ch.D.); accord: *Julius Bendit Ltd. v. I.R.C.* (1945), 27 Tax Cas. 44 (K.B. Div.).

⁴⁸ *F.A. & A.B. Ltd. v. Lupton*, [1971] 3 W.L.R. 670, [1971] 3 All E.R. 948 (H.L.); Carey, Trade—The Elusive Concept, [1972] British Tax Rev. 6.

⁴⁹ *Supra*, footnote 44.

⁵⁰ [1971] 1 All E.R. 222, [1970] 1 W.L.R. 1441 (Ch.D.).

⁵⁰ *Ibid.*, at pp. 230 (All E.R.), 1449 (W.L.R.).

his stock-in-trade into an investment. For example, a trader in land may purchase land with the intention of reselling it in the course of trade. Subsequently, he changes his mind and decides to develop the land as an income-producing investment. Two problems arise: (1) is the trader deemed to dispose of the land for its fair market value when he converts it from inventory into an investment and (2) when he ultimately sells the land, how should the gain or loss be apportioned between capital gain (or loss) and ordinary income (or loss)?

In *Allarco Developments Ltd. v. M.N.R.*,⁵¹ the taxpayer company, a land dealer, purchased land for resale in the course of its trade. When the city rezoned much of the land as parkland, the taxpayer's plans for subdividing it were frustrated and the company reached an agreement with the city to exchange most of this land for land owned by the city. Since the taxpayer proposed to construct and operate a hotel and parking garage on the land which it had acquired from the city, to obtain the necessary financing, it entered into a sale-and-leaseback transaction whereby it sold the land to an insurance company for \$1,000,000.00 and took back a lease of the land for ninety-nine years. The Minister contended first, that the original purchase and the sale-and-leaseback were transactions in the course of trade and assessed the taxpayer accordingly. Jackett P., as he then was, rejected this argument on the facts, holding that because the land which the taxpayer had acquired from the city was an investment, its sale-and-leaseback to the insurance company was not a transaction in the course of trade. Alternatively, the Minister contended that because the original land was inventory, when the taxpayer exchanged it for investment land worth at least \$1,000,000.00 it had effected a taxable realization, a barter, in the course of its trade. In response to this argument, the learned judge said:

I doubt that [the Minister's alternative contention] is a correct view of the matter. In the first place, I do not think that the somewhat complicated transaction with the City can be severed into parts and I do not think that there was a simple exchange as such. In the second place, the transaction with the City was a part of the series of transactions whereby the appellant acquired its long term leasehold interest in the present hotel and garage complex and was not a transaction in the course of the appellant's trading business at all. The better view, in my opinion, is that the appellant, in effect, removed the park lands in question from its trading inventory to use them to acquire the hotel and garage site and that, upon so removing them, it was bound, for the purpose of computing its profits from the trading business, to take into the revenues of its trading business the fair market value of the lands so removed. I think this would have been so if a trader in house properties took a house out of his inventories to use it for his private residence,

⁵¹ [1970] C.T.C. 390, 70 D.T.C. 6274 (Ex.Ct) reversed, [1972] C.T.C. 172, 72 D.T.C. 6154 (S.C.C.).

and I see no difference where a trader removes trading inventories to use them as capital assets of a producing business or as consideration for the acquisition of such assets.⁵²

Although the learned judge qualified this passage as "a tentative view",⁵³ its effect is that the *Sharkey* principle should apply to the trader who appropriates assets from stock-in-trade in order to hold them as investments. In other words, the trader should credit his trading account with fair market value at that time.

In the Supreme Court of Canada, the majority reversed this decision, on other grounds, namely that the Minister's first argument was correct. The majority did not consider the validity of the principle expressed by the learned trial judge. To paraphrase Mr. Justice Pigeon, *dissentiente*, the Supreme Court took the view that the transaction was an exchange of a trading asset for a permanent investment, in the course of trade, rather than an appropriation from trading stock of an asset for investment.

Three further points should be noted. First, in the *Allarco* case, Jackett P., expressed more acceptance of taxing imputed income than he had in a previous case.⁵⁴ As leading counsel for the Crown in the *Frankel*⁵⁵ case, he had argued, successfully at the trial level, for the application of *Sharkey v. Wernher*. Thus, the learned judge is, with respect, fully aware of the *Sharkey* case and of its implications. Second, although the Supreme Court of Canada has been faced with the *Sharkey* principle on three occasions,⁵⁶ the court has never disapproved of it. On two occasions, it was distinguished. Third, the Department of National Revenue has recently announced its practice with regard to traders who convert inventory assets into investments and *vice versa*.⁵⁷

Contrary to the tentative opinion expressed by Jackett P.,⁵⁸ when a trader appropriates from his stock-in-trade an asset as an investment, the government's practice is that he is not deemed to have disposed of it at that time. Rather, he must bring into his trading account the *cost* of that asset. And when he ultimately

⁵² *Ibid.*, [1970] C.T.C., at p. 396, 70 D.T.C., at p. 6278.

⁵³ *Ibid.*

⁵⁴ *Lagacé and Lagacé v. M.N.R.*, [1968] C.T.C. 98, 68 D.T.C. 5143.

⁵⁵ [1959] C.T.C. 244, 59 D.T.C. 1161 (S.C.C.), reversing, [1958] C.T.C. 314, 58 D.T.C. 1173 (Ex.Ct.).

⁵⁶ The three cases are: *Frankel*, *ibid.*; *Allarco*, *supra*, footnote 51; and *Orlando v. M.N.R.*, [1962] C.T.C. 108, 62 D.T.C. 1064, per Cartwright J., dissenting.

⁵⁷ Conversion of Property From or To Inventory, Interpretation Bulletin No. IT-102; *cf.* Conversion of Capital Asset into Inventory—Change of Intention (1973), 14 Can. Current Tax, #3450.

⁵⁸ Accord: *Wilson v. M.N.R.*, [1955] C.T.C. 87, at p. 91, 55 D.T.C. 1065, at p. 1067 (S.C.C.), per Rand J.: "It is clear, then, that on principle the use of one's property for the purposes of one's business involves the appropriation to the business of an economic value which is consumed in carrying on the business."

sells the asset, in computing his capital gain or loss, he can deduct from his proceeds that cost figure. Thus, a trader may be able to convert ordinary income into capital gain by appropriating from his stock-in-trade for investment purposes, those items which have appreciated in value, before disposing of them. However, the Department's practice lacks symmetry.

When a trader, in the converse situation, converts capital property into inventory, he is not deemed to have disposed of the asset. But, when he sells the asset in the course of his trade, the general principle, which is broadly consistent with the *J. Bert Macdonald* case, is that he must apportion his profit as between capital gain and income according to the *fair market value* of the asset at the time of conversion. However, Revenue practice does not even follow completely the *Macdonald* case. The taxpayer's capital gain or loss is not the difference between fair market value at the time of conversion and proceeds of disposition but between original cost, adjusted by adding to it the amount of the gain included in business income and by deducting from it any amount deducted as business loss, and the proceeds. Thus, in respect of this kind of self-supply, Revenue practice is ambivalent towards the principle in *Sharkey v. Wernher*.⁵⁹

Finally, section 13(7) and section 45, which deal respectively with **capital cost allowance** and capital gains, provide that when a taxpayer changes the use of capital property, wholly or partially, as between income-producing and other purposes like personal consumption or recreation, he is deemed to dispose of the asset. Because the disposition is deemed to take place at the asset's fair market value or proportion thereof, one effect is that income in such forms as capital gain or recapture is imputed to the taxpayer. However, this effect appears to be incidental to the main purpose of these provisions, which is to exclude from recognition any decline in value attributable to personal consumption. A fundamental principle of income tax disallows any deduction for personal or living costs. Thus, the policy underlying these provisions is rather different from the policy of taxing imputed income. Nevertheless, since these deemed dispositions involve both appro-

⁵⁹ Cf. *Land Dealing Co. v. Commissioner of Taxes*, 1959 (3) S.A. 485, 22 S.A.T.C. 310 (Southern Rhodesia: the company had acquired land as an investment. Later, when it had appreciated, the company converted it into stock-in-trade and sold it at a profit. The company argued that, according to the *Sharkey* principle, the "cost" of the land in computing trading profit should be the fair market value at the time of the conversion. The court held, that the business income was the difference between selling price and actual cost because: (1) it would be improper to exempt from tax part of the gain and (2) otherwise, if the asset had declined in value after the conversion, an artificial loss would be deductible; contra: *Commissioner of Income-Tax v. Kooka* (1962), 46 Income Tax R. 86 (Supreme Court of India); and see *Taylor v. Good*, [1973] 2 All E.R. 785 (Ch.D.).

priations and fair market value, they offer some support for the taxation of imputed income.

IV. *Self-Supply of Services.*

Examples of this type of imputed income include the doctor who saves the expense of hiring another doctor to treat his family by doing so himself⁶⁰ and the lawyer who draws his own or his child's will. Even the lawyer who surrenders a lucrative practice in order to teach as a professor of law at a modest salary has been said to enjoy imputed income to the extent of the income foregone.⁶¹ "Leisure itself, enjoyed by the taxpayer, is consumption of something of value—the taxpayer consumes his time instead of working to earn market-type income".⁶²

Many writers have observed that the taxation of this form of imputed income, while correct in theory, is extremely objectionable in practice. For example, a tax on leisure would probably raise few tax dollars and many taxpayers' tempers. Bearing in mind "[t]he bucolic atmosphere which is inevitably associated with this type of imputed income",⁶³ one is surprised to find that there is any authority for its taxation.

Nevertheless, Mr. Justice Rowlatt, who subsequently denied that any form of imputed income was taxable,⁶⁴ apparently approved the taxation of imputed income which arises when a taxpayer supplies services to himself. In *Back v. Daniels*,⁶⁵ the taxpayers were a firm of wholesale potato merchants and salesmen. In addition to carrying on this business, they grew their own potatoes on farm land which they owned and they marketed these potatoes through their business of potato merchants and salesmen. Rowlatt J., said:

It seems to me that they are simply in the position of potato growers who sell their own potatoes in London, which they have every facility for doing, because they are potato salesmen as well as growers of potatoes. The respondents do not dispute that in addition to their liability

⁶⁰ The example ignores professional courtesy among physicians, which in itself, raises problems of constructive receipt and perhaps, imputed income.

⁶¹ McNulty, *op. cit.*, footnote 4, p. 29.

⁶² *Ibid.*, p. 28. Where a taxpayer enters into a covenant not to compete, should the consideration which he receives for not working (*i.e.*, for his leisure) be taxed as remuneration for services? In England, such receipts would not be exigible as income, although capital gains provisions might apply: *Higgs v. Olivier*, [1952] Ch. 311, 33 Tax Cas. 136 (C.A.). But, in the United States such receipts are income: *Cox v. Helvering* (1934), 71 F. 2d 987 (D.C. Cir.). In Canada a covenant not to compete may also be part of the sale of goodwill and taxable under the eligible capital provisions or it may create income from employment under section 6 (3).

⁶³ Marsh, *op. cit.*, footnote 2, at p. 526.

⁶⁴ See text at footnote 8, *supra*.

⁶⁵ [1924] 2 K.B. 432, 9 Tax Cas. 183 (K.B. Div.).

to income tax under Sch. B. [profits of the occupation of land] they may be liable to income tax on a sum in the nature of a commission to themselves for selling their own potatoes, in the same way as they sell other people's potatoes in London on the market.⁶⁶

In the *Sharkey* case,⁶⁷ Lord Radcliffe pointed out that, in the Court of Appeal, on the appeal from Rowlatt J.'s decision, none of their Lordships disapproved of this passage and Scrutton L. J., noted only that the assessment included a "conventional commission assigned to them as salesmen for selling their own potatoes . . .".⁶⁸

And there are other cases which support, to a lesser extent, the taxation of the imputed income which arises from the self-supply of services. When an insurance agent earns a commission for selling himself insurance he is required to include the commission in his income for tax purposes.⁶⁹ Similarly, a real estate salesman who earns a commission from his employer on selling property to himself must include that commission in his employment income.⁷⁰ And a stock salesman who purchases stock for his own account, thus earning a commission, would also be taxable thereon.⁷¹ It is arguable that, depending on the facts, these cases come close to the taxation of imputed income. However, the better view seems to be that since these transactions involve the payment of cash, the market place, and remuneration for services (at least from the employer's perspective), they do not really offer much support for the taxation of imputed income.⁷²

Applying the decision in *Sharkey v. Wernher*, the United Kingdom's Inland Revenue recently made a vigorous effort to extend the definition of taxable income to include imputed income from the self-supply of services.⁷³

In *Mason v. Innes*,⁷⁴ the Revenue contended: "Where a trader or a professional person appropriates value to himself by consuming or to a donee by giving away an asset (instead of selling it and

⁶⁶ *Ibid.*, at pp 499 (K.B.), 195 (Tax Cas.). (Because of the minor differences in wording, see footnote 8, *supra*.)

⁶⁷ *Supra*, footnote 27, at pp. 81 (A.C.), 503 (All E.R.), 304 (Tax Cas.).

⁶⁸ [1925] 1 K.B. 526, at p. 541, 9 Tax Cas. 195, at p. 201.

⁶⁹ *Ostheimer v. U.S.* (1959), 264 F.2d 789 (3d. Cir.) cert. den., 361 U.S. 818, noted in (1958), 58 Mich. L. Rev. 292; *Comm'r v. Minzer* (1960), 279 F.2d 338 (5th Cir.), noted in (1959), 45 Virginia L. Rev. 748; and *George E. Bailey* (1964), 41 T.C. 663 (Tax Court of the U.S.).

⁷⁰ *Comm'r v. Daehler* (1960), 281 F.2d 823 (5th Cir.), noted in, [1959] Duke L.J. 476 and in (1960-61), 12 Syracuse L. Rev. 538; *Grant v. M.N.R.*, 67 D.T.C. 249, [1967] Tax A.B.C. 326, per St.-Onge.

⁷¹ Cf. *Snell v. M.N.R.* (1957), 17 Tax A.B.C. 186, 57 D.T.C. 299, per Fordham, Q.C.

⁷² Cf. Haskell and Kauffman, *supra* footnote 5, with Eustice, Cases Taxing an Employee on Commissions on Sales to Himself Threaten Other Fringes, (1960), 13 J. Taxation 322.

⁷³ See, Potter, *op. cit.*, footnote 27.

⁷⁴ *Supra*, footnote 41.

appropriating the proceeds) then his profits must be computed by treating him as receiving the value he appropriates." The taxpayer, Hammond Innes, who had written a new book, gave the rights to the book to his father. These rights were valued at £15,425. Moreover, the taxpayer had deducted in computing his professional income, the expenses of travelling and gathering material for the book. Of crucial importance was the fact that he kept his accounts on the cash basis. The Inland Revenue argued that on the principle of *Sharkey v. Wernher*, the taxpayer should bring into his professional income the fair market value of the copyright. Both the High Court and the Court of Appeal unanimously rejected the Crown's attempt to extend the taxation of imputed income beyond the trader to the professional taxpayer. Ignoring Lord Radcliffe's approval of *Back v. Daniels*, the judges in *Mason v. Innes* managed to restrict the principle in *Sharkey v. Wernher* so that it did not encompass professionals who derived imputed income from supplying themselves with their own services.

At the outset, it should be noted that their Lordships clearly did not regard an author's copyright as the stock-in-trade of the business of writing. "Copyright is an incident attached by law to the book, fortifying that which [the writer] has produced and giving it a value which it would not have if it could be reproduced illegitimately in the shape of pirated editions."⁷⁵ Their Lordships assumed that like other professionals, a writer did not have any stock-in-trade. Second, it is fair to say that Goff J., the trial judge, and Lord Denning M. R., who wrote the leading judgment in the Court of Appeal, recoiled from the taxation of imputed income on the self-supply of services because they foresaw some very undesirable implications. Thus Goff J., said: "The principle, if applied to professional men, must mean that they cannot give their services within the ambit of their profession without, in some cases at least, becoming liable to income tax on notional fees, which in my judgment is a *reductio ad absurdum*."⁷⁶ And Lord Denning M. R., also found the consequences abhorrent: "Suppose an artist paints a picture of his mother and gives it to her. He does not receive a penny for it. Is he to pay tax on the value of it? It is unthinkable. Suppose he paints a picture which he does not like when he has finished it and he destroys it. Is he liable to pay tax on the value of it? Clearly not. These instances—and they could be extended endlessly—show that the proposition in *Sharkey v.*

⁷⁵ *Carson v. Peter Cheyney's Executor*, [1958] 3 All E.R. 573, at p. 584, (1958), 38 Tax Cas. 240, at p. 268 per Lord Keith of Avonholm, quoted with approval by Goff J., in *Mason v. Innes*, [1967] Ch. 436, [1967] 1 All E.R. 760, at p. 764, 44 Tax Cas. 326, at p. 333 (Ch.D.).

⁷⁶ *Ibid.*, at pp. 448 (Ch.), 765 (All E.R.), 334 (Tax Cas.).

Wernher does not apply to professional men."⁷⁷ Finally, in the words of Davies L. J., their Lordships concluded that the *Sharkey* principle was restricted to: "A trader or to a person whose accounts are made up on an earnings basis and who has stock-in-trade which he may other than in a commercial manner transfer to himself or for no consideration to a third party."⁷⁸ According to Russell L. J., the Crown's attempt to impose tax on the imputed income of a professional taxpayer who keeps his accounts on the cash basis was as futile as an attempt "to mix oil and water".⁷⁹

Learned judges and writers have noted, correctly, it is submitted with respect, that the alleged key of distinction, between cash basis and accrual basis taxpayers, is unconvincing.⁸⁰ It is inconsistent with the theoretical concept of imputed income. Nevertheless, although theoretically incorrect, the decision in *Mason v. Innes*, to exclude from the tax base the value of services supplied to oneself, can be justified on practical grounds: (1) a taxpayer's satisfactions from supplying himself with services are often incapable of measurement in monetary terms (2) an attempt to tax all such forms of imputed income except leisure would encourage people to consume greater amounts of their time in leisure pursuits, (3) on the other hand, any attempt to tax leisure has been described as clumsy and undesirable and (4) the tax revenue would be derisory. It is well to bear in mind the admonition of Holmes J., that: "The income tax laws do not profess to embody perfect economic theory."⁸¹ Moreover, the author who gives away a copyright may incur liability for capital gains and provincial gift tax.

V. Housewives' Services.

The definition of imputed income includes the value of the services which the taxpayer's wife and children supply in the home. How can the value of the services of a good wife be measured? Proverbs 19:14 says: "House and riches are the inheritance of fathers: and a prudent wife is from the Lord." Even though wise Solomon

⁷⁷ *Supra*, footnote 41, at pp. 1090 (Ch.), 928 (All E.R.), 339 (Tax Cas.).

⁷⁸ *Ibid.*, at pp. 1092 (Ch.), 929 (All E.R.), 341 (Tax Cas.).

⁷⁹ *Ibid.*, at pp. 1093 (Ch.), 930 (All E.R.), 341 (Tax Cas.).

⁸⁰ *Legacé and Legacé v. M.N.R.*, *supra*, footnote 54, at pp. 110 (C.T.C.), 5150 (D.T.C.), (Ex. Ct), per Jackett P., and Whiteman and Wheatcroft, Income Tax and Surtax (1971), pp. 352-353 would extend the reasoning of *Mason v. Innes* to all professionals, whether on the cash or the accruals basis. Since Canadian professionals must now keep their accounts on an accrual basis, and they can elect not to bring in their work-in-progress, the question remains open whether *Mason v. Innes* would apply: (1) to all professionals, at one extreme, (2) to none of them, at the other extreme, or (3) to those who have elected to exclude their work-in-progress.

⁸¹ *Weiss v. Weiner* (1929), 279 U.S. 333, at p. 335.

stated that a good wife was worth more than material goods, for tax purposes, Parliament has attempted to put an arbitrary value on housewives' services.

It has frequently been observed that like any other taxpayer who supplies himself or herself with his or her own services, the housewife who works in her home generates income.⁸² "The provision of housekeeping services to oneself or to one's family adds to the tax capacity of the individual or family just as the sale of labour services for cash adds to taxable capacity. To use an old tax adage, 'saving the pocket' is equivalent to 'adding to the pocket'."⁸³ Indeed, the housework done by wives may be the most significant kind of self-consumption of one's own services.

Because the tax base excludes this form of imputed income, it falls short of the theoretical ideal and causes inequity and unneutrality.

Where both spouses are gainfully employed in market activities, they will have greater taxable income than a married couple in which only one spouse is gainfully employed outside the home (assuming that both couples are otherwise identical). The second couple's economic capacity is said to be understated by the value of the spouse's full-time services in the house. And, the exclusion of this form of imputed income is unneutral for it tends to encourage the wife to remain at home rather than to undertake outside employment. Thus the tax system creates a "barrier" to married women who wish to work. Even if one subscribes to the view that married women should stay at home anyway, this form of tax discrimination is an inefficient and undesirable means of effecting that social policy. On the other hand, it does encourage marriage: that is, of the male householder to his housekeeper, or of the single woman to her chauffeur!

Broadly, there are two possible solutions to this problem: (1) the tax base could be extended to include housewives' services or (2) a deduction for the working wife's expenses could be allowed.

After accepting the theoretical soundness of taxing this form of imputed income, The Royal Commission on the Status of Women concluded that it should not be taxed in practice because of the problems of administration, fairness, and taxpayers' liquidity: the effect would be to force wives to seek gainful employment.⁸⁴

By allowing a deduction for child-care expenses, Parliament

⁸² E.g., Marshall and Walsh, *Marital Status and Variations in Income Tax Burdens*, [1970] British Tax Rev. 236; Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers* (1971), 21 Buffalo L. Rev. 49.

⁸³ Hartle, *op. cit.*, footnote 3, p. 85.

⁸⁴ Report of the Royal Commission on the Status of Women in Canada (1970), pp. 293-298; Hartle, *op. cit.*, *ibid.*, *passim*.

adopted the second of the two alternatives. However, section 63 allows a modest deduction not only to the working wife but also to a husband and even to single taxpayers, in certain circumstances.⁸⁵ The government has justified this reform on two theoretical grounds: (1) to reduce the barrier against wives who want gainful employment and (2) to recognize that "child care expenditures constitute a real cost of earning income".⁸⁶ Although such a deduction does achieve some equity among married couples, it does not affect the tax discrimination against single taxpayers insofar as they do not receive imputed income from wifely services. Moreover, the deduction is only partial and its limits are arbitrary.⁸⁷ And all personal deductions are regressive. "An upper income taxpayer receives a larger tax reduction than does a lower income taxpayer"^{87a} in respect of the same amount of child-care expenses. The amount of the subsidy varies directly with the marginal rate of tax. Thus, it is most beneficial where it is needed the least. Finally, the Royal Commission on the Status of Women observed that the marital deduction for the dependent spouse is inconsistent with the theory of imputed income and continues to deter wives from working outside the home.⁸⁸

VI. Mutual Trading.

Although the *Carter Report* recommended against the taxation of imputed income for the time being, it did note that members or beneficiaries of such "mutual organizations"⁸⁹ as "co-operatives, credit unions, caisses populaires, mutual insurance companies . . . boards of trade, labour organizations, fraternal orders . . . private clubs, and . . . charitable organizations",⁹⁰ whether incorporated or not, can derive imputed income from such groups. "For example, if an individual makes an investment from which he derives income in the form of interest or rent, and spends the income on recreation, he will be taxable on the income but will not be allowed the cost of the recreation for tax purposes. When an individual invests in a recreation club, however, the investment and recreation activities are merged in the club and he does not receive any readily measurable income from his investment; the income that otherwise would have arisen has been used to reduce the cost of

⁸⁵ Arnold, Section 63: The Deduction for Child Care Expenses (1973), 21 Can. Tax J. 176.

⁸⁶ Hon. E. J. Benson, Minister of Finance, Proposals for Tax Reform (1969), p. 15.

⁸⁷ Marshall and Walsh, *op. cit.*, footnote 82, at p. 241.

^{87a} Weidenbaum, Shifting from Income Tax Deductions to Credits (1973), 51 Taxes 462.

⁸⁸ Report on Status of Women, *op. cit.*, footnote 84, p. 293.

⁸⁹ Report of the Royal Commission on Taxation (1966), Vol. 4, p. 99.

⁹⁰ *Ibid.*

his recreation below what would have been necessary if he were acquiring it separately. In principle, income should be imputed to those individuals who merge these income-earning and personal benefit activities; there is no difference in the taxable capacity of those who merge the activities and those who do not."⁹¹

By the common law doctrine of "mutual trading" such groups were exempted from tax. Thus, a form of imputed income was excluded from the tax base. In a recent case,⁹² Lord Wilberforce explained the doctrine in most helpful terms:

Cases in which groups of persons making contributions towards a common purpose have been held not liable for tax on any surplus over expenditure fall under a number of heads. The expression "the mutuality principle" has been devised to express the basis for exemption of these groups from taxation. It is a convenient expression, but the situations it covers are not in all respects alike. In some cases the essence of the matter is that the group of persons in question is not in any sense trading, so the starting point for an assessment for income tax in respect of trading profits does not exist. In other cases, there may be in some sense a trading activity, but the objective, or the outcome, is not profits, it is merely to cover expenditure and to return any surplus, directly or indirectly, sooner or later, to the members of the group. These two criteria often, perhaps generally, overlap; since one of the criteria of a trade is the intention to make profits, and a surplus comes to be called a profit if it derives from a trade. So the issue is better framed as one question, rather than two: is the activity, on the one hand, a trade, or an adventure in the nature of trade, producing a profit, or is it, on the other, a mutual arrangement which, at most, gives rise to a surplus?⁹³

Following numerous precedents, the learned judge held that, where a group, to which the mutuality principle would *prima facie* apply, supplies benefits to non-members, in market transactions, it forfeits the exemption to that extent. Such transactions give rise to ordinary income. The result is a fine, and perhaps arbitrary, line between tax-exempt mutuality, on the one hand, and taxable trading, on the other. Like such other questions as residence, it is ultimately a question of fact and degree. Moreover, by modifying the common law position, the Income Tax Act has added further complexity. For example, social and recreational clubs are taxable on their investment income over \$2,000.00.⁹⁴ Co-operatives, caisses populaires, credit unions and mutual insurance corporations are also taxable. While they may be able to deduct patronage dividends to their members, generally such dividends are taxable income to the recipients.⁹⁵ These statutory modifications thus involve a limited attempt to deal with imputed income.

⁹¹ *Ibid.*, p. 137.

⁹² *Fletcher v. Income Tax Commissioner*, [1971] 3 All E.R. 1185 (J.C.P.C.).

⁹³ *Ibid.*, at p. 1189.

⁹⁴ Cf. Non-Profit Organizations—Taxation of Income From Property, Interpretation Bulletin No. IT-83.

⁹⁵ Income Tax Act, ss 135-143.

A recent Canadian case involved mutual trading and imputed income.⁹⁶ The taxpayer was a contributor to the Canadian Scholarship Trust Foundation. Administered by a trust company, the scheme required a subscriber to make periodic contributions over a number of years. After deducting expenses, the trust company credited to the contributor's account his deposits and the interest compounded thereon. As of October 31st, 1970, approximately 39,000 subscribers had furnished the trust company with deposits which exceeded twenty-six million dollars and on which the accumulated interest exceeded six million dollars.

Each subscriber could designate a child as a beneficiary. If the subscriber ultimately made all the required contributions, the trust company would refund them to him and would pool the accumulated interest with that of the other contributors in a trust to provide scholarships to some of the beneficiaries. Even if all the payments were not made, any contributions prior to default would be refunded, but the accumulated interest would be pooled in the scholarship trust fund and the beneficiary's right to participate would be forfeited. Thus the scholarship fund consisted of the interest which had been credited to the various subscribers' accounts.

The Department followed the practice of assessing each subscriber on the interest which the trust company credited to his account in the year even though such interest might never be paid for his child's benefit.⁹⁷

In this test case, the taxpayer successfully challenged the Department's practice. Both in the tax Review Board and in the Federal Court, Trial Division, the interest credited to the subscriber's account was held not to be taxable. Although neither judgment adverted to it, the subscribers to this scheme enjoyed imputed income in the form of a chance to recoup a scholarship for the benefit of their children. According to economic theory, when the value of this chance exceeds the subscriber's contributions the difference is taxable as imputed income. And, the excess of any scholarships actually paid over the amount of imputed income which was assessed to the subscriber should be exigible either in the beneficiary's hands under section 56(1)(n) or, preferably, attributed back to the subscriber under section 56(2).

In spite of these unfavourable decisions, apparently the Department has not changed its practice.⁹⁸

⁹⁶ *The Queen v. Quinn*, [1973] C.T.C. 258, 73 D.T.C. 5215 (F.C., per Heald J.), aff'g, [1972] C.T.C. 2517, 72 D.T.C. 1413 (T.R.B., per A. J. Frost).

⁹⁷ Interest Credited on Funds Deposited with Scholarship Trust Plans, Interpretation Bulletin No. IT-22.

⁹⁸ The Minister is appealing to the Federal Court of Appeal.

Conclusion

The long-standing assumption that the income tax base excludes imputed income must be qualified. On the one hand, the Act and the cases recognize more kinds of imputed income than is generally realized. On the other hand, the practice of the Department of National Revenue, at the present time, at least, is far from aggressive in attempting to catch imputed income. Even though the Inland Revenue did lose in *Mason v. Innes*, by contrast to its approach, our Department of National Revenue is virtually ignoring *Sharkey v. Wernher*. However, the problem involves extremely difficult social and political considerations. At one extreme, it is clear that the theoretical ideal of taxing all forms of imputed income is impracticable. Since the definition of taxable income must fall short of that ideal, it must inevitably represent an uneasy compromise. If the problem appears to be insoluble with an income base, the only answer may be a consumption tax. For example, the United Kingdom value added tax, which extends to professionals, does tax self-consumption of both goods and services.⁹⁹ However, on this side of the Atlantic, many experts are opposed to the value added tax for a variety of reasons.¹⁰⁰ Thus, it appears that the problem of imputed income may continue indefinitely.

⁹⁹ Value Added Tax (Self-Supply) No 1, Order 1972; Value Added Tax (Self Supply) No. 2, Order 1972, noted in [1972] British Tax Rev. 873. "Personal use" is also a form of consumption taxable under the German statute and occurs when an entrepreneur uses his personal business enterprise in some way for his personal consumption or other noncommercial purposes. For example, a butcher who takes meat home from his shop for dinner and a business man who uses his company car for personal purposes or who makes business gifts which are not deductible under the German tax laws are subject to the tax on added value for these transactions. (The extent to which such transactions are reported and the tax actually paid is, of course, another question)." Fuller, *The Tax on Added Value*, [1972] Illinois L. Forum 269, at p. 279.

¹⁰⁰ E.g., Musgrave, *Problems of The Value Added Tax* (1972), 25 Nat. Tax J. 425.