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Although great care has been taken to prepare these notes there may be errors and omissions. These notes are no substitute for attending lectures and scrutinizing the suggested and required readings. Enjoy.

TABLE OF CONTENTS

1. Introduction 1

A. SOME STARTERS 1
1. Tax must be direct 1
2. Tax must be imposed within the province 1
3. Tax must be imposed for the purpose of raising revenue for provincial purposes 1
B. INCOME TAX COLLECTION PROCEDURE 1
1. Tax Return 1
2. Assessment 2
3. Audit 2
4. Objection 2
5. Reassessment 2
6. Appeal 2
C. OBJECTIVES OF THE ITA 2
1. Raise Revenue 2
2. Equity and Fairness 3
3. Neutrality 3
4. Simplicity 3
5. Economic Stabilizations 3
6. Balance 3
7. International Competitiveness 3

2. Who is Subject to Canadian Income Tax? 4

A. RESIDENCY 4
1. Full-Time Resident 4
2. Part-Time Resident 6
3. Non-Resident 7
B. TAX TREATIES 8
C. EXEMPTIONS 8
D. ABORIGINAL TAXATION 8
General Immunity 8
Treaty Exemptions 8
Indian Act Exemption 8
Recalma v. The Queen (1998) FCA 9

3. What is Subject to Income Taxation? 10

A. TAX BASE 10
B. CHARACTERIZATION OF RECEIPTS 10
Statutory Interpretation 10
Framework for Characterizing Receipts 10
C. PARAGRAPH 3(A) 11
ITA 3 – Income for taxation year 11
D. SOURCE CONCEPT OF INCOME 12
1. Source Concept of Income 12
2. Haig-Simon Definition of Income 12
3. Comprehensive Tax Base Reformulated (Carter Commission) 13
What is Not Included in a Tax Base? 14
ITA 81 – Exemptions 15

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NEXUS BETWEEN TAXPAYER AND SOURCE 16
Tax Avoidance *16*
Income Splitting & Attribution Rules *16*
Alternative Minimum Tax (AMT) *17*

4. Rates of Taxation 18

5. Income from Office or Employment 19

GENERALLY 19
A. WHO IS AN OFFICER OR AN EMPLOYEE 19
ITA 5(1) – Starting Point *19*
Consequences of Income for Office or Employment *19*
B. EMPLOYEE OR INDEPENDENT CONTRACTOR? 20
Tests to Characterize *20*
Common Law Characterization *21*
C. AMOUNTS INCLUDED IN COMPUTING INCOME 22
ITA 5 – Basic Rules for Office/Employment *22*
D. BENEFITS 22
ITA 6 – Value of Benefits *22*
Benefits of Any Kind *22*
E. ALLOWANCES 24
Relocation Cost (Benefit or Reimbursement) *25*
F. VALUATION (OPPORTUNITY COST) 26
G. DEDUCTIONS 26
Travel Expenses *26*
Legal Expenses *27*

6. Income From Business or Property 28

ITA 9 – Profit *28*
A. INCOME FROM PROPERTY 28
ITA 9(3) – Gains and Losses Not Included *28*
Rental from Real Property *28*
Payments Based on Production *29*
Interest on Land *29*
B. INCOME FROM A BUSINESS 30
Organized Economic Activity Test *30*
Reasonable Expectation of Profit Test *30*
Adventure or Concern in the Nature of Trade *31*
C. DEDUCTIONS 32
Calculating Net Income *32*
Generally Accepted Accounting Principles (GAAP) *32*
1. Defining Net Income – Business Purpose Test *33*
2. Reasonableness Requirement (ITA 67) *34*
3. Personal Living Expense *34*
4. Home Office Expense (ITA 18(12)) *35*
5. Childcare Expense *35*
6. Interest *36*
7. Public Policy (Illegality) *37*
D. COMPUTATION OF PROFIT 37
1. Cash Method *38*
2. Accrual Method *38*

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3. Computation of Profit for a Business *38*
4. Inventory *39*
E. CAPITAL V. CURRENT EXPENDITURES 40
1. Tangible Property *40*
2. Protection of Intangible Assets *41*
Repair v. Renovation *41*
F. CAPITAL COST ALLOWANCE 42
Depreciation *42*
Meaning of Cost *43*
Eligible Capital Expenditures *43*
Disposition of Depreciable Asset *43*

7. Income Producing Properties 44

Irrigation Industries v. M.N.R. 1962 SCC *44*
COMMODITIES 45
M.N.R. v. Taylor *45*
IT Bulletin: IT346R *46*
EXEMPTIONS FROM CAPITAL GAINS 46

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1. Introduction

A. Some Starters

A tax is a compulsory payment by a taxpayer to the government. The total revenue that the government raises through the income tax act is a function of the tax base multiplied by the tax rate.

The Constitution Act 1867 enumerated the taxing powers between the federal government (91(3)) and the provincial government (92(2)), confining the provincial power to direct taxation and the federal power was given unlimited authority. As a result, provincial authorities must satisfy three steps in order for provincial taxation to be constitutionally valid.

1. Tax must be direct

Atlantic Smoke Shops v. Conlin (1943) CTC

This case defined direct and indirect taxation. A direct tax is one demanded from the very person who it is intended or desired to pay it. An indirect tax are those demanded from one person in the expectation and intention that s/he will indemnify himself at the expense of another.

2. Tax must be imposed within the province

AG of BC v. Estate of Ellett (1979) BC CA

Tax must be imposed within the province in order for it to be valid.

3. Tax must be imposed for the purpose of raising revenue for provincial purposes

Caron v. The King (1927) PC

The federal government may enter into direct taxation even though s.92 grants this power specifically to the provinces.

BC Electric Railway Co. v. The King (1946) PC

Federal taxation powers may extend to taxation outside of Canada, whether or not these powers are enforceable outside of Canada.

Note: Most provinces sign tax collection agreements with the federal government so the federal government collects the province's share of income tax and sends the sum to the provinces.

B. Income Tax Collection Procedure

1. Tax Return

ITA 150 – (1) requires that every individual who is liable to pay tax in a particular taxation year must file a tax return for that year. (2) The Minister has the right to demand the filing of a return by an individual who is not liable to pay tax. The general rule is that the return must be filed by 30 April of the following year.

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2. Assessment

ITA 152 – (1) requires the Minister to assess the tax payable by the taxpayer and this must be accomplished with all due dispatch. ITA 158 – the tax must be paid forthwith.

3. Audit

ITA 231.1 – (1) the auditor has the power to inspect books and records of the taxpayer and also permits the auditor to enter business premises without a warrant and the questioned person must provide all reasonable assistance and answer all proper questions. ***ITA 231.1*** **–** (3) to enter a dwelling place requires a warrant issued by a judge.

4. Objection

A taxpayer may object to the decision of the Minister. ***ITA 165(1)*** – within one year after the filing due date and 90 days from the notice of assessment.

5. Reassessment

ITA 152(4) – the Minister has the power to reassess a return that has already been assessed (there are limits on this power). ***ITA 162*** – a reassessment will include interest on overdue taxes and possible civil penalties if the Minister concludes that a breach of the Act has been committed.

6. Appeal

The taxpayer may appeal the Minister's decision within 90 days from the date of mailing of notification of the Minister's decision. The burden of proof rests upon the taxpayer, however, to prove there was no wrong committed.

Johnston v. MNR

The burden is on the taxpayer because ***ITA 152(8)*** established that an assessment is deemed binding notwithstanding any error, defect, or omission in the assessment. The taxpayer, as the appellant, ought to affirmatively establish the proposition upon which s/he relies. Moreover, the taxpayer has the best access to the facts.

ITA 163 – Civil penalties may be imposed on the taxpayer for the repeated failure to report income and knowingly or negligently making false statements or omissions on a return.

C. Objectives of the ITA

There are seven main objectives of the Income Tax Act. Note that raising revenue is the primary objective and all others are secondary objectives that must be balanced and often compete with each other.

1. Raise Revenue

The ITA exists to raise revenue for government objectives. It was originally implemented to help the government finance war. It has stuck ever since. Note: Tax Revenue = Tax Base x Tax Rate.

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2. Equity and Fairness

There are two types of equity:

1. Horizontal Equity – persons in similar circumstances should pay the same tax
2. Vertical Equity – persons in different circumstances should bear appropriately different taxes. The Carter Commission applied the 'ability to pay' criterion:
    a. Proportional – all income is taxed at a flat rate
    b. Regressive – tax rate decreases as income increases
    c. Progressive – rate of tax increases as income increases (adopted in Canada)

3. Neutrality

The tax system ought not to effect people's behaviour, but rather ought to level the playing field. The Canadian government has a past history of not being neutral by inserting tax incentive schemes to motivate and encourage certain activities by people.

4. Simplicity

The tax system should be reasonably simple to comprehend and to apply. It should be easy for an individual to file his or her own return and for the government to administer to the system.

5. Economic Stabilizations

The tax system should play a stabilization role and ensure that it reflects the changing times and needs of the person.

6. Balance

The government should not rely too much on one kind of tax, but instead ought to achieve balance between corporate and personal taxes and other such taxes as payroll and sales.

7. International Competitiveness

The tax system should be competitive with other countries to ensure that Canadians feel like they are getting true value for their dollar and subvert the risk of a potential brain drain.

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2. Who is Subject to Canadian Income Tax?

The general rule is that the person who earns income in Canada is liable for any tax payable on the income. There are a number of bases for income taxation that range from citizenship, to residency, to domicile.

Citizenship – (US Approach) citizenship is viewed as your political connection to a country and thus you ought to pay taxes on your worldwide income to the country for which you have a political connection.

Residency – (Canadian Approach) sometimes referred to where one is ordinarily resident, this approach requires a closer relationship with a country that mere citizenship and emphasizes the economic association one has with a country. The Carter Commission recommended that we continue using residency and described it as focusing on the connection to a country that is more than citizenship, but less than domicile.

Domicile – The factors here considered are the individuals presence within some jurisdiction and the intention to maintain a permanent home within the jurisdiction.

Source of Income – Tax is imposed on the source of income because that income is derived from the country of source through working, investing, or carrying on a business therein.

A. Residency

The residency concept finds its source in ***ITA 2(1)*** where "tax is payable by every person *resident* in Canada at any time in the year." Pursuant to ITA 2(3), non-residents are liable for tax only on income from Canadian sources. The policy underlying this reflects the social and economic connection that one may have with Canada. A social and economic connection results in worldwide income being taxable while a single connection results in income from Canada.

1. Full-Time Resident

There are two ways that an individual can be found to be a full-time resident to Canada:

A. Statute

ITA 250 **– Statutory Residency**

Under ***ITA 250*** – deems certain persons to be resident in Canada (statutory residence). Note: the term resident is not defined in the ITA and a taxpayer may be a full-time resident in more than one country. In the absence of a tax treaty, a taxpayer who is a full-time resident in more than one country may be taxed twice. Canada and the US have entered into a treaty that alleviates this burden by formulating the country of residence (Canada-US Tax Convention, Article IV(2) – page 2311).

B. Common Law

Thompson v. MNR (1946) SCC

The taxpayer was deemed to be a full-time resident of Canada because he had a settled routine of life that included Canada. The court considered the concept of '*ordinarily resident'* and concluded that it means

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residence in the course of the customary mode of life of the persons concerned. The common law definition of residency is, thus, concerned with the following factors:

a) Residency is a question of fact;
b) Depends on the circumstances (must look at all the factors and determine their *cumulative* effect);
c) It does not matter how much time you spend in the country (ie over or under 183 days);
d) A common factor to consider is whether there is a home;
e) Every person at all times must have some residence – can it be identified elsewhere?; and,
f) The subjective intent of the taxpayer is not determinative – the court will look at the taxpayers objective intent.

The consequence of this taxpayer being found as a full-time resident is that he had to pay tax on his worldwide income.

Dennis M. Lee v. MNR (1990) TCC

A taxpayer can be held to be a full-time resident for part of the year and be taxed accordingly. This case enunciated a number of factors to consider in determining residence. No single factor is determinative, but the cumulative effect could be a determination of residency.

- Habits of life
- Ties elsewhere
- Mailing Address
- Driver's License
- Will prepared
- Org memberships
- Spouse's Res
- Telephone listing
- Bank Accounts
- Legal documents
- Registrations
- Local subscription
- Business Listing
- Corp Involvement
- Vacation property
- Regularity of visits
- Insurance policies
- Cdn Pension Plan
- Burial Plot
- Immigrant status
- Dwelling place
- Length of stay
- Securities Accts
- Filing Cdn Return
- Employment
- Cdn credit cards
- Post Office Box
- Magazine Subscrip
- Personal belonging
- Ties with Canada

IT-221R2 – Summary of Common Law Residency

An individual is resident in Canada if Canada is the place where he, in the settled routine of his life, regularly, normally, or customarily lived in Canada (consider the above factors). Where an individual leaves Canada, Revenue Canada will consider the following factors to determine if they will remain a resident:

a) *Permanence and Purpose of Stay Abroad* – must be gone for at least 2 years before considered a non-resident. If less than 2, will be presumed to be a resident;
b) *Residential Ties within Canada* – Revenue Canada will look at such ties as enunciated in Dennis Lee, the major tip offs are: dwelling place, spouse and dependant, personal property and social ties;
c) *Residential Ties Elsewhere* – everyone must be resident somewhere and it is possible to be resident in more than one place at the same time for taxation purposes;
d) *Regularity and length of visits to Canada*- A non-resident will not be affected by occasional visits to Canada.

R&L Food Distributors Ltd v. MNR (1977) TRB

This case involved the statutory interpretation of a *sojourner* (a sojourner is taxed under rates in section 117 and is subject to tax on their worldwide income for the full taxation year). ***ITA 250(1)(a)*** – "deemed resident if sojourn in Canada in the year for a period(s) totaling 183 days/more". In this case, the court held that if you commute for employment purposes over 183 days, that will not deem you to be a sojourner. There are three factors to satisfy in order to be considered a sojourner:

1. Physically present for more than 183 days;
2. Visit must be temporary/transient; and,
3. Must be a resident of another country during this 183 days or more.

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2. Part-Time Resident

A. Statute

You can only be a part-time resident in the year that you arrive in Canada or the year that you depart from Canada (commence/cease). According to ***ITA 2(1)*** – "every person resident in Canada *at any time of the year*". Thus, you may pay for the entire year even if you are only in Canada for part of the year.

ITA 114 – Calculation for PT Resident

For the period where they person is a part time resident, they pay tax on their worldwide income, but for the period of non-residency, they only pay tax on income earned in Canada. ***ITA 115*** – deals with taxable income earned in Canada by non-residents.

ITA 250(3) – Ordinarily Resident

A reference to a person resident in Canada includes a person who was at the relevant time 'ordinarily resident' in Canada. This provision allows the courts to look beyond the physical presence of a taxpayer in a given year and look at the life and routine of the taxpayer in the years before and afollowing the year in question.

B. Common Law

Schujahn v. MNR (1962) Exch. Ct.

Upon sufficiently severing ties to Canada an individual will be deemed to be non-resident. Where the individual is resident for part of the year and non-resident for another, then s/he will be considered a part-time resident to Canada and will be taxed accordingly. Note: a sojourners is not a part-time resident, but instead is considered a full-time resident. The Dennis Lee factors are telling and the decision will be made case-by-case.

Severing Ties With Canada – Non-residents may not retain any residential ties in the form of personal property or social ties within Canada after their departure.

Note: you cannot be deemed a resident pursuant to ITA 250 on immigration/emigration for the entire year. If you leave Canada and do not establish a permanent resident elsewhere, there is a presumption that you remain a resident in Canada.

The Queen v. KF Reeder (1975) FCTD

Taxpayer moved to France on the understanding that he would return to Canada. The taxpayer was deemed to be a resident of Canada because he was 'ordinarily resident' in Canada while working in France. The court defined 'ordinarily resident' as the place where the settled routing of life regularly, normally, or customarily takes place. Physical presence is not determinative – one must look at the customs of life. This is a question of fact to be determined based on:

1. Past and present habits of life;
2. Regularity and length of visits to the area asserting residence;
3. Ties within that jurisdiction – including personal connections and commitments;
4. Ties elsewhere; and,
5. Permanence or otherwise of purpose to stay abroad.

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3. Non-Resident

A non-resident is not taxed on worldwide income, but taxed on income earned from sources inside Canada. There are two basic criteria to establish that an individual is a non-resident:

1. A degree of permanence in the stay abroad; and,
2. An absence from Canada for more than two years

A. Statute

ITA 2(3) – Taxation of Non-Residents

You still must pay tax if you are employed in Canada, carrying on business in Canada, or you have disposed of a taxable Canadian property.

ITA 253(b) – Extended Meaning of Carrying on a Business

Where a person who is a non-resident solicits orders or offers anything for sale in Canada through an aged or servant, whether the contract or transaction is to be completed inside of Canada or partly in and partly outside of Canada.

ITA 248 – "Business"

A business includes a profession, calling, trade, manufacture or undertaking of any kind whatever and an adventure or concern in the nature of trade but does not include an office or employment.

B. Common Law

Grainger & Son v. Gough (1896) HL

This case made the distinction between contracting within a jurisdiction and contracting with a jurisdiction. The court set out a test that equated carrying on a business with one factor: the jurisdiction in which the contract is made.

Sudden Valley Inc., v. Canada (1976) FCA

ITA 253(b) was enacted to address the issue of whether a binding contract needed to be made in Canada for an individual to be carrying on business. The contract does not have to be made in Canada in order to be found liable. It is enough to solicit offers and have the authority to do so.

Tara Exploration and Development Co v. M.N.R. (1970)

An 'adventure in the nature of trade' is an isolated happening. The provision requires that one 'carried on business in Canada at any time of the year'. An adventure cannot be 'carried on' and as such it does not meet the criteria of 'carrying on' business, although an adventure in the nature of trade is included under the definition of 'business'. The question is whether you could take the phrase 'carry on business' and state 'carry on an adventure in trade'. Whether or not someone is carrying on a business is a question of fact and the court will look at:

1. Where the operations take place; and,
2. Where the profit is generated in substance.

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B. Tax Treaties

The primary purpose of the treaty is to avoid double taxation on the individual. In Canada, a foreign tax credit allows a taxpayer who must pay tax in Canada to get a credit against tax payable in Canada for any amount, which s/he has already paid to a foreign government. The taxpayer is allowed to credit the amount and apply it against the amount still owing to the Canadian government. The foreign tax credit provides no benefit other than an application of a non-refundable tax credit.

C. Exemptions

ITA 149 – Division H Exemptions

Under the ITA 149 certain persons are exempt from tax, that includes individuals, corporations, certain types of trusts etc., For example, registered charities, non-profit organizations, labour organizations are exempt from taxation. Another important provision is ITA 149(1)(d), which exempts federal, provincial, or municipal corporations where 90% of the capital is owned by the federal, provincial, or municipal corporation and no person can have the right to purchase capital of that corporation.

ITA 81(1)(a) – Statutory Exemptions

An amount which is declared exempt from income tax by any other enactment of parliament will not be included in the income of a taxpayer. The most important provision for us to consider is the Indian Act.

D. Aboriginal Taxation

General Immunity

First Nations people claim that they have immunity from income tax because they are their own distinct sovereign nation. This argument is not accepted by Canada and instead it is argued that First Nations aboriginal Canadians still have a significant connection to Canada that are significant enough to justify the levying of taxes.

Treaty Exemptions

With the exception of oral assurances to one treaty, none of the old treaties that were entered with aboriginals contained any tax exemptions. The First Nations history dictates that they were given explicit and solemn promises and assurances that their way of life would not be interfered with. Freedom from taxation, as such, was a condition precedent from entering into any treaty in the first place. The government's position is that no promise was made and even if it were extinguished it is not justified because the government objective of raising revenue outweighs all other objectives.

Indian Act Exemption

There is an exemption under the Indian Act for certain kinds of taxes – a very limited exemption. There is no tax in the situation where an Indian or band on a reserve has an interest in surrendered lands. There is also no tax for personal property that is situated on a reserve. Personal property and land was decidedly left untaxed to eliminate and lessen the threat of potential loss. The courts approach these exemptions narrowly.

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Williams v. The Queen (1992) CTC

Sets the law out for determining the situs of property. One must look at the situs of the taxpayer, the situs of where the payment was made, the situs of the employment, and the situs of where the payment will be used. Once these factors are identified, they are weighed in light of three considerations:

i) The purpose of the exemption under the Act;
ii) The way those factors with respect to the type of property in question are assessed;
iii) Examine the factors in light of the nature of the taxation of the property.

Recalma v. The Queen (1998) FCA

A group of natives invest $4 million in mutual funds obtained from a bank whose situs is on the reserve. The investments yielded a return. The issues was whether or not the income return was taxable – the situs of the return was the mainstream economy.

Note: Departure Tax – when an individual leaves Canada s/he deems to have sold all capital properties and acquired them immediately thereafter and, as such, is taxed on them. The idea is that you cannot just leave Canada without paying taxes.

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3. What is Subject to Income Taxation?

A. Tax Base

The tax base is the subject of taxation – the basis upon which tax is levied. The federal government's tax base is taxable income. The provincial government's tax base is the federal tax payable. Provincial income is calculated by applying a tax rate to the federal tax payable. In Canada tax is payable on all receipts that are considered a part of the tax base.

B. Characterization of Receipts

Statutory Interpretation

There is only one approach to statute interpretation: The words of the Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. In order for a receipt or an individual to be taxable under the Act, the legislature had to specifically include them or the receipt.

Stubart Investments v. The Queen (1984) SCC

The modern rule of tax interpretation requires that the words of the Act are to be reading in their entire context. One must look at more than the literal words, but also to the purpose and spirit of the Act.

Teleological Approach

1. The ordinary rules of interpretation should be followed;
2. A particular provision should be given a strict/liberal interpretation depending on the underlying purpose of the legislation, which must be identified in the context of the legislation;
3. The taxpayer or tax department will be favoured based only on the particular legislative provision and not some predetermined presumptions;
4. Substance should be given precedence over form to the extent that it is consistent with the wording and objective of the Act; and,
5. Only a reasonably doubt, not resolved by the ordinary rules of interpretation, will be settled by recourse to a residual presumption in favour of the taxpayer.

Framework for Characterizing Receipts

Only a reasonably doubt not resolved by the ordinary rules of interpretation will be resolved by a presumption in favour of the taxpayer. Such a resort will only be had if it cannot be solved by the ordinary rules of interpretation.

Bellingham v. The Queen (1996) FCA

In order to determine whether or not something is a taxable receipt, the court will look to the enumerated sources found within ITA 3. However, a taxable receipt could arise from a source not enumerated in section 3. Any receipt from a source inside or outside of Canada can be taxable. This is an absolute adherence to the source doctrine. The court here rejects the teleological approach stating that it cannot be applied to section 3.

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Schwarz v. The Queen (1996) SCC

A $360,000 payment could not be characterized as arising from any one of the enumerated sources of income. The court is restrictive in its approach in this regard and held that since there could be no specific allocation the receipt should be characterized as a windfall (non-taxable). This taxpayer was never an employee because he was never actually employed or in the service of an employer. Never losing employment it could not be said that the funds were to compensate for the lost employment.

Fortino et al. v. The Queen (1997) CTC

Taxpayers were paid a sum as compensation so that they would not compete. The court held that contingent obligations that arise under the transfer of capital make it income. ITA 42 deals specifically with condition and capital contingency – recall that a specific provision will always override the general provision.

Consider how these cases would have been decided had either the source theory of income, the Haig-Simon definition of income, or the Carter Commissions Comprehensive Tax Base scheme been adopted.

Minet Inc., v. The Queen (1998) CTC

Because the taxpayer never had an absolute right to the money the court held that he was never in actual receipt. In order to receive one must have an absolute right to the potential earning.

Buckman v. MNR (1991) CTC

A lawyer who embezzled funds was held liable to pay tax on those funds because they are converted to personal use. In this sense they are realized gains that are treated like receiving income from a business.

Gilbert v. Commissioner of Internal Revenue (1977) US 2nd Cct.

Where a taxpayer withdraws funds from a corporation that he fully expects to repay and expects to be able to do so and makes an assignment of assets to secure the amount owed, he does not realize the income as per the above noted test.

C. Paragraph 3(a)

ITA 3 – Income for taxation year

3. The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer's income for the year determined by the following rules:
   (a) determine the total of all amounts each of which is the taxpayer's income for the year from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business, and property.

This is not an exhaustive list, but the courts have stuck with a strict interpretation and have not found any other sources. Income from these sources is considered to be fully taxable and the courts have interpreted this very restrictively. Basically, ITA 3 sets out what income is. The tax base has been broadened a bit away from the source theory of income. For example, realized capital gains are only partially taxable. Any increase in the value of capital should not be taxed under the source theory because the capital itself is the source/capital.

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Canada v. Fries (1990) SCC

Strike pay should not be considered income and should not be taxable. Strike pay does not have an identifiable source. It is unclear whether it can be interpreted as income from a source. If there is doubt, the issue should be resolved in favour of the taxpayer. The general rule is that income from unenumerated sources is not taxable.

D. Source Concept of Income

1. Source Concept of Income

The source concept of income arose in England at the turn of the century and emphasized the source from which the amount arose rather than the use to which it was put. Basically, no income can arise if there is no source. The disposition of the source itself, considered to be capital, is not income. The most important consequence of the source definition is that if an amount cannot be fit into a schedule it cannot be classified as emanating from a source and must be outside of the definition of income. Under the concept, gifts, inheritances, windfalls, and capital gains are outside the theory. The source concept taxes only on realized and not accrued gains.

1. There can be no income if there is no source;
2. Disposition of a source considered to be capital does not give rise to income;
3. Income is a yield from a productive source

If an amount cannot be classified as coming from a specified source, then it does not fit into the definition of income for tax purposes.

Criticisms of the Source Theory

1. Restrictive
2. Out of Date
3. Unclear how to deal with new receipts that do not arise from one of the enumerated sources
4. Hard to determine what is capital and what is income
5. The limited concept of income results in inequities being created in the taxation system
6. What is an identifiable source?

2. Haig-Simon Definition of Income

Income is the gain and net worth plus consumption in any given period. Important aspects to the definition include:

a) Source is not relevant
b) Accrued unrealized gains are included in computing income
c) Imputed income is included in the defintion

Haig's Definitions

Income: the money value of the net accretion to one's economic power between two points in time. This is often referred to as the consumption plus accretion or simple accretion calculation. It is mostly concerned with the increase in economic power.

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Simon's Definition

Income: the sum of the market value of rights exercised in consumption plus the change in the value of the store of property rights between the beginning and the end of the period in question.

General Definition

Income: Gain and net worth plus consumption in a given period. This measures the taxpayers income for a year by placing value on all goods and services the taxpayer consumed and all gains or losses whether realized or not that had accrued over the year in all of the assets owned by the taxpayer.

Criticisms of Haig-Simon Definition

1. The system is very onerous
2. The theory is administratively impractical
3. Difficult to value assets every year

3. Comprehensive Tax Base Reformulated (Carter Commission)

The Carter Commission carefully analyzed both theories of income and rejected the source theory and adopted the Haig-Simons theory as the basis for their reform of the ITA.

The Carter Commission recommended a modified version of the Haig-Simons definition so that it would be compatible with the enunciated objectives of taxation and be administratively feasible. The Carter Commission also made some concessions in the name of social policy considerations.

The Carter Commission made a number of recommendations for Tax reform in Canada including but not limited to:

1. A comprehensive Tax Base including any net accretion to wealth;
2. A neutral system that would provide no incentive for taxpayer's to mitigate taxes without concessions, credits, deductions, exemptions, and exclusions;
3. A progressive rate structure;
4. A system that utilizes the family as the tax unit; and,
5. Full taxation on all capital gains.

There are two primary deviations from the Haig-Simons definition.

A. Capital Gains

Haig-Simon Position	Carter Commission	Government Response
All capital gains should be valued and included in income	Accrued unrealized gains should not be included in the tax base, but all accrued realized capital gains should be included	Only 50% of realized capital gains are to be included in income

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B. Imputed Income

Haig-Simon Position	Carter Commission	Government Response
The value of all goods and services consumed in a year should be included in a taxpayer's income	Imputed income should remain exempt from tax	Imputed income will remain exempt from tax (it is not included in the tax base)

There are two branches of imputed income that fall under the Haig-Simons definition:

1. Income From Services – When individuals use their talents or energy to produce goods or services that they or their family can enjoy, there is a net accretion to their economic power;
2. Income From Property – The net accretion which occurs where an individual owns property that produces goods or services that may be enjoyed

What is Not Included in a Tax Base?

1. Gifts and Inheritances

These are non-recurring amounts that constitute the transfer or old wealth and not the creation of new wealth. A gift is a voluntary transfer of real or personal property without consideration from a donor. Note, however, that if a donee gets a gift in his or her capacity as an employee that it may be caught under ITA 5 and 6 and s/he receives it at fair market value as per ITA 69.

Haig-Simon Position	Carter Commission	Government Response
Gifts and inheritances should be included in the tax base	Recommended the inclusion of these in the tax base and we should get rid of other taxes on them	Gifts and inheritances are not taxed through the ITA

Re Erig Estate (1999) SCC

This case dealt with the legality of probate fees instituted by the provincial government. The court held that the fee is unconstitutional because it amounts to an estate tax. Cabinet put the 'fee' into place through a regulation. A new tax cannot be imputed through Cabinet, but instead must use the formal amending process.

2. Windfall Gains

Windfall gains are unexpected or unplanned gains that cannot be linked to one of the traditional sources of income.

The Carter Commission argues that windfall gains should be included in the tax base because they increase the individual's net worth. The government's response to this is that windfall gains are not taxed as the payment is not earned as a result of an activity or the pursuit of gain. Some examples of windfall gains include: Voluntary payments to help a farmer for flooding; gambling proceeds with the exception of a taxpayer in the business of gambling; and, lottery winnings.

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Gambling Profits as Windfalls

Gambling profits are indeed taxable if you are operating a business. The courts have to draw a distinction between a taxpayer engaged in the hobby of gambling or whether one is engaged in a business. The court is looking to see whether the person is reasonably expecting a profit from their activities.

MNR v. Harry Edgar Morden (1961) Exch Ct

For a gambling gain to be taxable, it has to be derived from carrying on a business. The court will consider a number of factors:

i) The degree of organization of the operation;
ii) The existence of special knowledge or insider information;
iii) The taxpayer's intention in distinguishing between gambling for pleasure or for livelihood; and,
iv) Extent and frequency of activities.

If the court decides that one is engaged in the business of gambling, then winnings are taxable and losses are deductible provided that the gambling activities are legal.

3. Tax Incentives

Tax incentives are deductions and credits designed to reduce the individual's taxable income.

Haig-Simon Position	Carter Commission	Government Response
There should not be any deductions or incentives	There should be certain types of tax incentives to meet objectives	There are tax incentives

The government has held that any deviation must be justified on one of two grounds:

1. The departure must promote a major national objective and the tax mechanism must be the most effective way of achieving it; Or,
2. It must be administratively feasible

The government uses these incentives in order to persuade public behaviour and are hardly neutral (which is one of the objectives).

ITA 81 – Exemptions

Capital gifts and windfalls are 'exclusions' and not 'exemptions'. An exemption is an amount to be declared exempt by an act of Parliament. If there is some other statute that exempts it from income, the ITA is in accord with that other statute.

The Queen v. Cranswick (1982) CTC

Payment was made by the parent company to its subsidiary to prevent possible litigation arising out from the sale of part of the subsidiary's assets below book value. The court held that the payment was not an enumerated source of income, thus it was a windfall and is not taxable. Since the payment was of an unusual and expected king that one could not set out to earn as income it would not be taxable. The ITA can deem other things to be income or can exclude things from an identifiable source. In the absence of a special statutory definition extending the concept of income from a particular source, income from a source will be that which is typically earned by it or which typically flows from it as the expected return.

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Nexus Between Taxpayer and Source

Tax Avoidance

A taxpayer is entitled to arrange his or her affairs to mitigate the amount of tax owing. In other words, the taxpayer is entitled to arrange his or her affairs for the sole purpose of achieving a favourable position regarding taxation and no distinction is to be made in the application of this principle between arm's length and non-arm's length transactions.

Statutory Limits on Avoidance	Description	Notes
1. Arm's Length Concept	Problems arise in taxation when the parties to a transaction do not have the customary opposing economic interests, but have a common economic interest that enables them to arrange the terms of the transaction to produce the least amount of tax. Transactions are said to be no at arms length.	Transactions are prohibited from being at non at arm's length. However, the ITA does not specifically define the term.
2. Income Splitting & Attribution Rules	The transfer of income from one person to another who is taxed on the income at a lower marginal rate than that applicable to the transferor.	See Below
3. Inadequate Consideration	In certain circumstances, the Act requires the recognition of fair market value proceeds on the transfer of property.	ITA 69(1) – Inadequate Considerations
4. Alternative Minimum Tax	Attempts to ensure that taxpayer's pay a sufficient amount of tax on their economic income.	See Below

Income Splitting & Attribution Rules

Income Splitting

Defined as where one large income is divided into several smaller incomes. A high income earner may attempt to divert to a spouse or child some income to reduce his or her tax liability without suffering any loss of the control of goods or services. This is done to lessen tax liability and so that the individual does not suffer a loss on goods and services.

Attribution Rules

The general rule is that a person who recognizes income for tax purposes is that person who is entitled to income. The exception to the general rule is the attribution rule that provides that income belonging to the one person is deemed for tax purposes to belong to another person as stipulated by the Act. If the rule applies, income that belongs to one person is deemed by the Act to belong to another person.

Three Important Attribution Rules

1. ITA 74.1(1) – Transfer and Loans to Spouse (Income)
    a. The attribution will be deemed to end when the spouse dies, the transferor departs from Canada, or the spousal relationship ends
2. ITA 74.1(2) – Transfer to Related Minor (Income)

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        a. The minor must be under 18 years of age and resident in Canada
3. ITA 74.2 – Transfer to Spouse or Related Minor (Capital Gains)
    a. Sale – sale will be caught by ITA 74.5 unless at least at fair market value
    b. Loans – rule applies unless the loan is made at a commercial rate of interest
    c. Property – property of any kind and includes money

General Anti-Avoidance Provision (GAAR) ITA 245 – if there is no provision in the Act, Revenue Canada under GAAR has a right to review anyways. As such, Revenue Canada would not have to push for the enactment of legislation for every single type of anti-avoidance scheme. Note: GAAR has not been applied as frequently as expected.

Neuman v. The Queen (1998) SCC

ITA 56(2) – Indirect Payments, does not apply to dividends. The person directing a payment must have a pre-existing entitled to the funds for 56(2) to apply. Note, however, that ITA 74.4 can apply to income-splitting done through a corporation. In this case only the director was entitled to declare dividends while a subsidiary attributed the income. Since the subsidiary who split the income did not have a pre-existing entitlement to the funds, the court held that it was a proper procedure.

Note: GAAR will not be applied to such cases as it accepts that indirect payments do not apply to dividends as provided in the Neuman situation.

Ferrel v. The Queen (1998) TCC

Ferrel's children are the beneficiaries of a trust and they are both 18 years of age or under. Fees were paid into the trust and the issue is whether or not those fees are attributable back to Ferrel. Capital gains or losses realized on the disposition of property are not attributed to the original transferor as per the attribution rules. The court proceeded on the grounds of ITA 56(2).

Romkey et al. v. The Queen (2000) FCA

A corporation was reorganized by two brothers who took their Class B non-voting shares and held them in trust for their children. The two taxpayer brothers paid for the shares and then said that the amount of payment came from family allowance. Revenue Canada has always had a longstanding administrative policy that allows one to take family allowance amounts and transfer them to the children without any tax applying. Taxpayers didn't have enough evidence to document a transfer to their children. The issue was whether or not there had been a transfer in property to the minor children. A transfer is when the owner of property deals with the property so as to divest him or herself of it. There was no valid consideration for the transfer here as the alleged subscription price of applying the children's Family Allowance Benefits was not documented. The court found that there was no transfer of property.

ITA 120.4 – Income will now be taxed at the highest marginal tax rate for dividends etc., children then will pay as if they are taxpayers in the highest bracket (47% in Ontario).

Alternative Minimum Tax (AMT)

ITA 127.5 – the taxpayer must calculate both the regular tax payable and also the AMT and pay the greater of the two amounts.

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4. Rates of Taxation

The statutory rate structure is straightforward and set out in ITA 117. The personal tax credit is set at $7,231 and once it is exceeded the statutory rate starts to apply. The schedule in section 117 contains three brackets:

0-30,004 17%
30,004-60,009 25%
69,009+ 29%

All of the provinces also impose an income tax, which is imposed on the taxpayer's federal taxable income.

There are three basic types of rate structures that may be used each with it's own set of advantages and disadvantages.

System	Advantages	Disadvantages
Progressive Rate increases as income does	Operates to stabilize the economy Reduces inequality by redistributing wealth in the economy	Provides incentive for tax avoidance schemes Economic incentive may be decreased
Proportional A single rate applied to all	Acts as an incentive to make money Avoids discrimination between earners Avoids bracket creeping	May have a regressive effect on low earners Lacks the stabilization effect
Regressive Tax burden decreases as income increases	Encourages individuals to work and save Stabilizes the economy during periods of deflation	Offends the principles of equity

A marginal rate of tax is determined by looking at the rate levied on the last dollar of income. An average rate of tax is determined by dividing the total tax payable by the taxable income. Both the federal and provincial government's impose surtaxes on high-income earners.

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5. Income from Office or Employment

Generally

Two of the enumerated heads under the ITA are office and employment. Recall that income from each source must be separately calculated according to the rules applicable to that source. Therefore, it is important to distinguish between income from office and income from employment.

The computation of income follows a four-step process:
1. Characterize the receipt as either income or capital
2. Classify the income receipts by source
3. Apply the computational rules to each source of income
4. Add up all the sums of each distinct source

Note: we are not restricted to the enumerated sources in ITA 3. A court can determine that there is another source not listed because the section says, “Without restricting the generality of the foregoing.” Moreover, a source of income may exist inside or outside of Canada.

Three important points to remember about ITA 3(a) is that:
a) Capital gains are excluded and only ordinary income is included in 3(a);
b) Dealing with source by source income computation inside or outside of Canada;
c) Only positive amounts are dealt with and not losses.

A. Who is an Officer or an Employee

Employment - Includes general wages and salary and is defined as follows: the position of an individual *in the service of another person* including her majesty or foreign state or sovereign.

Office – requires the office holder to have a fixed or ascertainable stipend or remuneration.

ITA 5(1) – Starting Point

A taxpayer’s income for a year from office or employment includes salary, wages, or other remuneration including gratuities received by the taxpayer for a taxation year. Both office and employment refer to the term individual. Corporations are thus excluded because individuals do not include corporations.

From ITA 248 we see “Office” defined – is the position of an individual entitled to a fixed or ascertainable stipend or remuneration and includes (see definition).

The rationale for having a separate office category is that office refers to a position created by statute independent of the person who fills the position. However, office and employment are lumped together for our purposes because the computational rules are the same for both.

Consequences of Income for Office or Employment

1. ITA 153(1) – the employer is required to withhold from the employee the tax payable on the income and remit it to Revenue Canada. The employer must also hold CPP and IE premium payments. An employer who fails to do so may be held liable both civilly and criminally.

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2. ITA 5 – requires taxpayer's to include income from office or employment received in the year. Income is generally calculated on a cash basis. In contrast, business income may be recognized as earned on an accrual basis.
3. ITA 249 – the taxation year is the calendar year.
4. ITA 8 – the employee or officer may deduct only a limited set of expenses while a self-employed business person has a considerably wider scope to deduct under ITA 9 and 20.

B. Employee or Independent Contractor?

The deductions available to office and employment income are much less beneficial than those for business and property income. Thus, taxpayers want to be independent contractors.

Employee – key phrase in the definition is '*in the service of some other person'*. A *contract of services* is developed where one is in the service of another person.

Independent Contractor – yields a profit which is not ascertainable in advance – there is no fixed or ascertainable regular salary amount. A *contract for services* is developed.

One receiving income as an independent contractor is receiving business income and is, thus, eligible for the liberal business income deductions.

Tests to Characterize

1. Traditional Control Test

The question to ask is whether the master has a right to direct what the employee would do and how it was to be done to determine the degree of control. If yes, you had a master servant relationship because there was control. The courts rely on the degree and nature of control over the person purportedly employed.

2. Integration Organization Test

The question to ask is whether the taxpayer is an intrinsic part of the organization with employee status (employee) or are they an adjunct to it as applying services on their own account (independent contractor)?

3. Economic Reality Test (Entrepreneur)

The question to ask is whether the taxpayer who is engaged for services has the chance for profit or the risk for lass. There are for major factors to consider (four earmarks for the entrepreneur):

a) Control
b) Ownership of tools
c) Chance for profit
d) Risk for loss

4. Specific Results Test

The question to ask is whether the person has placed his or her services at the disposal of the employer for a period of time without reference to a specific result. If yes, then they are an employee.

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5. Total Relationship Test

Take a look at all the tests and make a decision. Consider the entire scheme of the operation and all the tests must be applied together. A test applied solely may lead to absurd results so we must consider the totality. Factors to consider are:

a) Whether the individual who is performing the services provides his or her own equipment;
b) Whether the individual hire his or her own helpers;
c) The degree of financial risk taken;
d) The degree of responsibility for investment and management had;
e) Whether and how far the individual can profit from the task; and,
f) Whether the individual is an intrinsic part of the business.

The following cases deal with whether the individual was an independent contractor or an employee.

Common Law Characterization

Hauser v. MNR (1978) TRB

The court considered each of the tests and concluded that Hauser, because the hospital supplied him with all the necessary equipment, was an employee. The Court distinguished between:

1. Contract Of Service (Employment)
    a. One party agrees for a period of time or indefinitely to work for another party;
    b. Does not envisage the accomplishment of a specific task
    c. Requires personal service
2. Contract For Service (Business)
    a. Does envisage the accomplishment of a specified job or task;
    b. Normally does not require the contractor to do anything personal (just produce a product).

Alexander v. MNR (1969) CTC

Dr. Alexander was a radiologist with a contract requiring him to discharge professional responsibilities and some administrative work. The court found that he was self-employed in applying the specific-results test because his contract provided from the completion of specified tasks. Moreover, he would be financially liable for any mistakes he made in the lab. A contract of employment does not normally identify a specified job or task.

Rosen v. The Queen (1976) FCTD

The court applied the integration test to determine that a full-time government employee circulating as a part-time lecturer was an employee. The court applied the integration test: under a contract of services an individual is employed as part of the business and the work is done as an integral part of the business. In a contract for services, the individual's work, although done for the business, is not integrated into it but is only accessory to it.

Moose Jaw Kinsmen Flying Fins v. MNR (1988) FCA

The court held that one of the factors to look at in any determination is that actual contract. The court looked at the existing contract between the parties, which appeared to be an employment contract. It would appear that the existence of a contract in this case created a control relationship – a contract of

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service. A contract is not always determinative, however, and the wording is not to be looked at in isolation.

Wiebe Door Services Ltd v. MNR (1986) FCA

This case is now the authority and it revised the integration test and named the total relationship test. Test: is the person who is performing the services performing them as a person in business and/or on his own account? If the person is performing them as a person in business there is a contract for services (business), if not there is a contract of service (employee).

Cavanagh v. Canada (1997) CTC

Cavanagh was a tutorial leader who provided his own supplies and was responsible for all off-campus expenses. He set his own times for tutorials and was free to hire others to assist him. The court found that he had a possibility of profit and assumed the risk of loss and, therefore, should be considered an independent contractor. Moreover, he was paid irregularly, which did not look like salary or wages.

C. Amounts Included in Computing Income

ITA 5 – Basic Rules for Office/Employment

Lists salary, wages, and other remuneration including gratuities as income for the purposes of Office and Employment. The word salary and wages are not defined separately in ITA 248.

"Salary" – refers to the remuneration received over a longer period of time – fixed payments by employer at regular intervals to a person doing work other than manual/mechanical work

"Wages" – refers to a shorter period of time – fixed payments by an employer at regular intervals for time during which the employee is at the employer's disposal

"Other Remuneration" – is considered to be broad enough to catch all sorts of employee benefits and we must look to the case law for a definition

"Gratuities" – defined as voluntary payment made in consideration of services rendered in the course of office/employment

D. Benefits

ITA 6 – Value of Benefits

ITA 6(1)(a) – Value of Benefits: the value of board, lodging, and other benefits of any kind whatsoever received or enjoyed by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment. If you receive a benefit, it must be included in computing the taxpayer's income from office and employment.

Benefits of Any Kind

Policy: If one employee receives all compensation in the form of salary and wages and another receives it in the form of salary, wages, and benefits, if the benefits are not included there will be a violation of

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equity. Moreover, there will be a huge loss in government revenue, which is the government's primary objective.

For a benefit to be taxable, Canadian Courts require that the benefit had the character of remuneration for services.

Test: First, is the payment or benefit made to the employee a gift in his or her personal capacity (taxable) or compensation for services (non-taxable) by virtue of employment? Revenue Canada has suggested that the following should be included in Income:

- Board
- Lodging
- Rent free Housing
- Travel Benefits
- Holiday Trips
- Prizes and Awards
- Frequent Flyer Miles
- Travel Expenses
- Tuition Fees
- Gifts

Second, for whose benefit is the payment made? (Employer or employee?) If the benefit is made primarily for the advantage of the employer, it will not be taxable.

IT47OR – Employee Fringe Benefits

Part A (Included & Taxable)	Part B (Not Include & Non-Taxable)
○ Board and Lodging	○ Discounts on Merchandise
○ Rent-Free & Low-Rent Housing	○ Subsidized Meals
○ Travel Benefits	○ Uniforms & Special Clothing
○ Gifts (Including Christmas*)	○ Subsidized School Services
○ Holiday Trips, Prizes, Incentives	○ Transportation to the Job (Pick Up)
○ Frequent Flyer Miles	○ Recreational Facilities (Owned)
○ Tuition Fees	○ Transportation Passes
○ Cost of Tools	○ Removal Expenses
○ Financial Counselling	

*Exception: single gift less than $100 for a wedding, Christmas etc., limited to twice annually.

The employer is obligated to determine the value or make a reasonable estimate of the benefit and include it on the employee's T4 under employment income before deductions and also under taxable allowances and benefits.

In the past, for a benefit to be taxable the court required that the benefit had the character of remuneration for services. The law until The Queen v. Savage (1983) was that of Tennet v. Smith: the benefit had to be capable of being converted into money's worth and if it was not it was not a taxable benefit because it lacked the character of remuneration for services.

The Queen v. Savage (1983) SCC

Benefits do not have to be remuneration for services. If the taxpayer receives any economic benefit or material advantage in their capacity as an employee, it will be a taxable benefit. This case establishes a presumption that the benefit was received in the course of employment.

Generally, goods are valued at their fair market value – what a willing buyer would pay for the product and what a willing seller would take for it.

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Laidler v. Perry (1965) HL

It was argued that a series of 10 pound vouchers should be characterized as gifts as opposed to benefits inspired by the hope for future provisions of service and goodwill between the parties. The court looked at the intent of the transaction and held that the business person hoped to obtain beneficial results for the company in the future. The voucher was given as a reward for that goodwill and, hence, was a benefit.

S Campbell v. MNR (1958)

For a receipt to be taxable it need not be reoccurring – it can be a one time receipt. It is irrelevant whether the payment is voluntary or is to be made by way of a legal contract. The nexus between the payment and receiver must be considered and in this case the payment was made for the services performed by the receiver.

Paul G Arsens v. MNR (1969) TAB

Arsen's employees went on a business trip at Arsen's expense. Arsen put up large posters in all of his restaurants advertising the trip to Disney World and used it as a publicity campaign. During the trip the employees were at the beck and call of Arsen. The issue was whether or not the trip was planned primarily to obtain publicity for restaurants or a benefit of the employees. The court enunciated the *Primary Benefits Test*:

- If the primary benefit is a business purpose and not for the benefit of the employees, the courts will not find a taxable benefit – if the primary purpose is for the employer, there is no taxable benefit.

IT 470R – Vacation Benefit

Where an employer pays for a vacation it is a taxable benefit that may be reduced if there is conclusive evidence to show that there was some business taking place during the vacation.

E. Allowances

Allowance	Reimbursement
Taxable Benefit ITA 6(1)(b) Limited predetermined sum of money payable to an employee in advance that is not accounted for and at the disposal of the employee with prejudice	**Non Taxable Benefit** Payment to indemnify one for actual expenses incurred during the course of employment that must be accounted for by the individual. Can be taxable if for living expense ITA 6(1)(a).

ITA 6(6) – Remote Location – if you work in a remote location and receive an allowance it will not be taxable.

The Queen v. Demers (1981) FCTD

Taxpayer receives an adjustment in salary to compensate him for his move to Haiti. The entire amount was taxable as it amounted to an adjustment in salary. There was no loss in this case as in Ransom – the money was, thus, considered a taxable allowance.

The Queen v. Huffman (1990) FCA

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Plain clothes detective wanted to buy and clean suit for work. Detective submitted receipts and received $500 back from his employer. MNR demanded that it be included in income. The court held that it was not a taxable benefit, but instead a reimbursement:

i) No personal benefit was received – it was an employment outlay
ii) Applied Savage – clothing was needed for work and individual was simply put in the same position as before
iii) He could not use the clothes for person reasons, but only for work

Revenue Canada's Position: distinctive uniforms and special clothing designed for protection is not a taxable benefit.

Campbell v. MNR (1955) Tax ABC

Taxpayer was a nurse using her car to transport patients and supplies on a voluntary basis. Hospital began to pay her under the heading of 'miscellaneous expense'. The court held that it was an allowance and should be included in her income. Of note is that she was paid $50 monthly, was not required to produce any receipt, and could not verify the amounts she spent on the car.

Relocation Cost (Benefit or Reimbursement)

Cyril John Ransom v. MNR (1967) Exch Ct

Ransom put his house up for sale as he was transferred from Sarnia to Montreal. The house took a long time to sell and he incurred a massive loss. His employer compensated for the loss. The court held that it was a reimbursement incurred through is employment and not taxable:

i) It was not due to person reasons that he put his house up for sale;
ii) He had not choice in moving.

Where an employee is reimbursed for a loss incurred through his or her employment, it is not taxable.

The Queen v. Phillips (1994) FCA

Taxpayer transferred from New Brunswick to Winnipeg and paid more for his house in Winnipeg than the amount he received from the sale of his house in New Brunswick. His employer compensated for the difference. The court held that this was a taxable benefit as the type of house to live in is a personal choice. The employee received an economic advantage in that his net worth was increased. Where it is not a reimbursement in the sense of putting you back to where you were before, but instead increases your net wealth or has a personal advantage for the employee, it is a taxable benefit.

Legislative Response

If you incur a loss on the sale of your home as a result of a work-related relocation, if you move to a home at least 40km closer to your new place of employment, the first $15,000 of any payment received from your employer as reimbursement is non-taxable – 50% of the portion over that amount will be taxed as a taxable benefit.

Krull v. Canada (1996) CTC

The employer assisted the employees by providing a mortgage interest subsidy reflecting the difference in interest on the mortgage caused by the larger principal sum of purchasing a home in Toronto as opposed to Calgary. The court held that this was not a taxable benefit as the taxpayer's received no material advantage. The net worth of the employee had not increased.

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F. Valuation (Opportunity Cost)

What should a benefit be valued as for income tax purposes if deemed to be taxable? The following cases set out some basic methods. The courts will generally start with the fair market value of a benefit, but their task is to assess the value of the benefit to the taxpayer in relation to his/her net accretion of wealth.

Fair Market Value – the price that would be willingly paid by a buyer, that does not have to buy, to a seller, that does not have to sell.

Wilkins v. Rogerson (1961) All ER

This is the UK model. Valuation should be worth or equal to the disposable value to the employee if s/he were to take the benefit and sell it immediately.

Youngman v. The Queen (1990) FCA

Taxpayer sells his home and provides an interest free loan to his company. Taxpayer's company pays to build him a $395,000 home which he rents at a rate of $1100/month until he can purchase the home. MNR believed that there was a greater benefit and that the rend paid was not reflective of it. Fair market value is not always the sole indication of real value – the taxpayer here provided a benefit to the company. The interest payable on the loan would have equaled the difference in value of the rent.

G. Deductions

Unless a deduction is in the ITA (for employment) one will not generally get it. This is because employment income is taxable on a gross basis without consideration for deductions that would normally be allowed by accountants (GAAP). There are a number of allowable employee deductions. In order to take a deduction for meals that you ate during the course of employment you have to be away from home for at least 12 hours.

Travel Expenses

ITA 8(1)(h) – covers all travel expenses except automobile expenditures

To satisfy a deduction for travel expenses, the taxpayer as employee must:

1. Ordinarily be required to carry on their employment away from the employer's place of business;
2. Be required to pay their own traveling or automobile expenses under their employment contract;
3. Taxpayer must not be in receipt of any travel allowances for expenses; and,

Note: Certain employees do not fall under the provisions

The employer is required to file a F2200 form that requires the employer to verify that the above conditions have been met.

Martyn v. MNR (1962) Tax ABC

Travel expenses to work are not deductible because they are personal living expenses. However, where an individual has a home office, travel from that home office to visit clients will be deductible.

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Legal Expenses

A person may deduct legal expenses when they are incurred in connection with a claim for back salary or back wages. The employee, however, must subtract from their legal expenses any costs that s/he may have received.

R. v. Swingle (1977) FCTD

Dues are deductible if you are required to pay them in order to exercise the very right to carry on your profession and earn salary remuneration. There must be a direct relationship between the membership and the professional status. The Statute must recognize you as a professional before you are allowed to take the deduct.

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6. Income From Business or Property

The rules for calculating income are the same for busing and property.

ITA 9 – Profit

Income for a business or property is the taxpayers profit from that property. What you will be taxed on for business/property is your profit from that business or property.

ITA 248 – Definitions

"Property" – any kind of property whatever, including:
a) A right of any kind, a share, or chose in action;
b) Unless the contrary intention is evident, money;
c) A timber resource property;
d) The work in progress of a business that is a profession

"Business" – Includes a profession, calling, trade, manufacture, or undertaking whatever, and also includes an adventure or concern in the nature of trade.

Both concepts are very broadly defined.

A. Income from Property

ITA 9(3) – Gains and Losses Not Included

The sale of property will yield income from business or be a capital gain. Such a sale does not yield income from property, as property income does not include a capital gain fro a disposition of property. Moreover, a loss from property does not include capital loss from the disposition of property.

The courts will insist that a taxpayer have a reasonable expectation of profit from a property before a loss will be deductible.

Rental from Real Property

Presumption – rental from a real property will be considered to be income from property because the rents were paid for the use of the property and not for any service provided. It is sometimes difficult to decipher whether the income is from a property or a business.

Maloney v. MNR (1989) TCC

In this case the court held that rental losses were not income from property where the taxpayer rented a house to his mother at a low rent below the costs to run such property. The court employed a test and will deny rental loss if:
a) The property is rented to friends/relatives;
b) The rental property is in a resort area; or,
c) If the property is intended to be a future retirement or vacation home.
The court is looking for a purely commercial relationship and suspicions otherwise may negate an application for losses.

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A. Where the Landlord Provides Services in Addition

Normal Services	Extraordinary Services
Income from Property Include heating, airconditioning, water, electricity, maintenance of the building	*Income from Business* Include restaurant provided, housekeeping service, laundry service etcetera (moves in direction of hotel)

Walsh v. Micay (1965) Exch Ct

The court looked at the landlord's provision of heat, stove, refrigerator, janitorial work to common areas, and snow removal and held that these are normal services provided by a landlord, thus the rental rates were providing income from property.

B. Where the Landlord Employs Staff to Manage Properties

One must ask whether this is an organized activity and the amount of time spent in that organization. Any substantial time and organization will be considered to create income from a business.

Payments Based on Production

Where income received from the ownership of property is dependent on the production from property. Unless the payments are dependant on the use of the land it may be concluded as capital income or other.

ITA 12(1)(g) – Payments Based on Production or Use

Any amount received by a taxpayer that is dependant on the use of or production from property, if it is an instalment payment, is income in the hands of the recipient.

MNR v. Morrison (1966) Exch Ct

Compensation for damage caused to property will not constitute income from property as it is not dependant on the production or use of that property.

Interest on Land

The Act does not define the term 'interest'. The basic definition is the price of borrowed money; interest can be any sum that has to be paid by the borrower to the lender as the price for borrowing the loan.

ITA 16(1) – Blended Payments

A blended payment is one that combines both interest and capital at the same time. Where an amount paid under a contract is part interest and part principle, the interest part is deemed to be income from property.

A recipient of blended payments must unblend them into interest and principle portions and record the income accordingly. The purpose of the section is to catch the case where there is concealed income in a loan repayment or an installment purchase agreement.

Groulx v. MNR (1967) SCC

Where one pays a higher price than fair market value, the extra payment may be regarded as interest.

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Percini Estate v. The Queen (1982) FCA

An interest paid on three sums dependant on profit was deemed to constitute interest and must, therefore, be included as income from property. A court will not look to a contract to see whether a portion is expressly defined as interest, but rather will look at the substance of the interactions and payments.

B. Income from a Business

Grainger & Son v. Gough (1896) HL

Business refers to economic or commercial activity – something more than the mere passive ownership of property.

Organized Economic Activity Test

One must consider whether the business is being operated in a commercially reasonable fashion. A gain acquire without a systematic effort will not be income from business. A hobby, for example, that produces a windfall gain, such as gambling or betting, will not be considered a business.

Graham v. Green (1952) KB

Betting on horses, even on a large scale, whether the requisite organization was considered a hobby. There is no tax on a hobby such as income from betting as it is neither profit nor gain for ITA purposes.

Walker v. MNR (1951) Exch Ct

Where the activity of gambling was organized activity sufficiently extensive and systematic it was considered income from a business. The court will look at the facts of each case and consider, among other things, the following:

a) Is it for pure amusement or is it systematically carried on with a view of making money?
b) Is there an intention to make profit on the bettor's part?
c) This assessment is to be done objectively.

MNR v. Harry Edgar Morden (1961) Exch Ct

Casual winnings from bets are not taxable because it is not a sufficiently organized activity to be characterized as a business.

Reasonable Expectation of Profit Test

This is not an expectation of reasonable profits, but considers whether it was reasonable to expect any profits. The court will decipher between a business and a hobby by asking whether there was a reasonable expectation of profit.

Moldowan v. The Queen (1977) SCC

The test is an objective determination considering the following: the profit and loss experience in the past years, the taxpayer's training, the taxpayer's intended course of action, the capability of the venture to

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show a profit, and etcetera. The purpose here is not to second guess the taxpayer's judgment – the court will not punish a taxpayer for a misguided judgment.

Tonn v. The Queen (1996) FCA

If there is a reasonable expectation of profit, the court will allow those losses to be deducted. The court has a adopted a three-pronged test:

1. Nature of the operation;
2. Scale of the operation and the people involved and the context; and,
3. Time required to make an activity profitable – during the start of a corporation, the courts will be more lenient in applying the reasonable expectation test.

On the third prong – just because one does not make a profit or know that it is not reasonable to make a profit in the start-up years of a corporation or undertaking does not mean that the undertaking does not have a reasonable expectation of profit. The benefit of the doubt will go to the taxpayer where the undertaking does not have a strong personal element (making it akin to a hobby or fanciful dream).

There are also a number of factors to consider, such as profits and loss experienced in past years, the taxpayer's training and experience, the taxpayer's intention, the capability of the venture in general to show profit, the amount of time spent, and whether the business operation is intended to be purely commercial or whether it has some personal or non-business motive.

Adventure or Concern in the Nature of Trade

The tension in the case law is whether it is a trade or concern in the nature of trade or whether it is a mere investment. A trader is defined as someone who buys or sells property in an organized way with a reasonable expectation of profit where the primary purpose of the activity is the sale of assets. An investor makes personal investments out of savings with a view to yielding a capital gain rather than any business income.

Isolated Transaction Test

Where the taxpayer does an isolated transaction he may not be a trader. However, where the transaction is a speculative one and if there is an intention to yield profit, then the income will be business income.

Taylor v. MNR (1956) Exch Ct

A single transaction may be an adventure in the nature of trade or a concern in the nature of trade (business) where:

i) A taxpayer buys and sells property that is not for personal use and that will not yield income and there is a presumption that s/he will sell it with the intention of making profit;

Atlantic Sugar Refineries v. MNR (1948) Exch Ct

A gain made in carrying out a scheme for profit making will be considered an adventure or concern in the nature of trade although it is an isolated transaction.

California Copper Syndicate v. Harris (1904) Scotland

This case helps distinguish between:

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Investment – where the owner of an ordinary investment chooses to realize it and obtains profit, the profit is not assessable to income tax.

Trade – profits obtained from the realization/conversion of securities may be assessable as an act done in carrying off a business. The fact that a transaction is an isolated one does not exclude it from a category of trade.

Taxpayer's Intention Test

By looking at the taxpayer's primary intention, the court may be able to distinguish between an intention to sell for profit (business income) and an intention to hold property for any other purpose than resale (investment).

Regal Heights v. MNR (1960) SCC

In this case the primary intention was to convert land into a shopping center with the secondary intention of selling the land if unable to do so. This was considered an adventure in the nature of trade and, thus, fell under business income. If property is purchased primarily for non-resale purposes, but a secondary alternative intention is to sell it at a profit if the primary purpose proves impossible and it is sold, then the income will be business and not capital.

Reicher v. MNR (1975) FCA

The secondary intention to sell must have existed at the time that the property was acquired. It must be an operating motivation at the time of acquisition and not a mere possibility. Note: resale is always a possibility after acquisition.

Irrigation Industries Ltd. v. MNR (1962) SCC

This case deals with corporate securities. Where securities are held with the intent of securing income from them as a source, the profit will be capital. However, if the intent/purpose is to make that profit by resale, then any income will be business income. Test: was it an investment made with the intention of holding the securities or was it made with the intention of disposing them as soon as possible?

*This case has been heavily criticized

C. Deductions

Calculating Net Income

ITA 9(1) – Net Income

The concept of profit is not defined in the ITA, so we must turn to accounting principles to figure them out. Net profit, though, is still a question of law.

Generally Accepted Accounting Principles (GAAP)

What are inclusions and what are the deductions? GAAP – Generally Accepted Accounting Principles – is defined as rules that are used by accountants in the preparation of financial statements and are accepted by the accounting profession as producing accurate information about the financial condition of a person

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or enterprise that is subject of the financial statement. Generally, when looking at gross income inclusions, if GAAP includes it, you include it – if GAAP does not include it, then do not include it.

Generally, the taxpayer, by virtue of ITA 9, would take their gross income less deductions to calculate income. Incorporating GAAP the taxpayer goes through a two step process:

Step One - In order to determine inclusions and exclusions we look to GAAP. If GAAP says that a gross receipt should be included in the income of the taxpayer then we should include it, if GAAP says no then we should exclude it.

Step Two – Go to the ITA as well as the case law in order to determine whether the Act or caselaw prescribes a different treatment for receipts or inclusions or a different treatment for outlays, expenses, or deductions. Special consideration ought to be given to the following provisions:

ITA 12 – outlines specific receipts that are to be included in the taxpayer's income
ITA 18 – limits deductions for certain expenses
ITA 20 – allows a deduction of capital cost allowance by overriding ITA 18
ITA 20(1)(c) – allows a deduction of interest
ITA 67 – denies a deduction of expenses that are otherwise deductible to the extent that the amount of the expense is unreasonable

Steps in Brief

1. Calculate net profit according to GAAP
    a. GAAP appears no where in the ITA
    b. Begin with financial statements
    c. Is there a valid deduction? If not then:
2. Look to ITA and case law to see if there is anything that modifies any specific inclusion or deduction
    a. ITA 18 – Lists deductions that are not allowed
    b. ITA 20 – Lists allowable deductions

1. Defining Net Income – Business Purpose Test

ITA 18(1)(a) – Deductions (Business Purpose Test)

No deductions are allowed unless the expenditure(s) were *made for the purpose of gaining or producing income* from the business or property. This is the starting point and provides a general statement regarding what can or cannot be deducted.

Note: One is not free to select between and among different methods of capital cost allowance. If you cannot find the deduction in the Code, then you will not get the deduction.

Imperial Oil v. MNR (1947) Exch Ct

To determine whether an expenditure is for the purpose of producing income, it must be looked at in the light of its connection with the operation, transaction, service in respect of which it was made so that it may be decided whether it was made not only in the course of earning the income, but as part of the process of doing so. The court will look to see if a cost was incurred as part of the ordinary operation of the business. Ask: *Was it a normal risk of the ordinary business operation?* ITA 18 does not require the generation of a profit in direct relation between the expenditure and the profit.

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IT 467R – In order to deduct damages, they must be incidental to or a risk normally inherent in the business operations. They do not have to have a direct relationship to the generation of profit. Damages may include a payment in settlement to avoid litigation.

2. Reasonableness Requirement (ITA 67)

ITA 67 – an expense is deductible only if it is reasonable.

ITA 67.1 – provides that what is deductible regarding food beverage and entertainment is 50% of the lesser amount of what was actually paid or the fair market value for it.

Royal Trust Co. v. MNR (1957) Exch Ct

This case has been overruled by an ITA enactment specifically forbidding the deductibility of club memberships and golf green fees etcetera. However, the test is still good. The court found that recreational fees paid for by the company on behalf of the employees were deductible because the payments were a normal business practice for the trust companies, which produced business contacts and opportunities for the company. Test one must establish a link between the expenditure and the gaining and production of income for it to be deductible.

Malden Brothers v. MNR (1987) CTC

A total salary entitlement of $26,000 between a husband and wife was divided into two equal parts so as to reduce tax liability. The tax board readjusted the wife's income because her contribution was only worth $8,500. The remaining sum was added to her husband's income. The apportionment must be reasonable and justified.

No. 511 v. MNR (1958) Tax ABC

A taxpayer sponsored a baseball team and listed $25,000 as an advertising expenditure. The court held that advertising is a valid expenditure, but reassessed the cost of the advertising. The gross income for the taxpayer was less than $50,000 and the court held that it was unreasonable to allocate nearly half of the taxpayer's gross to advertising and publicity. As such, the reasonableness provision was applied and the deductible expense was reduced to $5,000.

Scott v. MNR (1998) FCA

A self-employed taxpayer was allowed to deduct expenses incurred for extra food and water outside of ITA 67(1) because the nature of his foot and transit courier business required extra food and beverage to fuel his body. The court asks three questions:

a) What is the need that the expense meets;
b) Would the need exists outside or apart from the business; and,
c) Is the need intrinsic to the business.

3. Personal Living Expense

Generally, traveling back and fourth is a personal living expense. Deciding where to live is a personal consumption decision. However, upon reaching the place of work, other than the journey home a

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taxpayer is allowed to deduct travel expenses incurred in the carrying on of their business. There are restrictions.

Cumming v. MNR (1967) CTC

Traveling from home to office would not normally be deductible unless the taxpayer could establish that his or her primary place of work is the home. In this case, since the home office was the base of the taxpayer's practice, he was able to deduct the expense of traveling elsewhere. Note: the courts do not allow a full deduction of travel expenses and apportion the operating expenses of the car used for such travel.

Note that the 'but for' test has been consistently rejected by the courts.

Thomas Harry Benton v. MNR (1952) Tax ABC

The court held that the expense of a housekeeper to perform the usual domestic duties of a farm so that the taxpayer could perform the farming duties was not a valid business expense. The 'but for' test was rejected in drawing a proper nexus. Ie, 'but for' the housekeeper I could not have performed around the farm.

4. Home Office Expense (ITA 18(12))

ITA 18(12) – Two part test for the deductibility of Home Office expenses:

1. It must be the individual's principle place of business; and,
2. It must be used exclusively for the purpose of earning income from business and used on a regular and continuous basis for meeting clients, customers, or patients in respect of the business.

This applies to income earned from Office/Employment, but requires that the individual perform 50% or more of the business duties at the home and that the employer certifies that the taxpayer falls within one of the prongs of the test.

Logan v.MNR (1967) Tax ABC

Where a room is used solely for work related purposes the court will allow the expense associated with that room to be deducted.

Mallouh v. MNR (1985) TCC

Where a room is not used exclusively for business, but also for other purposes and activity, the court will not allow the expenses to be deducted.

Note: A taxpayer may take Capital Cost Allowance on the portion of the home allocated as the home office. However, in so doing the taxpayer loses the principle residence exemption associated with capital gains to the extent of the space allocated to that home office.

5. Childcare Expense

ITA 63 – deals with the deductibility of the child care expense; allows $7,000 for a child under 7 and $4000 for children ages 8-13.

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Symes v. The Queen (1994) SCC

A taxpayer hires a full time nanny and attempts to deduct the expense as a business expense. The court held that the child care expenses are not deductible as a business expense. Childcare make the individual *available* for work, but there is no direct link to the production of income as such.

Dissent: two female judges dissented claiming that there has been a change in social reality that ought to be addressed and the business purposes test does not prohibit this particular expense from being deducted.

Eansor and Wydrynzki "Troubled Waters" argue that denying individuals child care expenses discriminates as it creates barriers. The expense should be deductible. Traditional doctrine holds that they are not incurred in the ordinary course of business and are, thus, not deductible. However, today's social reality is different. Even Iaccobucci agrees that the legislature should re-evaluate these provisions. As such, child care acts as a barrier to participation in the work force. Look at fairness of allowing the expense – both sides.

6. Interest

ITA 18(1)(b)

In computing the income of a taxpayer from a business or property, no deduction shall be made in respect of an outlay, loss, or replacement of capital; a payment on account of capital; or, an expense in respect of depreciation. According to the courts, interest is not deductible because it is a payment on account of capital. The court has held that interest is prohibited from deduction. Interest will only be deductible in very limited circumstances – only if it encourages the accumulation of capital, which will produce taxable income.

ITA 20(1)(c)

Amount borrowed or an amount that is payable for property used for the purposes of earning income for business or property will be deductible. The courts will allow a deduction of the interest that one pays on property that is acquired for the purpose of earning income.

Huffman v. MNR (1954) Tax ABC

The price planning for the purchase of a number of mining leases was based on the purchaser paying 25% of the gold mined until the purchase price was paid for. The issue was whether the payments were income from property or whether they were capital in nature. The court held that since the installments depended on dates and amounts that were unknown they could not be included in the taxpayer's income under ITA 12(1)(b) from property at the time. The legislature changed the wording of the ITA to include 'amounts received' during a period. In order for something to fall under 12(1)(b) you must know:

a) How much it is; and,
b) When it is going to be paid.

Otherwise the income is capital in nature.

Broughman & Trust v. MNR

There must be a direct link between money borrowed and the income earning property in order for a taxpayer to deduct the interest paid on the principal sum as a business expense.

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Note: one cannot deduct the interest of his or her own home because it is not a capital outlay designed to produce income. If, however, one has an office a portion of the mortgage interest may be deducted as the existence of an office is a direct link between the capital outlay and producing income.
ITA 20.1 – A taxpayer may take a deduct when property is disposed of for an amount of consideration that is less than fair market value.

The Queen v. Attaie (1990)

There must be a sufficient nexus between an interest earning investment and borrowed funds in order to deduct the interest paid on the borrowed funds justifying that the borrowed funds were used in other investments to produce capital.

7. Public Policy (Illegality)

Disallowance of deductions most often rests with the judge. To the extent that the ITA is silent, deductibility is with the judge. The issue is whether the judge should step in the sphere or send it to the legislature. Note: Section 3 does not distinguish between income from a legitimate source and activities and income from illegal activities.

MNR v. Eldridge (1964) Exch Ct

A call girl argued that she was entitled to deduct expenses of an illegal business if the government is going to tax the proceeds. The court held that there is no valid reason to disallow deductions from income provided that they pass the computation of profit analysis (business purposes test etcetera). The taxpayer need only to support the expenses with proper documentation like any other taxpayer regardless of the illegality of the activity if taxes are going to be assessed on the income.

65302 BC v. The Queen (2000) SCC

Because parliament has not specifically disallowed the deduction of fines the court will consider that the statute has spoken because it is silent. The court held that if parliament wanted to disallow the deduction of fines etcetera that it would have done so as it had done with the disallowance of expenditures made in order to commit a criminal offense (ITA 67.5). The taxpayer, however, must still show a nexus between the acquisition of the fine and the production of profit.

Note: Take a look at ITA 67.5 and observe the exceptions that exist regarding illegality and fines.

IT 1042R – Prohibits the deduction from income of penalties or fines imposed by the ITA itself.

Day and Ross v. The Queen (1976) FCTD

If a fine incurred is inevitable and characteristic of a business then it will be considered as be directly related to the production of income.

D. Computation of Profit

Profit is equal to gross revenue minus deductions. The cost of inventory is a deduction and where the value of one's inventory decreases over the year so as to result in 'negative' profit, the taxpayer may apply ITA 9 and claim a loss. There are two methods of accounting that we need to discuss before we get to this point:

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1. Cash Method

Revenue, which is actually received by the taxpayer and expenses actually paid by the taxpayer in the accounting year are deductible. The key is what is 'actually' paid.

ITA 5 - The cash method is used to account for income from office and employment.

ITA 28 – Farming and fishing businesses are required to use the cash basis.

ITA 12(1)(c) – disallows the use of the cash method to postpone the recognition of interest income.

ITA 12(1)(g) – requires the use of the cash method for payments made based on production or use.

In all other circumstances the taxpayer has the choice between accounting methods provided that the method produces an accurate financial picture.

There are not too many controversial issues that arise with this method. One such minor issue, however, is characterizing the receipt of income by cheque. The court handles cheques like cash for accounting purposes and, thus, revenue is recognized when the cheque is received. The cash basis, however, is not appropriate for determining business statements and does not provide a realistic result of the business operations.

2. Accrual Method

Income is recognized in the year in which it is earned and that is the case whether or not the payment has actually been received by the taxpayer. If it is earned it will fall into revenue regardless of whether it has been received.

Matching Principle – Revenues and expenses should be matched to the period of time in which they relate. With very few exceptions, all businesses must use the accrual method. Moreover, revenue is earned when the performance is substantially completed and not when the revenue is actually received.

ITA 12(1)(b) – the accrual method is to be used by all businesses other than fishing or farming

Sale of Goods – goods are sold at the point of time when they are delivered.

Expenses – expenses are considered at the point in time they are incurred and not when the taxpayer is in receipt of a bill. The bill is recognized as a cost or expense when the cost is incurred and not later when the bill arrives.

3. Computation of Profit for a Business

Revenue is treated as earned for financial accounting purposes in the period in which the recipient substantially completes performance of everything that she or he is required to do as long as the amount due is ascertainable and there is no uncertainty about collection. The sale of goods, then, occurs at delivery of the good. An expense is incurred when a cost is used up in a business to earn revenue. All costs that relate to a particular period must be used within that period even if they have not been paid and even if there is no immediate liability to pay them. For example, a hydro or telephone bill will be considered as an expense during the period of consumption as opposed to the point of billing.

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4. Inventory

ITA 248 – "inventory" means a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method and, with respect to a farming business, includes all of the livestock held in the course of carrying on the business."

What is considered as inventory depends on the nature of the business. The nature in which the asset is put to use will determine what is inventory. An auto lot's inventory are its cars, while the cars in a pizza delivery service are capital. The distinction is in regards to the trade. The car lot trades cars, so cars are the inventory. The pizza delivery service trades pizzas and so the car is not inventory. Instead, the car is used in the pizza trade – the car, is thus, an income-producing asset – capital.

ITA 10 – provides a number of rules on inventory accounting that must be complied with.

ITA 10(1) – Inventory shall be valued at its cost to the taxpayer or its fair market value, whichever is lower. However, Regulation 18.01 permits a taxpayer to value his or her entire inventory at fair market value. Thus, the taxpayer has two choices:

1. Inventory at cost or fair market value (ITA 10(1)); or
2. Entire inventory at fair market value (Regulation 18.01)

Once the taxpayer chooses one method, however, s/he must use this method throughout the entire life of the business unless s/he is granted special permission as per *ITA 10(2.1).*

ITA 10(2) – opening inventory is equal to the closing inventory from the immediately preceding year.

Where a taxpayer is not able to specify the value of his or her inventory (because prices fluctuate etcetera), Revenue Canada will allow the taxpayer to use two GAAP methods:

1. Average Cost – assumes that the cost of each unit of closing inventory and the goods sold was the average of the cost of all the units held at the beginning of the year and purchased throughout the year; or,
2. FIFO – first in last out where it is assumed that the goods sold were the first goods purchased and allocates the most recent costs to closing inventory and the oldest costs to goods sold

The weight of judicial authority suggests that *fair market value* equals an objects replacement costs – the cost of producing or purchasing similar inventory property at a particular time. Where a piece of inventory has become obsolete, the courts have allowed the taxpayers to use net realizable value (the estimated sale price of the property less the cost of sale).

Frieson v. The Queen (1995) SCC

The taxpayer was allowed to use the fair market value method of inventory accounting on a parcel of land that had steadily decreased in value of a period of years. The taxpayer was deemed to be in the business of buying and selling land, although it was an isolated single transaction. The taxpayer was allowed to deduct the devaluation of the land as an inventory deduction as per ITA 10(1). The issue was whether the taxpayer was able to write down the value of the property under ITA 10(1) as inventory and claim a business loss under ITA 9 or whether the property could only be held as a loss when disposed of. The court held that the nature of the business allowed the taxpayer to properly identify the land as inventory and proceed under ITA 9.

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E. Capital v. Current Expenditures

A business person would want his or her expenditures to be current as opposed to capital because the taxpayer can deduct the entire amount of a current expenditure within that taxation year. However, if it is a capital expenditure, the entire amount cannot be deducted in that taxation year, but must be deducted according to the schedule set out as the depreciation of capital assets. If the ITA does not allow for a deduction under the Capital Cost Allowance provisions, then the expenditure is not accountable unless it is a current expense.

The policy behind this is the matching principle – the life of the capital assets worth ought to be matched with the revenue it might generate.

There are a number of tests to distinguish between a current and capital expenditure. The courts have held that the taxpayer's intention in acquisition is relevant. No single test is determinative. The test as per Revenue Canada is simple:

Capital Expenditure	Current Expenditure
a) Does not regularly recur b) Large Cost c) Improves, enhances, or adds to capital property	a) Regularly recurring (law) b) Has small cost c) Restores to normal operating capacity or capital property (law)

1. Tangible Property

British Insulated v. Helsby Cables Limited (1926) HL

Capital expenditures have an enduring benefit and something with an enduring benefit may not be wholly deducted within a single taxation year. Enduring Benefit Test: if the expenditure is made with a view to bringing into existence an asset or advantage for the *enduring benefit* of a trade it will be a capital benefit. The word endure means that the benefit will last beyond the current year. A benefit may be acquired through both the acquisition of an asset and the discharging of a liability.

Denison Mines Ltd. v. MNR (1972)

In this case ore was extracted and sold. The extraction resulted in the creation of the throughways. As such, the removal of the ore is a current business deduction as it created proceeds of disposition – gross income.

Johns-Manville Canada v. The Queen (1985) SCC

The characterization of expenditures in tax law is really an issue of public policy. Where a tax statute is not explicit, ambiguity should be resolved in favour of the taxpayer. In this case, the cost of purchasing land was a current expense as it was a bona fide purchase in the course of everyday business – it was part of the day to day operations although not a once in a while thing. *Where the expenditure is incurred in the course of everyday business, it will be characterized as a current expenditure.*

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2. Protection of Intangible Assets

Canadian Starch Co v. MNR (1968) Exch Ct

The taxpayer spent $80,000 to *develop* goodwill in a trademark. Goodwill is an intangible asset. Be the owner of the name 'Visa' for instance is valuable, but intangible. The court held that if goodwill is bought outright or acquired, the single acquisition will be considered a capital expense. Thus, a company that purchases the name "Coca-Cola" will have made a capital expenditure. However, an expenditure in the process of the development of goodwill is characterized as a current expenditure. Thus, if I try to develop the trademark "Varvolium" by advertising and hiring a designer etcetera, then I will be in the process of the operation – a current expenditure.

MNR v. The Dominion Natural Gas Co (1941) SCC

The taxpayer had incurred legal fees to protect his supply boundaries to settle a matter once and for all. The court applied the enduring benefits test and held that since the fees were incurred for the purpose of procuring for the company the advantage of an enduring benefit they would be characterized as capital in nature. Capital expenditures yield enduring benefits.

Kellogg Company of Canada v. MNR (1942) Exch Ct

Legal fees were incurred by Kellog Co. to preserve a right in a tradename. The court held that expenses incurred to acquire a capital asset are capital expenditures while those incurred to preserve a capital asset are current expenditures.

Note: some argue that because the legal fees here removed a cloud on the title and improved the quality of it, it was an enduring benefit.

Repair v. Renovation

Repairs to a capital asset is generally deductible as a current business expense. As the repair parts get bigger and they are for a substantial amount of income, then the question arises as to whether the expenditure is on the repair or the replacement of a component and, therefore, it is capital and falls under ITA 18(1)(b).

Case	Repair (Current Expense)	Renovation (Capital Expense)
Shabro	• Replacing Worn or Damaged Parts • Regularly Recurring Expense • Restore something to normal operating capacity	• Enduring addition or improvement • Does nor Recur Regularly
Canada Steamship	• Small cost in relation to the asset being repaired	• Big Cost in Relation to the Asset Being Repaired

Canada Steamship Lines Ltd. v. MNR (1966) Exch Ct

In this case the repair of floors and walls to a ship was a repair (current expense) while the replacement of the boiler was a renovation (capital expense). The character of the walls and plates remained the same. The boiler was a capital expense because it was an integral part of the ship and it could not move without it. Revenue Canada's position: if the cost is large relative to the asset, they will argue the expense as capital. The court's have held that cost is not determinative, but is a factor.

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The Queen v. Shabro Investments Ltd (1979) FCA

An expense incurred that improves or renovates is considered a capital expense. The court distinguished between the two:
Capital Expense – Enduring addition/improvement that does not recur regularly
Current Expense – replaces worn/damages parts, regularly recurs, and restores something to normal capacity

Goldbar Developments v. The Queen (1987) FCA

If one is forced to make a repair s/he should not be forced to ignore technological advancements. In this case, the taxpayer replaced a shotty old brick wall with one using metal cladding at a cost of $242,000. The court held that this was a current expense! The court emphasizes that the taxpayer had no choice and that there exists a public safety issue.

MacMillan Bloedel Ltd. v. MNR (1973)

The court held that the acquisition of new tires for the taxpayer's trucks should not be considered a current expense, but rather added to the value of the trucks and depreciated accordingly under Class 10 depreciation schedule. Because the trucks were a source of income, the matching principle should here apply where revenue matches expenses as they are incurred.

F. Capital Cost Allowance

Depreciation

A capital expense may be deducted from income by amortizing the cost of the asset over the period of its estimated life. In order to do so, one must look to the ITA and determine whether or not the item appears in the Capital Cost Allowance regulation under one of the classes for depreciation and then take the capital cost allowance.

Note: Class 8 is the broadest of the classes – if you cannot find it anywhere else check Class 8. You cannot opt to take a capital cost allowance deduction over a current expense deduction. Moreover, land is not depreciable.

ITA 11.02(1)(c) – the property must be purchased for a business purpose to be allowable under capital cost allowance. Inventory is not depreciable, only capital assets.

Undepreciated Capital Cost = (A+B) – (E+F)
A (Initial Cost of the Property)
B (Recapture on the Property)
E (CCA Previously Claimed)
F (Proceeds of Disposition Up to Cost)

Note: When making calculations in the year of acquisition, the half-year rule applies. Taxpayers are only entitled to ½ of the CCA in the year of acquisition.

Thus, in the year of acquisition UCC = ½ [(A+B) – (E+F)]

UCC represents the amount that the taxpayer may apply as a deduction to his or her earnings.

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Meaning of Cost

Undepreciated Capital Cost is the cost of a depreciable asset that is added to the UCC for CCA purposes. The ITA does not defined what cost means. The general rule is that cost is equal to the amount that the taxpayer expended for the asset.

Ben's Ltd. v. M.N.R. (1995)

One cannot include in a business deduction the depreciation of assets that were not acquired for the purpose of producing income. Deductions cannot be applied on land.

Eligible Capital Expenditures

The ITA in 1972 was amended to include a separate amortization system for the deduction or depreciation of intangibles – these are called eligible capital expenditure. ITA 14(5) defines an eligible capital expenditure as all expenses incurred after 1971 for the purpose of gaining or producing income from a business that are capital in nature and are not otherwise deductible under the ITA.

The Queen v. Saskatoon Drug & Stationery Company Ltd. (1978)

The leasehold interest was depreciable under CCA and goodwill under the eligible capital expenditure system. The taxpayer structured his affairs to maximize the depreciation allowable in one year.

Disposition of Depreciable Asset

When you dispose of a depreciable asset you will have either depreciated them faster or slower than they should have been. The ITA provides that if the actual life of the asset differs from the estimate useful life provided for in the Act, then the taxpayer must either recapture or is entitled to a returnable loss.

When the ITA depreciates the asset faster than its actual life, the ITA requires that the computed amount is included in the taxpayer's income. There will only be a negative balance in the UCC account if there are dispositions of property in the Class for proceeds, which exceed the positive balance of the UCC.

The ITA adjusts for the fact that depreciation is set lower than what the taxpayer experiences – terminal losses – the taxpayer gets a deduct for the positive amount in the UCC account when there are no properties remaining in the account. Note: you have no choice but to take the deduction – you must take the deduction. The ITA will not allow the taxpayer to structure their affairs in any other way (must be consistent with the matching principle).

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7. Income Producing Properties

When a taxpayer buys and sells a property that is traditionally viewed as an investment – the normal treatment is that the transaction is an investment that generates profit or loss from capital. Generally, if a taxpayer buys or sells it will generate a capital gain.

Irrigation Industries v. M.N.R. 1962 SCC

The appellant was incorporated in 1947 for the purposes of purchasing farm property and constructing an Alfalfa Mill. In 1993, Irrigation purchased 4000 shares of the common stock of a mining company and had to borrow some of the money to do so. After doing so the company had an overdraft of $40,000. The company was called upon by the bank to make good on the overdraft. 2400 shares were sold, which paid off the overdraft. The rest of the shares were sold in June and applied against their loans. The issue here is whether an isolated purchase of shares from the treasury of a corporation and their subsequent sale constitutes an adventure in the nature of trade and, therefore, the sale generates income from a business. It was held for the taxpayer. The court found that the purchase of the shares was speculative, but it was not an adventure in the nature of trade. The reason why it was not is because it was difficult to conceive of any case in which securities that are purchased by a taxpayer would be in circumstances where the taxpayer had no intent of disposing them at some point. Martland J held that the test to characterize these types of transactions cannot be the subjective intent of the purchaser at the time of purchase. The IT Bulleting sets out the test.

The test to be applied is set out in Taylor and it is:

1. Whether the person dealt with the property purchased by him in the same was a dealer would;
2. Whether the nature of and quantity of the subject matter excludes the possibility that the sale of the property was an investment.

It did not matter that the taxpayer had the intention of disposing of the shares at a profit as reasonably soon as possible. The fact that the taxpayer had intent to sell the shares does not matter.

Shares issued from the treasury of a corporation can never be considered an adventure in the nature of trade. Corporate shares are unique because they constitute an investment rather than an article of commerce and they represent an interest in a corporation. They are not created for the purpose of doing business and the acquisition of a share has long been recognized as a method for investing capital in a business enterprise.

Martland should be wrong. The decision is wrongly decided.

First consideration – you cannot look at the nature of the property and draw a conclusion regarding what it is. The case is a case of speculation and generally when a taxpayer purchases property for speculative purposes that is going to be an adventure in the nature of trade (Subject to Taylor and Regal Heights etc.,).

A series of SCC cases have come down and made it very clear that Irrigation Industries is poor law. When you are dealing with income producing assets, such as corporate securities, whether they are shares or debt, the determination of whether they generate income is not dependent upon the particular characteristics of the share or debt, but rather on the intention of the taxpayer when income-producing properties are acquired. If the intention is to hold securities as a source of income (looking for dividends) and looking to make a capital gain, then you will have capital gains and not income.

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Example One

A taxpayer was an investment company and it sold at a profit a number of shares from its holdings. The court had to determine what the intent of the taxpayer was at the time of acquisition. The court found that the primary intention of the taxpayer at the time of acquisition was to invest. They were trying to generate income from these shares. As a result, the intent at acquisition was to invest – capital gain.

If the primary intention is to make a quick sale through primary realization, then the intent is to make income from a business.

Example Two

The taxpayer had purchased corporate securities at a discount. The court found that it was an adventure in the nature of trade that generated income when sold. The purpose of the operation or business was that he was a stamp collector or dealer. The court found that he was purchasing these securities with the primary intent of flipping them. The possibility of resale in this context does not hold any water because there will always be a possibility of resale.

It must be the intent to invest at the time of acquisition, otherwise it will be held to be income from a business.

1977 - a taxpayer can elect capital treatment for all dispositions of Canadian Securities (shares, debt, adventures at discount etcetera). All Canadian security dispositions are treated as either income from a business or capital gains. The provision applies to individuals and corporations, but excludes traders or dealers. The only question that arises under these new provisions is whether or not a taxpayer is a dealer or trader. The election is permanent according to Revenue Canada (ITA 39). There is no provision to change your election.

Commodities

These are non-income producing assets – currency, gold, silver, lead, and etcetera. The key is recognizing the nature of the property to apply the test not to make a determination. When there is a non-income producing asset, there is a presumption that the taxpayer purchased the property with the intention of resale. This presumption can be rebutted.

M.N.R. v. Taylor

The taxpayer purchase 1500 tons of lead contained in 22 railway cars. This lead was sold at a profit. It was an isolated transaction, as the taxpayer had never made this type of purchase before. The taxpayer did not purchase the lead for use in its business – it was simply flipped. The court found, thus, that it was an adventure in the nature of trade. Because the taxpayer could not do anything else with the lead other than resell it, the presumption arises. The court found that in this case the presumption could not be rebutted.

The presumption can be rebutted if you establish that you had an intention to invest it. Take, for example, Gold. Gold is a non-income producing asset. If disposed of, income from a business. Stating that it was held for a reason can rebut the presumption. When the economy goes down, taxpayers purchase gold, which for the taxpayer is a good insurance policy.

Note: The secondary intention doctrine is confined only to real estate.

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IT Bulletin: IT346R

Speculators in commodities can report either as capital gains all capital gains or report as all business losses. Once this determination is made, they must follow it every year. The difference between this process and that under section 39 for corporate securities is that this particular election is only under an IT Bulletin – not the law, but the Minister's interpretation.

There are three different types of assets. Each has to do with intention and each has its own twist depending on the nature of the asset.

Exemptions from Capital Gains

Only 50% of taxpayers profit or loss is included under section three. If you sell an asset or generate capital gain, 50% is included and you get 50% of your losses. In addition to the preferential rate, some capital gains are partially or fully exempt from taxation period. The most well known exemption is the principle residence exemption (page 636). There are two IT Bulletins (IT437R and IT120R).

Most homeowners do not pay any capital gains tax when they dispose of their principle residence. If the taxpayer's residence is the principle residence for only part of the period of ownership, then only a partial exemption will exist as per ITA 40(2)(b) and (c). There can be no capital loss because it is a loss on personal use property. In the absence of a relocation loan, when you dispose of your principle residence and generate a loss there is no recognition under the Act.

The principle residence exemption is limited in a number of ways:

1. You must fall within the definition of a principle resident (ITA 54);
2. You must own the principle residence and be a resident in Canada, but the property need not be in Canada. There are two types of ownership (legal and beneficial); beneficial ownership is divided into two:
    a. Equitable – entitled to use, but no legal interest, such as property held in trust. These people have a principle interest in the land. Does not include a tenant, licensee, or possible adverse possessor;
    b. Beneficial – when a person has the use and benefit without legal title, but enough of the incidents of ownership (the bundle of rights). This is a factual determination. Does the taxpayer have the incidents of ownership? (Possession, right to exclude, collection of rents, right to mortgage).
3. You can only have one principle residence at a time. Prior to 1981, the taxpayer had the ability to designate residences. The ITA changed to limit principle residence as one per family unit – this is a classic example of parliament changing ITA to catch.
4. Principle residence includes up to ½ hectare of surrounding land (1.24 acres). To the extent that the principle residence is surrounded by more than 1.24 acres of land, it does not mean automatic exclusion, but rather that you must justify for the balance (ie contributing to the taxpayers use and enjoyment of the housing unit as a residence). Originally, the use and enjoyment test was difficult to meet at the courts required that the taxpayer show the additional land was necessary and indispensable to the use and enjoyment of the property. The test has become much more flexible – it is a subjective test and the taxpayer's lifestyle is relevant.
    a. Carlyle v. MNR – One way of establishing that land in excess of 1.24 acres is necessary for use and enjoyment is by reference to the objective test. Where the land does not there qualify under the objective test, it can on reference to the subjective intent analysis.

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5. If you are dealing with farm property (IT120R5) you have a choice of two methods – farm property is different than a property held for other purposes.

Complete or partial change in the use of property from a principle residence (such as renting or then taking use) there is a deemed disposition under the Act on change of use and the taxpayer is deemed to have disposed of the property at fair market value. The taxpayer may elect for the deemed disposition not to apply (The Act acknowledges that this is a genuine problem).

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