**Fall**

20

Income Tax Summary

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# The Logic, Policy and Politics of Tax Law

## Why Study Tax Law?

* Tax law is pervasive
	+ Much of the advice lawyers give to clients would be incomplete without some consideration of the tax implications
* Provides a unique lens through which to study many related legal subjects
* The study of tax law is intellectually fascinating
* Tax law is at the heart of almost every social and economic policy
	+ It involves the consideration of equality, equity and fairness and the design and implementation of the tax rules
	+ **Tax expenditure provisions:** provisions of *ITA* not designed to raise revenue but intended to achieve social & economic objectives
* Tax law also raises fundamental questions of morality – How do you determine if someone is paying their fair share of taxes?

## Basic Objectives of this Course

* To learn the vocabulary of tax law, the tools of tax analysis, tax policy principles, and some basic frameworks that are essential in understanding and evaluating tax law and policy issues
* To learn to identify, analyze and apply the basic provisions of the *Income Tax Act*, regulations and case law
* To learn tax law theory that will be useful to your understanding of and ability to critique the law
* Learn how to think about tax law, not what to think!

## What is a Tax?

* “compulsory transfer of money from private individuals or organizations to government not paid in exchange for specific good/benefit”
* **The distinguishing characteristic of taxes are that they are compulsory and unrequited**
* Taxes are not paid as consideration for a good or service received in exchange
* Some taxes are easy to identify such as the income tax while others are not as easily identifiable
	+ Is the price paid for a lottery ticket a price of a good or a tax?
		- Likely both although some portion of the price is paid in return for the opportunity receive the prize , the amount you pay for a lottery ticket far exceeds the value for that opportunity
			* E.g. if a lottery tickets cost $5 and the value of the winnings are $5 million. The value of the ticket will depend on the chances of winning. If your odds of winning are 1 in a million then $5 may be okay.
			* The amount raised by selling the tickets that exceeds the prize value is a tax
		- Why does the distinction matter?
			* Because if the government is collecting tax through the sale of lottery tickets then we should evaluate the policy choice in the same way that we evaluate a tax
			* The tax on lottery tickets is not a well designed tax and is highly regressive
* In contrast to a tax, a **price** is an unrequited & compulsory/non-compulsory
	+ Lottery ticket, employment insurance, Canada Pension Plan premium
* Distinction between tax and price matters where the government competes with the private sector (Government tax revenue – expenses vs. private sector revenue -expenses) to inform policy questions of whether government should continue funding certain programs.

## Classification of Taxes

* All taxes have five components:
	+ Base
		- Amount, transaction or property upon which tax is levied (e.g. how much a person earns is the base for income tax. How much a person spends is the base for a consumption [PST, GST, HST, VAT] tax. The amount represented by a person’s property is the base for a wealth tax.
	+ Unit
		- Who is actually being taxed (i.e. the individual taxpayer)
	+ Rate
		- The rate a which the tax is levied
			* Actual: rate stated in statute
			* Marginal: rate that applies to next dollar of income earned (often same as actual)
			* Average: total average rate of the tax paid by a unit
			* Effective: Actual rate paid by people account for deductions and exemptions (e.g. Dividend income vs taxed income – what the corporations pays vs what you pay)
			* Progressive: What we have in Canada. As income goes up, the rate at which you tax taxes increases. This refers to the percentage of tax, not the dollar amount.
				+ Takes an increasing proportion of income as income rises
				+ Only the next dollar is taxed at a higher rate
			* Proportional: Everyone pays a certain percentage (“flat tax”)
			* Regressive: Opposite of progressive, rate of tax decreases as income increases
	+ Period
		- The period over which tax is being assessed
	+ Administrative rules

## Base

* The amount upon which the tax is levied
* There are three obvious bases upon which a broad-based tax might be levied:
	+ Income (e.g. income tax, payroll tax)
		- The amount an individual earns
		- The base is income
		- In the *Act*, income is defined by reference to the sources side of the household budget as the net amount an individual earns from sources such as employment, property and business
		- Government might impose a tax on only some aspects of income such as wages and salaries. These are known as **payroll taxes** and are primarily used to finance social insurance schemes
	+ Consumption (e.g. provincial sales tax (PST), goods and services tax (GST), harmonized sales tax (HST), value added taxes (VAT), excise taxes)
		- The amount the individual spends
		- Essentially equivalent to an income tax that exempts the value of the taxpayer’s savings from tax
		- Federal GST is a value-added tax in which the tax rate is applied to the value added to the goods and services at each stage of their production
		- Provincial retail sales taxes are single-stage taxes collected by retailers when goods and services are sold
		- Consumption tax could also take the form of a personal expenditure tax
			* I.e. if individuals calculated all their income and deducted their savings at the end of the year, the balance would be the value of the goods and services they consumed in the year
	+ Wealth (e.g. estate taxes, gift taxes, property taxes)
		- The amount represented by an individual’s property
* The base is expressed in monetary terms: the dollar value of income earned, goods and services consumed, or property held
* The tax is calculated by applying the rate of tax, expressed as a percentage, to this base

## Unit

* The unit is the person responsible for paying the tax
* The Canadian *Income Tax Act* recognizes 3 such units:
	+ Individuals : a legal person and therefore liable for their own tax
	+ Corporations : a legal person and therefore liable for their own tax
	+ Trusts : not separate legal persons but are treated as such for purposes of the *ITA*
		- Trustee of the trust is responsible for filing the trust tax return and paying the tax owed

## Rate

* The rate is referred to the rate at which the tax is paid. Tax is usually calculated by multiplying the based by the rate
* Actual rate
	+ This is the rate of tax that is set out in the *Income Tax Act*
	+ This is the rate that is applicable to the taxpayer’s income as a whole
* Marginal rate
	+ This is the rate at which you pay on the next $1 of income that you earn
		- This is the rate of tax that applies to an additional dollar a taxpayer earns within each income bracket
	+ The Canadian *Income Tax Act* uses a progressive rate structure meaning the rate of tax increases as your income increases
	+ Higher rate only applies to extra income earned, does not retroactively apply to income already subject to lower tax rate
	+ E.g. if a tax payer paid a rate of 25% on their first 50, 000 of income and 50% on any income over 50, 000 the marginal rate on the first 50,000 of income would be 25% and the marginal rate on each dollar of income over 50, 000 would be 50%
* Average rate
	+ This is the average rate of tax you pay on all your income
	+ E.g. Assume a taxpayer paid a rate of 25% on their first 50, 000 of income and 50% on any income over 50, 000. If the taxpayer had 100,000 of income, they would pay 12, 500 on the first 50, 000 and 25, 000 on the next 50, 000. In total, they would have paid $37,500 in tax. The average tax rate is therefore 37.5%
* Effective Tax Rate
	+ Generally computed by reference to some broader measure of income than what is subject to tax
	+ E.g. under *Income Tax Act*, only one half of a capital gain is included in the taxpayer’s income. As such, if a taxpayer realizes a 10, 000 capital gain, they will only report 5, 000 of income. If the tax rate is 50%, they would pay 2, 500 in tax
* Progressive
	+ One that takes an increasing amount of income as income rises
		- The more you earn, the large the tax rate
	+ E.g. where a taxpayer pays 25% of tax on their first 50, 000 of income and 50% on any income over 50,000
	+ E.g. Income tax in Canada (tiered, step-wise)
* Proportional
	+ One that takes a constant portion of income, flat tax rate
		- E.g. GST in Canada is a flat 5%
	+ E.g. 25% no matter how much income the taxpayer earns
* Regressive
	+ Takes a declining portion of income as income increases
		- The less you earn, the higher rate of tax paid over total income
	+ E.g. where a taxpayer pays 50% of tax on their first 50, 000 of income and 25% on any income over 50,000
	+ E.g. I only make $100 per month and spend $100 on consuming necessities. GST is 5%. Therefore, I pay $100\*5=$5 in taxes. Of my total income, my tax rate is $5/100=5%. Ex: I make $1000 per month. I spend $100 on consuming necessities. GST is 5%. Therefore, I pay $100\*5% = $5 in taxes. Of my total income, my tax rate is $5/$1000 = 0.5%.Therefore, lower income individuals pay more tax relative to the amount of income they earn.
* Whether a tax is proportional, regressive, or progressive cannot be determined by only looking at rate structure, it needs to take into account other factors including how broad the base is measured and all available exemptions, deductions or credits. Consumption taxes tend to be regressive as lower income individuals consume more and earn less
	+ Will depend on things such as who really pays the tax, how broadly their income is defined, over what period of time their income is measured, and who is assumed to benefit from exemptions, deductions and credits in the tax base
* Generally, all taxes in Canada are regressive except income tax

## Period

* Refers to the length of time over which income is measured
	+ Calendar year
		- Individuals pay tax annually, meaning the period over which income is computed is a calendar year
	+ Fiscal period
		- Corporations are permitted to have an off-calendar year or fiscal period which is generally a period of 1 year but does not necessarily have a December 31st year end

## Administrative Rules

* The provisions of the *Income Tax Act* that set out the rules and procedures for the collection of tax
	+ The requirement to file a tax return
	+ Rules relating to verification and enforcement
	+ Objections and appeals
	+ Penalties

## Income Tax Terminology

* **Income (or net income):** taxpayer’s income for tax purposes calculated by the equation **Revenues - Expenses**
	+ This is a taxpayer’s income after expenses
		- First, the taxpayer “determines the total of all amounts of each of which is the taxpayer’s income for the year [other than capital gains] 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
		- Second, taxpayers add their net taxable capital gains to this total
		- Third, they subtract the deductions permitted in subdivision (e)
		- Fourth, they subtract any losses from employment, business, and property
	+ The rules for determining net income are contained in Division B Part I of the Act
	+ It is the aggregate the taxpayer’s income from all sources less the taxpayer’s losses and other statutory deductions
	+ Some items that increase a taxpayer’s ability to pay are exempt from taxes. (I.e. strike pay which the SCC has held is exempt from tax since it is not “income from a source”)
* Taxable Income
	+ This is the portion of the income that is subject to tax
	+ This section allows for the deduction of only a few additional amounts including:
		- A deduction of one-half of the employment income realized on the exercise of certain employee stock options
		- A deduction for business/other allowable losses carried forward from prior years or back from subsequent years
		- Payments such as worker’s compensation and social assistance that are included in the taxpayer’s net income
		- The equivalent of an interest free $25, 000 employee home relocation loan; and
		- Certain deductions for individuals residing in prescribed northern and isolated areas
	+ It is computed by taking the taxpayers net income and adjusting for certain other statutory deductions and inclusions
	+ For most people, their income is equal to their taxable income, but certain credits and benefits received through the *Income Tax Act* are reduced by the amount of income a taxpayer has. Parliament wanted to compute those benefits by reference to a measure that was closer to a taxpayer’s economic income and not one that was reduced by certain statutory deductions that do not reflect a real economic loss of income for the year
* Exemptions
	+ Described amounts that are excluded from the computation of income
	+ Benefit of exemptions depends on their marginal tax rate which will depends on the taxpayer’s taxable income
	+ When income is not subject to tax
	+ E.g. income earned on investments in an RRSP or TFSA are exempt from tax
* Deductions
	+ Reduce a taxpayer’s income
	+ When an amount of income is deducted from the total of a unit’s taxable income
	+ Taxpayers earning business/property income will be able to deduct business expenses which represent the cost of earning business or property income such as employee’s wages, depreciation on business assets and investment advisor fees
	+ Deductions take two general forms:
		- **General statutory deduction:** reduces a taxpayers income regardless of sources
			* Ie. A deduction for a contribution to an RRSP or for childcare expenses
		- **Deductions available in computing income from a source such as employment, business, or property**
* Credits (refundable and non-refundable)
	+ Amounts that reduce the amount of tax otherwise payable by the taxpayer
	+ Credits are further defined as refundable or non-refundable
		- If a credit is non-refundable, it will only reduce tax otherwise owing
			* I.e.., if a taxpayer has 1,000 credit but only owed 500 in tax, the credit will simply reduce the tax owing to 0. The remaining 500 of credit could potentially be used in a subsequent tax year or would be lost
			* Non-refundable- credit can only be used to offset income tax to be paid
		- A refundable credit is one that is refunded to the taxpayer if the amount of the credit exceeds amount payable
			* Get credit no matter what, could lead to payment from the government
			* Ie. If taxpayer had a 1, 000 refundable credit but only owed 500 in tax, the credit would reduce the tax owing to 0 and government would return or refund the remaining 500 credit to the tax payer. As such, taxpayer benefits from the full amount of the credit regardless of the amount of tax owing
* Technical tax provisions
	+ Establish and define the basic structural elements of the tax system: the base, the tax filing unit, the accounting period, the rates and the administrative apparatus
	+ Evaluated by the principles of equity, neutrality, and simplicity
		- Equity: the tax system should provide fair treatment. Not equal treatment, which is equality.
		- Neutrality: The tax system should not change or interfere with people’s decision making.
		- Simplicity: The tax system should be easy to apply and administer, but not easy to avoid
	+ Necessary so that the tax system can achieve its principle objectives of raising revenue and redistributing income
* Tax expenditure provisions
	+ Provide implicit subsidies to taxpayers (by reducing tax) to encourage certain types of activities or provide taxpayers with transfer payments
		- i.e. the government does not trust that people will save money on their own, so it cuts tax for payments to a CPP/RRSP/TFSA to provide an incentive for people to save
	+ Evaluated through budgetary criteria applied to spending programs
	+ Deductions and credits are both expenditures

## Structure of the Income Tax Act

* **Parts of the Act**
	+ Part I- Income Tax, ss. 2-180
		- Deals with the liability for tax and the computation of income
	+ Part XIII – Tax on Income from Canada of Non-residents, ss. 212-218.1
		- Deals with certain aspects of non-resident taxation, commonly referred to as withholding tax
	+ Part XV- Administration and Enforcement, ss. 220-244
	+ Part XVI – Tax Avoidance, ss. 245-246
		- Deals with the general anti avoidance rules
	+ Part XVII – Interpretation, ss. 248 – 262
* **Part I**
	+ Division A – Liability for Tax, s. 2
		- Main charging provisions that establishes liability for tax
	+ Division B- Computation of Income, ss. 3-108
		- Basic rules, ss. 3-4
		- Subdivision a – income from employment ss. 5-8
		- Subdivision b – income from property or business, ss. 9-37
		- Subdivision c – capital gains, ss. 38-55
		- Subdivision d – other sources of income, ss. 56-59.1
		- Subdivision e – deduction in computing income, ss. 60-66.8
		- Subdivision f – rules relating to computing income, ss. 67 – 80.5
		- Subdivision g – amounts not included in computing income, s. 81
		- Subdivision h – corporations’ resident in Canada and their shareholders, ss. 82-89
		- Subdivision i – shareholders of corporations not resident in Canada, ss. 90-95
		- Subdivision j – partnerships and their members, ss. 96-103
		- Subdivision k – trusts and their beneficiaries, ss. 104-108
	+ Division C- Computation of Taxable Income, ss. 109-114.2
	+ Division D – Taxable Income Earned in Canada by Non-residents, ss. 115-116
	+ Division E- Computation of Tax, ss. 117-127
	+ Division E.1 – Minimum Tax
	+ Division F- Special Rules Applicable in Certain Circumstances, ss. 128-143.2
	+ Division G- Deferred and Other Special Income Arrangements, ss. 144-148.1
	+ Division H- Miscellaneous Exemptions, ss. 149-149.2
	+ Division I – Returns, Assessments, Payment and Appeals, ss. 150-168
	+ Division J – Appeals to the Tax Court of Canada and the Federal Court of Appeal, ss. 169-180

### Deductions (Subdivision e)

* Includes statutory deductions in relation to:
	+ Contributions to an RRSP, s. 60(i)
	+ Moving expenses, s. 62
	+ Childcare expenses, s. 63
	+ Support payments, s. 60(b)

### Tax Credits (Part I, Division E)

* Includes various credits that reduce the amount of tax otherwise payable
	+ Married or common law tax credits, s. 118(1)(a)
	+ Credit for wholly dependent persons, s. 118(1)(b)
	+ Single credit, s. 118(1)(c)
	+ Credit for dependent persons, s. 118(d)
	+ Age credit, s. 118(2)
	+ Pension credit, s. 118(3)
	+ Charitable credit, s. 118.1
	+ Medical expense credit, s. 118.2
	+ Disability credit, s. 118.3
	+ Tuition credit, s. 118.5
	+ Credit for EI premiums and CPP contributions, s. 118.7
	+ Political contributions, s. 127(3)-(4.2)

## Modes of Reasoning

* Analytical Reasoning – aims to clarify
	+ It is not an inquiry into values or facts, instead it is an inquiry into the methods by which we search for such values or facts, the basis on which we assert them, and the concepts we use in formulating them
	+ The main methodology of analytical reasoning is logic
	+ Involves reasoning about concepts
* Normative Reasoning – involves making moral, ethical or value judgements
	+ It deals with what ought to be
	+ Involves reasoning about values
* Empirical Reasoning – about finding and explaining causal relationships
	+ Involves reasoning about facts

## Analytical Tools for Tax Analysis

### Inflation: Nominal Versus Real Values

* Inflation is the persistent rise in the general price level such that over time you can buy less things with $1
* The measure of inflations is used to distinguish between nominal value and real value
	+ **Nominal Value:** Value measured in current dollars
	+ **Real Value:** Value measured in constant dollars (i.e. adjusted for inflation)
		- Refers to the value of a concept measured in terms of the # of units of goods and services that can be purchased
		- Represent purchasing power
		- Ie. If you earn 10, 000 in year 1 and 11, 000 in year 2. You might say that your income increased 1, 000 in year 2 or 10%. However, what if the cost of all goods and services also increased by 10%. Now assume that you used all $10,000 in year 1. How much will it cost you in year 2 to purchase the same quantity in goods and services. The answer is $11, 000. Therefore, you will need to spend all your year 2 income to receive the same benefit from goods and services that your purchased in year 1. Therefore, even though your nominal income has increased by $1, 000 your income in real terms has remained the same. You are no better off.
* Bank of Canada’s inflation-control target range is 1% to 3%
* The rate of inflation is the percentage change in the price level from period to period

### Consumer Price Index (CPI):

* A common measure of inflation is a change in the CPI
* Measure of the average price of goods and services of a representative “shopping basket”, including food, shelter, furniture, clothing, transportation, and recreation
* Percentage change in CPI is the key measure of inflation
	+ CPI in July of 1914 was 5.9
	+ CPI in July of 2018 was 134.3
	+ CPI in July of 2020 was 137.2
* Therefore, a basket of goods that would have cost you $100 in 1914 would cost you $2, 225.42 today
* Average annual rate of inflation from 1914 to 2020 was 3.01%
* Current annual rate of inflation rate to July 2020 was 0.15% (likely because of COVID-19)

### Problems with Inflation

* Inflation creates at least 3 problems problems in the design of an income tax:
	+ Dollar values in *Income Tax Act* (e.g. tax brackets and credit amounts) will loose value over time if they are not adjusted for inflation. This is because if these amounts are not adjusted, their value in real terms will decrease year to year.
		- In Canada these values were not indexed from 1986 to 2000
		- Subsection 117.1(1)
	+ Taxation of the nominal value of income from capital
		- This is one justification for the partial inclusion of capital gains in income
		- This relates to the fact that a capital gain is only taxed when it is realized, generally when the property is sold. However, a large portion of the capital gain may simply relate to the increase from inflation. As such, there is no increase in the taxpayer’s wealth in real terms but they are still required to pay tax on the capital gain
		- One justification for why we only tax half of a capital gain is to offset the effect of inflation
	+ Nominal and not real value of tax losses are carried forward
		- Real value of tax losses erodes over time because of inflation, it is valued at less than what was lost at the time
		- This relates to the fact that a taxpayer is normally allowed to use a loss realized today to reduce their income in future tax years. Since it is their nominal value of these tax losses that are carried forward, their value in real terms will erode over time because of inflation

### Tax Deferral and the Time Value of Money

* The time value of money incentivizes tax deferral
	+ If you can defer the payment of taxes to the future, then you can invest that money today to make more money for the future
* Income is worth more in the future because you can invest it and gain interest. Maximize deductions today and defer gains/income to reduce tax. More money in pocket now = can invest = more time to grow. Timing is key to exploiting and designing the tax system
* Timing of income and deductions present some of the most critical issues for the design of an income tax
* Timing differences are commonly exploited by tax planners (i.e. minimize tac by brining production in now/benefitting today, but pushing income forward)
* The *Income Tax Act* is replete with provisions that are designed to deal with timing differences
	+ Capital cost rules, ss. 18(1)(b) and 20(1)(a)
		- If you could get a 100% write off today for a capital investment that would produce over the next few years, you could have the entire tax credit today and no revenue from the capital lost. This is a huge benefit in time value of money
	+ Matchable expenditure rules, s. 18.2
	+ Reserves, ss. 12(1)(a) and 20(1)(m)
	+ Prepaid expenses, s. 18(9)
	+ Prepaid interest, ss. 18(9.2) to 18(9.8)
	+ Prescribed debt obligation rules, s. 12(9) and reg. 700
	+ Weak currency debt, s. 20.3
* Time plays such a critical role in income taxation rules because the cost of paying tax today exceeds the cost of paying the same amount of tax tomorrow because of the theory of time value of money
* Future value
	+ Fundamental idea underlying the time value of money is that the value of capital increases over time because it can be used to earn additional income
	+ The future value of an amount is the amount that it will grow over the period
	+ For example,
		- Assume an interest rate of 5%. If you invest $1, 000 today it will grow to be worth $1, 050 in one year. Therefore, the value one year in the future of $1, 000 is $1, 050. We mean that a person is indifferent if they receive $1, 000 today or $1, 050 in one year since they are equal
* Present value
	+ Opposite of future value
	+ Converts future values into present values for purposes of comparison
	+ Again, assuming an interest rate of 5%, the value today (present value) of $1, 050 receivable in 1 year is $1, 000
* Simple Interest
	+ Computed by reference to the original amount only
	+ Interest is not earned on interest
	+ Amount of interest is constant each year
	+ For example,
		- $1, 000 invested at 10% simple interest would be worth $2, 000 in 10 years or $3, 000 in 20 years
			* This is the original 1,000 plus 20 years of interest at $100 per year
* Compound Interest
	+ Computed by reference to the original amount plus any accrued interest
	+ Interest is effectively earned on interest
	+ The amount of interest changes each year
	+ For example,
		- $1,000 invested at 10% compound interest would be worth $2,593.74 in 10 years or $6,727.50 in 20 years
			* With compound interest each year the interest is applied to original principal plus any accrued interest
* Asset Valuation
	+ Conceptually, the value of a financial asset is the sum of the present values of all future returns from the asset
	+ The higher the assumed interest rate or discount rate, the lower the present value of the asset
* Value of Tax Deferral
	+ Registered Retirement Savings Plans (RRSPs)
		- You are not taxed when you contribute to an RRSP, but you are taxed when you withdraw from it
	+ Tax Free Savings Account (TFSA)
		- Opportunity to invest tax free, supplement RRSP
* For example,
	+ John earns $1, 000 of income
		- Assuming a 40% tax rate he has $600 after tax, which he invests in a 20-year bond with a coupon of 5%:
			* At the end of 10 years he will have **$806** after tax
			* At the end of 20 years he will have **$1, 084** after tax
	+ Now assume that John contributed the $1,000 of pre-tax income to his RRSP and invests it in a 20-year bond with a coupon of 5%
		- Because it is invested in an RRSP, no tax is paid on the interest earned in each year
		- Assuming John’s tax rate is still 40% when he withdraws the income from his RRSP:
			* At the end of 10 years he will have **$977**  after tax
			* At the end of 20 years he will have **$1, 592** after tax
		- In either case he has more money after tax than when he invested the money outside of the RRSP. This is because by contributing to the RRSP, Jon was able to defer tax until a future date when he withdraws the money



* Capitalization Effect of Taxes
	+ Capitalization effect of a tax is the fall or rise in price of assets due to the imposition or removal of a tax
	+ The present value of a financial asset is basically the sum of the present value of all future returns of the asset. This is affected by the assumed interest rate but also on the amount of tax that is payable on the returns earned by the asset
	+ Demand and supply of investments are influenced by how the investments are taxed
	+ Changes in the way investments are taxed will result in windfall gains or losses for current holders of those investments
	+ For example:
		- $100 bond with a coupon of 5% is currently trading at par (market value is equal to face value)
		- The current rate of tax on interest is 50%
		- If the government amends the *Income Tax Act* to exempt interest paid on the bond from tax, how will this effect the price at which the bond trades?
			* The simple answer is that the price of the bond should increase to $200 because the price of the bond is determined by the after-tax rate of return on the bond. When the interest was subject to tax at 50% the after-tax annual return was $2.50, and the rate of return was 2.5%. If we assume the taxpayer was content with earning 2.5% after tax, how much would the taxpayer be willing to pay for a bond that pays 5% interest that is tax exempt?
				+ $200 because an after-tax return of $5 per year, generates a 2.5% rate of return when the bond is valued at $200
* Tax Incidence
	+ Deals with determining who bears the true burden of a tax. Who’s income or wealth is really reduced by a tax?
	+ The formal incidence of tax (meaning the person who is required to pay the tax) tells very little about who actually bears the tax since it is not necessarily the person who pays the tax to the government that bears the incidence of the tax
	+ The degree to which an individual bears the incidence of tax depends on the ease at which the individual can substitute other goods or activities for the taxed good or activity
	+ The incidence of tax is likely to be different in the short run and long run because it is easier for tax payer to adapt and change their behaviour over time
	+ Corporations cannot bear the incidence of tax. Why?
		- Never pay taxes – because corporations are just a vehicle to carry on an activity, thus they don’t care if you tax them the SHs are the ones who are affected (employees feel the brunt of it; prices go up and customers pay…) (so its individuals: consumer, SHs, employees who bare the burden, not corporations)
		- Instead, shareholders, employees, consumers might bear the incidence of tax through capital gains, reductions in wages, increase in price margins, etc.

## Income Trust Investors Suffer Massive Losses (CTV November 2006)

* There were changes to the taxation of income trusts that was announced by the government without prior notice on October 31, 2006. These tax changes effectively increased the tax rate on earning from investments in an income trust. The result of these changes was a precipitous decline in the value of income trust units.
* The income trust sector plunged in the wake of the federal government’s bombshell announcement of tax changes, and it dragged the TSX index down with it
* Analysts described a bloodbath as income trust investors saw more than $20 billion in paper losses, and pulled out of companies that had planned on covering to the legal structure
* The Toronto stock market’s main composite index plunged more than 300 points at the start of trading
* The index recovered a bit later on, but then the selling gathered steam, leaving the TSX down 324 points on the day. The index closed at 12,020.27 – a decline of 2.6%
* The S&P.TSX income trust index closed down 12%, and some individual trusts were down 18%

## Normative Justifications for Tax Laws

### Why we need an Income Tax System

* Raise revenue to finance the government
	+ Collecting taxes is one of the ways the government achieves its broad social and economic objectives
* Redistribute income
* The question of why we need a tax system can be substituted with why we need a government
	+ Some answers are that we need them to constitute the marketplace, to address market failures

### Constituting the Marketplace – Tax Laws Held Build the Marketplace

* Markets are not self-regulating
	+ There is no invisible hand and the markets do not successfully regulate themselves, so governments need to intervene and regulate to some extent
* The function of the marketplace is dependent on public infrastructure (i.e. judiciary, police, regulators) which is designed to develop and enforce private laws
* There can be no property without taxation. Why?
	+ Taxation forces the state to recognize that your property is, in fact, yours (through courts, the police)
	+ Without the right to exclude others, how can you really own any property? Property rights come from government through laws and regulations. In order for a government to function, it needs to be funded by taxes. Without taxes, society would not be able to fund the institutions that enforce our property rights
* Consumer surplus: when what you pay for a good or service is less than what you would have been willing to pay for it
* Producer surplus: when what you sell a good or service for is more than what it cost you to make
* Social gain or welfare gain: consumer surplus + producer surplus

### Market Failures

* Public Goods
	+ The market will only allocate resources efficiently if goods consumed by one person cannot be consumed by someone else; if those who do not pay for a good can be excluded from its consumption and, if individuals can decide whether or not to purchase the good
		- Public goods are goods that do not meet these criteria such as national defence because you cannot purchase it
	+ Not possible to exclude use by others (need to fund it through taxes to avoid free rider problem)
	+ Free rider problem where people try to benefit from the good without paying for them
	+ National defense, public parks, public infrastructure – these would not be supplied by a private a market
	+ The only way people can provide themselves with these goods is by paying taxes and providing them publicly for everyone
* Externalities
	+ Arise when the cost or benefit not fully incurred or enjoyed by the consumer or supplier of a good
	+ An externality is positive when a party benefits from the production or consumption of a good that they do not themselves produce or consume and negative where a party incurs a cost related to the production or consumption of a good that they do not themselves produce or consume
	+ Externalities create market failures because the cost incurred, or benefit realized by 3rd party is not accounted for in the price of the good or service. Governments attempt to internalize these externalities through tax expenditures or by imposing carbon taxes or excise taxes
		- Ie. Tax expenditures can be used to encourage the production of or subsidize the consumption of goods with positive externalities. Tax expenditures can also be used to subsidize producers in a way that causes them to internalize these externalities such as by investing in clean technology
		- Government may also impose excise taxes that can have the effect or curbing the production or consumption of a good that creates negative externalities such as tobacco or alcohol
	+ Negative externalities – the cost is not incurred by the supplier or consumer of the good, rather society as a whole incurs the cost
		- Issue is that there is no incentive to pay for this cost to society, so the government creates one through taxes
		- Pollution (negative externality)- Smoke from a local factory will impose medical, cleaning, and other costs on households that do not use the factory’s output. Government can regulate, imposes taxes, issue permits to deal with these.
	+ Positive externalities- the benefit is not enjoyed by the consumer or supplier of a good, rather society as a whole enjoys the benefit
		- The issue is that there is no incentive to provide this benefit for society, so the government creates one through the tax system
		- Education - There are social & private benefits to education and to ensure individuals consume the efficient amount of education, it might be subsidized
* Asymmetric Information
	+ Imperfect knowledge (e.g. securities regulation)
		- Markets can only operate effectively where both parties are fully informed and have access to relevant info
		- Without government intervention this would not be possible because often one party knows more about product or service than the other
		- One way to remedy this is for the government to mandate consumer & investor disclosure or product standards.
	+ Government pension plans provide much greater security than private pension plans and alleviate anxieties of choosing
* Cognitive Limitations
	+ People do not always act rationally
		- Ie. Many people do not make the rational decision to forgo consumption today to save for the future
	+ RRSPs, TFSAs
		- One justification for RRSP deduction is that is helps to overcome this cognitive limitation
* Incomplete Markets
	+ Failure of private markets to produce certain goods
		- In order for markets to allocate resources efficiently, there much be markets for everything for which consumers are prepared to pay a price that covers their production cost however sometimes, no market will emerge
	+ Moral hazard
		- I.e. it is unlikely a private market for employment insurance would develop since insurance companies would be concerned that the presence of insurance would cause more individuals to become unemployed
	+ Adverse selection
		- Insurance companies would be worried that only individuals likely to lose job would purchase insurance policy
	+ Employment insurance
		- The premiums are mandated and administered through the *Act.* Without a compulsory employment insurance regime, it is unlikely that private insurers would provide coverage. This is because the presence of insurance would cause more individuals to become unemployed. The problem of moral hazard and that only those likely to lose their jobs would purchase employment insurance (this is referred to as “**adverse selection”**)
* Morally Acceptable Distribution of Income
	+ Markets, even efficient ones, do not create an equitable distribution of income
	+ The view is that income taxation should be designed to redistribute wealth from those that have it to those that do not
* Economic Stabilization
	+ Smooth the business cycle
	+ Monetary policy; fiscal policy (i.e. gov’t will provide deductions in advance to businesses and puts $ in their hand that way)
	+ Government spending and Fiscal policy
		- 2008 financial crisis
		- COVID-19 pandemic
	+ CERB and many other financial supports are administered through the income tax system
* Economic Growth
	+ Current trend of lowering corporate tax rates internationally has largely been motivated by a belief that lowering these rates will help stimulate economic growth (if too high – businesses wont stay; will hinder foreign investment, etc.)

## Criteria for Evaluating Technical Tax Provisions

* There are two distinct types of tax provisions
	+ **Technical tax provisions:** establish and define the basic structural elements of the tax system
	+ **Tax expenditure provisions:** provide implicit subsidies to taxpayers to encourage certain types of activities or provide taxpayers with transfer payments
* Technical tax provisions are evaluated by the values of:
	+ Equity
	+ Neutrality
	+ Simplicity

### Equity

* Horizontal equity
	+ People in the same circumstances should be treated the same (i.e. pay the same taxes)
* Vertical equity
	+ Unequal’s should be treated appropriately differently, those who have ability to pay more should contribute more (ability/capacity to pay – how much is an “additional dollar” worth to a person with $10M vs. $30,000) (basis for progressive tax rate system)
* Most important criteria in evaluating the tax system
* In theory the most equitable or fair tax system is one that taxes people on their ability to pay. A taxpayer’s ability to pay is determined by their disposable income which is the income they have left over after covering the necessaries of life
* **Subsection 117(2)**
	+ The Tax payable under this Part by an individual on the individual’s taxable income or taxable income earned in Canada, as the case may be (in this subdivision referred to as the “amount taxable”) for a taxation year is:
		- (a) 15% of the amount taxable, if the amount taxable is equal to or less than the amount determined for the taxation year in respect of $45, 282;
		- (b) if the amount taxable is greater than $45, 282, but is equal to or less than $90, 563, the maximum amount determinable in respect of the taxation year under paragraph (a), plus 20.5% of the amount by which the amount taxable exceeds $45, 282 for the year;
		- (c) if the amount taxable is greater than $90, 563, but is equal to or less than $140, 388, the maximum amount determinable in respect of the taxation year under paragraph (b), plus 26% of the amount by which the amount taxable exceeds $90, 563 for the year;
		- (d) if the amount taxable is greater than $140, 388, but is equal to or less than $200, 000, the maximum amount determinable in respect of the taxation year under paragraph (c), plus 29% of the amount by which the amount taxable exceeds $140, 388 for the year;
		- (e) if the amount taxable is greater than $200, 000, the maximum amount determinable in respect of the taxation year under paragraph (d), plus 33% of the amount by which the amount taxable exceeds $200, 000 for the year

### Neutrality

* Individuals are the best judges of the benefits and costs to themselves with respect to the choices they make
* Taxes should therefore not distort the workings of the market or personal decisions
* The goal should therefore be to achieve the objectives of the tax system in a way that least alters personal choice
* Taxes should aim to effect individual choices as little as possible (i.e., dividend tac credit system – In Canada, corporations are allowed to pay in dividends so the tax is shared between the individual and the corporation rather than paying individual directly)

### Simplicity

* Does not mean that the rules in the *Income Tax Act* needs to be simple and easy to understand
* Instead, the concept of simplicity is used to convey a variety of desirable administrative attributes of a tax system,
	+ Comprehensibility – tax system should be understandable and consistently applied
		- Try to cover everything
	+ Certainty – the application of the rules should be determinable, predictable and relatively certain
		- Should be clear how the system works, applies and operates
	+ Compliance convenience – taxpayers should not be forced to devote undue time or cost in complying with tax system
	+ Administrative convenience – the cost of administering and enforcing the tax system should also be reasonable
		- Make it so people can do it, and the CRA can do it
	+ Difficult to avoid or evade – should not be difficult to avoid or evade offering minimal opportunity for non-compliance
		- It is easier to evade complex than simple rules. If people can evade them, it ruins everything and is very unfair
		- \*most tax rules are complex because neutrality and equity are often prioritized over simplicity

## Criteria for Evaluating Tax Expenditure Provisions

* Unlike technical tax provisions, tax expenditure provisions are evaluated through budgetary criteria applied to spending programs. This is because these provisions are analogous to spending programs. These provisions do not raise revenue and instead forgo revenue in pursuit of achieving the objectives of a policy
* The same goals can be achieved by the government taxing money as can be achieved by the government spending money
* Given that these objectives could also be achieved through direct spending by the government, it is necessary to evaluate them in the same way that other government spending programs are evaluated
* Therefore, when evaluating a tax expenditure provision, it is important to ask three questions:
	+ What is the government’s objective?
	+ To what extent is the objective achieved?
	+ Is there a better way to achieve the objective?
* Examples: RRSP (the deduction is a tax expenditure)
	+ Child Fitness Credit (the credit is an expenditure)

# Computing Tax Payable: An Overview

## Computing Tax Payable

* **Step 1:** Calculate income
	+ This is the taxpayers overall income
* **Step 2:** Calculate taxable income
	+ This is done by adjusting the taxpayer’s income by other amounts specified in the *Income Tax Act*
* **Step 3:** Calculate tax payable (based on taxable income)
	+ This is done by multiplying taxable income by the statutory tax rates
* **Step 4:** Deduct tax credits
	+ The initial amount of tax payable is reduced by the amount of any tax credits the taxpayer is eligible to claim
* **Step 1:** The starting point for computing income is s.3 of the *Income Tax Act*
	+ **Section 3 – Computation of Income**
		- The income of a taxpayer for a taxation year for the purpose of this Part is the taxpayer’s income for the year determined by the following rules:
1. Determine the total of all amounts each of which is the tax payers income for the year (other than a taxable capital gain from the disposition of a property) 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,
2. Determine the amount, if any, by which
3. The total of
4. All of the taxpayer’s taxable capital gains for the year from dispositions of property other than listed personal property, and
5. The taxpayer’s taxable net gain for the year from dispositions of listed personal property

Exceeds

1. The amount, if any, by which the taxpayer’s allowable capital losses for the year from dispositions of property other than listed personal property exceed the taxpayer’s allowable business investment losses for the year,
2. Determine the amount, if any, by which the total determined under paragraph (a) plus the amount determined under paragraph (b) exceeds the total of the deductions permitted by subdivision (e) in computing the taxpayer’s income for the year (except to the extent that those deductions, if any, have been taken into account in determining the total referred to in paragraph (a)); and
3. Determine the amount, if any, by which the amount determined under paragraph (c) exceeds the total of all amounts each of which is the taxpayer’s loss for the year from an office, employment, business or property or the taxpayer’s allowable business investment loss for the year,

And for the purposes of this Part

1. Where an amount is determined under paragraph (d) for the year in respect of the taxpayer, the taxpayer’s income for the year is the amount so determined, and
2. In any other case, the taxpayer shall be deemed to have income for the year in an amount equal to zero
* In accordance with Section 3(a) of the *Act,* you begin by determining the taxpayer’s income from all sources. The three principal sources of income included under section 3(a) are:
	+ Income from employment (subdivision a; sections 5 to 8)
	+ Income from business (subdivision b; sections 9 to 37)
	+ Income from property (subdivision b; sections 9 to 37)
* Next, you calculate the taxpayer’s net taxable capital gain – **paragraph 3(b)** (Subdivision c; 38 to 55)
	+ In accordance with paragraph 3(b), the taxpayer’s net taxable capital gain is the amount by which their taxable capital gains for the year exceeds their allowable capital losses for the year
	+ Also included in the calculation of net taxable capital gains is the taxpayer’s net gain from listed personal property – **clause 3(b)(i)(B)**
* The next step under paragraph 3(c) is to determine the amount, **if any**, by which the (**income + net taxable capital gain)** exceeds special deductions permitted in subdivision e (subdivision e; sections 60 to 66.8)
	+ Subdivision e deductions include certain general deductions that are not otherwise deductible in computing income from a specific source. These include deductions for:
		- Moving expenses
		- Childcare expenses
		- Spousal support payments
		- RRSP contributions
* Finally, in accordance with paragraph 3(d), you determine the amount, if any, by which the amount calculated under paragraph 3(c) **(income + net capital gain – special deductions)**  exceeds the tax payer’s current losses from employment, business or property in the current year
	+ Pursuant to paragraph 3(e), the amount determined under 3(d) is the taxpayer’s income for the year
	+ If no amount is determined under 3(d), the taxpayer’s income is deemed to be 0 in accordance with 3(f)
		- I.e. This is the case if taxpayer’s current losses for the year exceed amount computed under 3(c)
* **Step 2:** Once you have determined the taxpayer’s income for the year, you need to calculate taxable income.
	+ Subsection 2(2) states that the taxpayer’s taxable income for the year is the taxpayer’s income for the year plus the additions and minus the deductions permitted by Division C
	+ Division C – sections 109 to 114.2
		- Loss carryovers – section 111
			* These provisions permit a taxpayer to deduct a loss realized in one taxation year from the income realized in another taxation year
* **Step 3:** Once you have determined the taxpayer’s taxable income, you compute the initial **tax payable** by multiplying the taxpayers’ taxable income by the statutory rates
	+ The Canadian *Income Tax Act* uses a progressive rate structure meaning that the tax rate increases as taxable income increases. The taxpayer’s income is therefore taxed in different brackets. This means that as the taxpayer’s income increases, only the income that is subject to the higher bracket is subject to the higher tax rate
	+ The rate structure is set out in subsection 117(2) of the *Income Tax Act*
		- **Subsection 117(2) –** “The Tax payable under this Part by an individual on the individual’s taxable income… (in this subdivision referred to as the “amount taxable”) for a taxation year is
1. 15% of the amount taxable, if the amount taxable is equal to or less than the amount determined for the taxation year in respect of $45, 282;
2. If the amount taxable is greater than $45, 282, but is equal to or less than $90, 563, the maximum amount determinable in respect of the taxation year under paragraph (a), plus 20.5% of the amount by which the amount taxable exceeds $45, 282 for the year;
3. If the amount taxable is greater than $90, 563, but is equal to or less than $140, 388, the maximum amount determinable in respect of the taxation year under paragraph (b), plus 26% of the amount by which the amount taxable exceeds $90, 563 for the year;
4. If the amount taxable is greater than $140, 388, but is equal to or less than $200, 000, the maximum amount determinable in respect of the taxation year under paragraph (c), plus 29% of the amount by which the amount taxable exceeds $140, 388 for the year;
5. If the amount taxable is greater than $200, 000, the maximum amount determinable in respect of the taxation year under paragraph (d), plus 33% of the amount by which the amount taxable exceeds $200, 000 for the year;
* The tax brackets in subsection 117(2) are also indexed for inflation under section 117.1(1)
	+ This section provides for the annual indexing of certain amounts including the amounts under subsection 117(2) (after 2016)
	+ The indexing is designed to maintain the real value of the income tax thresholds over time
	+ The index tax brackets are reported on the Canada Revenue Agency’s website each year
* Federal Tax Brackets/Rates for 2020 computed in accordance with the indexing formula in subsection 117.1(1) are as follows:
	+ 15% on the first $48, 535 of taxable income
	+ 20.5% on the next $48,534 of taxable income (on the portion of taxable income over $48, 535 up to $97, 473)
	+ 26% on the next $53, 404 of taxable income (on the portion of taxable income over $97, 069 up to $150, 173)
	+ 29% on the next $63, 895 of taxable income (on the portion of taxable income over $150, 473 up to $214, 368)
	+ 33% of taxable income over $214, 368
* **Step 4:** Finally, to compute the final amount of tax payable you deduct any tax credits the taxpayer is eligible to claim
	+ After you determine the tax payable (what you owe) then you deduct tax credits
	+ There are numerous tax credits in the *Income Tax Act* including:
		- **Personal Credits (e.g. single and marital credits) –** **subsection 118(1)** – “For the purpose of computing the tax payable under this Part by an individual for a taxation year, there may be deducted an amount”
			* Everyone gets this one
		- **Charitable Gifts Credit -**  **section 118.1(3)** – “For the purpose of computing the tax payable under this Part by an individual for a taxation year, there may be deducted…”
		- **Tuition Credit** – **subsection 118.1(5)** - “For the purpose of computing the tax payable under this Part by an individual for a taxation year, there may be deducted…”
		- **Dividend Tax Credit** – **section 121** – “there may be deducted from the tax otherwise payable under this Part by an individual for a taxation year the total of …”
		- **Foreign Tax Credits**:
			* **Subsection 126(1)** – foreign non-business income tax
			* **Subsection 126(2)** – foreign business income tax

# The Source Concept of Income

## Legislative Framework

* Paragraph 3(a)
	+ 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:
1. Determine the total of all amounts each of which is the taxpayer’s income for the year (other than a taxable capital gain from the disposition of a property) **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**
	* + - * Courts in Canada have narrowly interpreted the scope of paragraph 3(a) and have generally refused to recognize other unenumerated sources. As a consequence, the sources of income included under this section have generally been limited to income from an office or employment, income from a business or income from property.
* The more detailed rules for calculating the income from each source are found in Part 1, Division B of the *Income Tax Act*
	+ Subdivision a – income from employment, ss. 5 – 8
		- S. 5 – sets out the general meaning of income or loss from an office or employment
		- S. 6 – deals with employment benefits
		- S. 8 – sets out the permitted deductions
	+ Subdivision b – income from property or business, ss. 9-37
		- S. 9 – sets out the general meaning of income or loss from a business or property
		- S. 12- lists specific inclusions for determining income from a business or property
		- S. 18 – outlines the general limitations on deductions
		- S. 20 – includes rules that permit the deductions of certain amounts that would otherwise be limited by section 18
	+ Subdivision d - other sources of income, ss. 56 to 59.1
		- Includes rules that require certain amounts to be included in computing income even though these amounts may not otherwise be considered income from a source under general principles
		- **Subsection 56(1)**
			* **Without restricting the generality of section 3,** there shall be included in computing the income of a taxpayer for a taxation year….
				+ retiring allowances, s. 56(1)(a)(ii)
				+ unemployment benefits, s. 56(1)(a)(iv)
				+ spousal support, s. 56(1)(b)
				+ payments from RRSPs and RRIFs, s. 56(1)(h)
				+ scholarships, fellowships, bursaries and prizes, s.56(1)(n)
				+ social assistance (welfare payments), s. 56(1)(u)
		- **Subsection 56(3)**
			* Effectively exempts from income the full amount of a scholarship, fellowship or bursary received by a student enrolled in an elementary, secondary or post-secondary institution

## What Is Income?

* The term “income” is not defined in the *ITA*
* The legislative scheme of the Act supports the conclusion that income is a net concept
	+ This means that income is generally defined as what you receive less what it costs you to earn it.
	+ This is consistent with the notion that taxes are levied according to an individual’s ability to pay
* Income can be defined as the aggregate of an individual’s consumption and the net increase (or decrease) in the individual’s wealth
	+ This is known as the Haig-Simons formulation of income: I= C + W (income = consumption + change in wealth)

## Role of the Courts in Defining Sources of Income

* Courts have played a critical role in determining what constitutes income from a source
* Courts distinguish between “income from a source” and “the source of the income”
	+ The fundamental distinction being between capital which is the source and income which is derived from the source
* *Eisner v Maccomber* (1919) 253 U.S. 189:
	+ “The fundamental relationship of “capital” to “income” has been much discussed by **economists the former being likened to the tree of the land, the latter to the fruit or the crop…”**
	+ The tree represents the capital and the fruit represents the income that is generated by the tree. You can pick the apples and sell them, but you can hold onto the tree to produce more applies – this is akin to capital gain
* The source concept of income arose in the UK when the economy was largely agricultural (hence the “tree and the fruit” analogy)
* This concept has also been influenced by the distinction between income and capital in trust law
* This differentiation between income and the source of the income creates a fundamental distinction between income and capital gains under the *Income Tax Act*
	+ Until 1972, capital gains were not subject to tax
	+ Today, capital gains are taxed preferentially **(i.e. only 50% of the gain is subject to tax)**
* An amount received by a taxpayer that has no recognized source (and is not proceeds from the disposition of a source) is generally not subject to tax. Where there is a windfall, “not income from a source”, it will not be subject to tax. These amounts include:
	+ Gift
	+ Inheritance
	+ Lottery prizes
	+ More receipts from gambling

#### Bellingham v. The Queen (FCA)

**Facts:** Taxpayer’s land was expropriated by the Town of Grand Centre in Alberta. The Alberta *Expropriation Act* included a provision which allowed the owner to dispute a price they were paid on the expropriation of their land. The statute granted authority to the Land Compensation Board to order an expropriating authority that has substantially undervalued the land to pay fair value, interest on the difference and quasi-punitive interest. Land Compensation Board determined that the amount paid by the town was considerably less than the fair value of the land. The Board awarded the taxpayer an amount equal to the fair value of the land (plus accrued interest), and a further amount of $114, 272 as “additional interest” under subsection 66(4) of the Alberta *Expropriation Act*, which was awarded because the amount of compensation originally paid by the town was considerably less than the value determined by the Land Compensation Board. The amount compensated for the land and the ordinary interest were both taxable and not at issue in this case.

**Issue:** Was the amount paid as additional interest income from a source within the meaning of paragraph 3(a)?

**Held:** The Federal Court of Appeal held that the amount was a tax-free windfall because it contained no compensatory element and was tantamount to a punitive damage award (punishing the land owner).

**Reasons:** Federal Court relies on *Cranswick* criteria and the *Surrogatum* principle

* Just because the statute called it “additional interest” does not make it interest. Interest is an amount paid to an individual for a debt owed. In this case, the payment was not made for that purpose
* **Where a payment is truly punitive and not intended to compensate, it will not be subject to tax**
	+ The payment was not intended to benefit the taxpayer, but rather penalize the government for inadequately valuating the land through their right to expropriate.
* Robertson J.A. at p. 6082:
	+ “In the case at hand, the source of the additional interest award is not the expropriating authority. That body is merely the payor. **The true source of the award is the *Expropriation Act*****which dictates as a matter of public policy, that expropriating authorities are obligated to pay a penal sum in circumstances where their behaviour falls below a prescribed standard. An award of additional interest under subsection 66(4) of the *Expropriation Act* is unrelated to the issue of fair compensation for expropriated lands.** That concern is dealt with fully under section 44 and subsection 66(2). In certain **respects, an award of additional interest possesses the attributes of a gift.** The taxpayer is the beneficiary, not of the expropriating authority’s largesse, but of the legislature’s desire to ensure that minimum standards of commercial behaviour are observed. The taxpayer’s gain is the expropriating authority’s loss. **The payment in question does not flow from either an express or implied agreement between the parties. There is no element of bargain or exchange. There is no consideration.** There is no quid pro quo, on the part of the taxpayer. **The payment is simply a windfall and, therefore, not income under paragraph 3(a) of the Act.”**

**Note:** Canadian courts have traditionally given a very narrow construction to paragraph 3(a).

**Ratio:** A windfall payment is not income for employment, business or property under section 3(a), and is not subject to tax. Where a payment is truly punitive and not intended to compensate, it is a windfall payment, and will not be subject to tax.

## The Cranswick Criteria

* List of factors that are indicative of whether a payment constitutes a windfall gain and is therefore not income from a source.
* A payment is more likely to constitute a windfall gain if:
	+ Does the taxpayer have an enforceable claim to the payment ? No 🡪 windfall
	+ Was there an organized effort on the part of the taxpayer to receive payment? No 🡪 windfall
	+ Was the payment sought after or solicited by the taxpayer in any manner? No 🡪 windfall
	+ Was the payment expected by the taxpayer, either specifically or customarily? No 🡪 windfall
	+ Does the payment have a foreseeable element of recurrence? No 🡪 windfall
	+ Was the payor a customary source of income to the taxpayer? No 🡪 windfall
	+ Was the payment in consideration for or in recognition of property, services or anything else provided or to be provided by the taxpayer? No 🡪 windfall
	+ Was the payment earned by the taxpayer, either as a result of any activity or pursuit of gain carried on by taxpayer or otherwise? No 🡪 windfall
* Criteria looked at holistically to determine whether amount should be treated as a windfall gain or as income from a source

## The “Surrogatum Principle”

* If someone pays you damages for loss of profit, you are not technically earning profit. So how should we treatment payment of damages for income tax purposes?
* Deals with characterization of an amount received by taxpayer in substitution for an amount that would have been income from a source
	+ I.e. taxpayer is wrongfully dismissed and receives damages, receive damages to compensate for lost profits under a contract breached, damages for personal injury where a portion are based on the loss of your opportunity to make income
* **Surrogatum Principle:** The tax treatment of a payment of damages or a settlement payment is the same as the tax treatment of whatever the payment is intended to replace
* Lord Diplock in *London and Thames Haven Oil Wharves, Ltd. V Attwooll, [*1967] 2 All E.R. 124 (C.A. (Civ. Div.)
	+ “Where, pursuant to a legal right, a trader receives from another person compensation for the trader’s failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits… the compensation is to be treated for income tax purposes in the same way as that sum of money would”
* Charron, J. in *Tsiaprailis v Canada,* 2005 DTC 5119 (SCC) at p. 5121:
	+ “The determinative questions are: (1) what was the payment intended to replace? And, if the answer to that question is sufficiently clear, (2) would the replaced amount have been taxable in the recipient’s hands?”

## Damages and Settlements

* Generally, compensation for loss of income is taxed as income
	+ Loss of profits (Parent Infringement), *Bourgault Industries Ltd. v. The Queen,* 2006 DTC 3420
	+ Early lease termination payment, *Spezzano* *et al. v. the Queen*, 2007 DTC 5580 (FCA)
	+ Disability insurance benefits, *Tsiaprailis v. Canada,* 2005 DTC 5119 (SCC)
* Compensation for a deductible capital expenditure may be taxed as income
	+ Reimbursement of legal fees are taxable, *Goff Construction Limited v The Queen*, 2008 (affirmed FCA, 2009 DTC 5061)
* Compensation for loss of or damage to capital property is a capital receipt and is taxed as proceeds from disposition of the property
	+ Lease termination payment, *The Queen v. Westfair Foods Limited¸* 91 DTC 5625 (FCA)
	+ Cancelation of dealer agreements, *Valley Equipment Limited v. The Queen*, 2006 DTC 3593 (TCC)
* Compensation for the loss of a business is treated as a capital receipt and may be taxable as eligible capital property
	+ *The Queen v Toronto Refiners and Smelters Limited*, 2003 (FCA)
	+ Payment for termination of non-compete agreements, *RCI Environment Inc v The Queen,* 2007 TCC
* Compensation that qualifies as special or general damages for personal injury or death is generally not taxable (this includes damages for personal injury or death where the compensation for the loss of future earning or the loss of earning capacity)
	+ Paragraph 2, Interpretation Bulletin IT-365R2: *Damages, Settlements and Similar Receipts*
		- **All amounts received by a taxpayer or the taxpayer’s dependent, that qualify as special or general damages for personal injury or death will be excluded from income** regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings of the taxpayer in respect of whom the damages were awarded. However, an amount which can reasonable be income from employment rather than an award of damages will not be excluded from income
* Compensation from punitive damages awarded 🡪 Windfall; not taxable (*Bellingham)*

#### Schwartz v. The Queen (SCC), 1996

**Significance:** This case provides an example of how Canadian courts approach issues of statutory interpretation when applying the rules in the *Income Tax Act*. It further illustrates the narrow and restrictive interpretation that Canadian courts have given to paragraph 3(a).

**Facts:** Taxpayer executed a written employment contract with new employer. Before taxpayer’s employment commences, prospective employer terminated the employment contract. Taxpayer accepted a payment of $360, 000 in settlement of his claim for breach of contract.

**Issues:** Was the lump sump payment taxable under paragraph 3(a) as income from a source? Alternatively, was it taxable under 56(1)(a)(ii)?

* One of the principal questions was whether the payment was to compensate for loss of employment. The answer was dependent on finding whether the taxpayer was in the service of his prospective employer prior to termination of his employment contract.

**Ratio:** Employment does not begin until the employee is obligated to provide services to the employer. The statutory interpretation of “employment” requires that a taxpayer be “in the service of” another person.

**Relevant Legislation**

* **Subsection 56(1)**
	+ Without restricting the generality of s. 3, there shall be included in computing the income of a taxpayer for a taxation year…
1. Any amount received by the taxpayer in the year as, on account or in lieu of payment of, or in satisfaction of,
2. A **retiring allowance…**
* **Subsection 248(1)**
	+ **“retiring allowance”** means an amount … received
1. on or after retirement of a taxpayer from an office/employment in recognition of the taxpayer’s long service, or
2. in respect of a **loss of** an office or **employment** of a taxpayer, whether or not received as, on account or in lieu of payment of, damages, or pursuant to an order or judgement of a competent tribunal,

by the taxpayer or, after taxpayer’s death, by a dependent or a relation of taxpayer or by the legal representative of the taxpayer,

* + **“employment”** means the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign) and “servant” or “employee” means a person holding such a position.

**Held: NOT TAXABLE**. The payment for termination of the employment contract is not a retiring allowance under s.56(1)(a)ii) and therefore, not income from a (other) source, because the taxpayer was never employed.

* In order for the $360, 000 to be taxable it had to have been granted in respect of the loss of employment where the taxpayer was in the service of some other person. Employment begins when the employee is under an obligation to provide services under the contract which is not necessarily the same moment that the contract is signed. Since Schwartz was not under any obligation to provide services to his employer, he was not employed and therefore the $360, 000 is not taxable as a retirement allowance

**Reasons:**

* Should the taxability be dealt with under section 56 or more generally under section 3(a)?
	+ La Forest, J. at p. 6117:
		- “…Parliament adopted a specific solution to a specific problem that resulted from a number of rulings by the courts respecting the taxability of payments similar to the one received by the appellant. Under these rulings, damages paid with respect to wrongful dismissal were not taxable as income from office or employment under s. 5(1); nor were they taxable as constituting retiring allowances. The Crown had at that point many options. The Minister could have argued that such damages were taxable as income from a source under the general provision in s. 3(a) of the Act. It could also have sought an amendment to the Act making such payments expressly taxable as income from office or employment. But neither of these courses was taken. Instead, the Act was amended twice so that such amounts could be taxable under s. 56 as income from “another” source. First, it was provided that termination payments were taxable. Then, the Act was amended to make such a payment taxable as constituting a retiring allowance. It is thus pursuant to these provisions that taxability should be assessed [under s. 56]. To do otherwise would defeat Parliament’s intention by approving an analytical approach inconsistent with basic principles of interpretation.”
			* Court here was saying the taxability of the payment must be assessed under s. 56 which then implies that La Forest was trying to say that the amount in question did not come within the scope of paragraph 3(a)
			* MacArthur thinks that the payment here was not a retiring allowance and therefore, it’s taxability should have been assessed under paragraph 3(a)
	+ In determining whether the lump sum payment should be included in income under section 56, La Forest focuses on the clear words of Parliament.
		- La Forest, J. at p. 6118:
			* “The key element in the words chosen by Parliament to deal with this situation is the definition of “employment” which is “the position of an individual in the service of some other person”. The statutory requirement that one must be “in the service” of another person to be characterized as an “employee” excludes, in my opinion, any notion of prospective employment when the phrase is given its ordinary meaning. An employee is “in the service” of their employer from the moment they are under an obligation to provide services under the terms of the contract. At the basis of every situation of employment is a contract of employment; however, employment does not necessarily begin from the moment the contract is entered into. Before having any obligation to provide services, one cannot be considered to be “in the service” of his or her employer or, more accurately, his or her future employer. Consequently, there cannot be any loss of a position that has yet to be held, under the definition of “retiring allowance” found in s. 248(1).
	+ What about subsection 6(3)(b)?
		- An Amount received by one person from another
1. During a period while the payee was in office of, or in the employment of, the payer, or,
2. On account, in lieu of payment or in satisfaction of an obligation arising out of an agreement made by the payer with the payee immediately prior to, during or immediately after a period that the payee was an office of, or in the employment of, the payer,

Shall be deemed, for the purposes of section 5, to be renumeration for the payee’s services rendered as an office or during the period of employment, unless it is established that, irrespective of when the agreement, if any under which the amount was received was made to the form or legal effect thereof, it cannot reasonably be regarded as having been received

1. As consideration or partial consideration for accepting the office or entering into the contract of employment,
2. As remuneration or partial renumeration for services as an office or under the contract of employment, or
3. In consideration or partial consideration for a covenant with reference to what the office or employee is, or is not, to do before or after the termination of the employment
	* + Inducement pays **🡪** amounts received by individual before they become employees
		+ The amount was received in satisfaction of an agreement. Was it received prior to employment?
			- S. 6(3) requires there to be an employee relationship at some point in time. In this case the SCC found that employment never existed, so you can’t even apply s.6(3). **NOT TAXABLE.**

## Losses

* A taxpayer may also realize losses in the year
	+ Current Income losses
		- Arise when a taxpayer receipts from a source of income are exceeded by the costs incurred to earn them
		- Losses from a source of income (e.g. employment, business or property)
		- Can be deducted against income earning the year from any other source or taxable capital gains
		- Losses must also be linked to a source of income from employment, business or property in order to be offset against income from any other source or taxable capital gains for the year
			* E.g. losses from business can offset income from employment
	+ Allowable capital losses
		- Normally arise when a taxpayer sells a capital property for an amount less than what they paid to acquire it
		- Defined in **para 38(b)** to be ½ of the taxpayer’s capital loss (defined in para 39(1)(b)) in the year from the disposition of the property
		- Only deductible against taxable capital gains realized in the year
		- Capital loss defined in s. 39(1)(b)
	+ Non-capital losses
		- The current income losses realized in a taxation year that cannot be used in that taxation year
		- This will be the case where the amount computed under 3(c) is less than the taxpayer’s current total losses deductible under paragraph 3(d)
	+ Net-capital losses
		- Arise when the allowable capital losses realized by a taxpayer exceed the taxpayer’s taxable capital gains

### Current Income Losses

* Paragraphs 3(c) and (d)
	+ (c) determine the amount, if any, by which the total determined under paragraph (a) (income) plus the amount determined under paragraph (b) (net taxable capital gains) exceeds the total of the deductions permitted by subdivision (e) in computing the taxpayer’s income for the year…, and
	+ (d) determine the amount, if any, by which the amount determined under paragraph (c) exceeds the total of all amounts each of which is the taxpayer’s **loss for the year from an office, employment, business or property…,”**
		- The amounts here are the taxpayer’s current income losses

## Loss Carryovers

### Non-Capital Losses

* Where the amount computed under paragraph 3(c) is less than the taxpayer’s total current losses deductible under 3(d), any unused losses become non-capital losses
* “non-capital loss” of a taxpayer for a taxation year is defined in subsection 111(8)
	+ INCOME LOSSES (business, property and employment)
	+ Includes the unused portion of an **allowable business investment loss** realized in a taxation year not more than 10 years ago (allowable business investment loss: specific type of loss that can occur when you sell or get rid of shares in a small business)
* Includes those losses from employment, business or property that were not deductible in a taxation year under paragraph 3(d)
* Deductible in computing taxable income
* Can be carried back 3 years or forward 20 years – **paragraph 111(1)(a)**
	+ Carrying a loss forward means that you can deduct the loss in a future taxation year
	+ Carrying the loss back requires the taxpayer to file an amended tax return or the previous taxation year and deduct the loss in that amended return
	+ Carry back example:
		- In each of 2010, 2011 and 2012, my business earns $10k. In each of those years, I had to pay tax on those earnings. In 2013, my business loses $30k. I can carry back this loss as far back as 3 years, which means I can cancel out my $30k of earnings for 2010-2012 and receive a tax refund for the taxes I had previously paid on those earnings
	+ Why forward 20 years? Public policy reason is that if a business cannot earn income in 20 years to offset historic losses, that business is unlikely to ever succeed and should reconsider continuing
* Can be deducted against income earned in the year from any other source or net taxable capital gains
	+ In this way, non-capital losses are not restricted
* Losses from older years must be used before non-capital losses from more recent years – paragraph 111(3)(b)

### Net Capital Losses

* What happens to a loss in the case where you only have your own business with no income from employment to offset it against? The loss from business falls into the pool of non-capital losses
* “net capital loss” of a taxpayer for a taxation year is defined in subsection 111(8)
	+ Include the unused portion of any **allowable business investment loss** realized in a taxation year more than 10 years ago
	+ E.g. losing money on the sale of a piece of property
* Can be carried back 3 years or **forward indefinitely – para 111(1)(c)**
	+ *Timing of capital gains depends on when you dispose of the property, government doesn’t want to impose artificial constraints requiring you to dispose of the property. Don’t want to trigger gains to simply get to use on-capital losses.*
	+ Carry back example:
		- In 2010, I have capital gains of $30k. In 2013, I have capital losses of $30k. I can carry that loss back through 2010 and receive a tax refund for the taxes I had previously paid on those capital gains
	+ Why forward indefinitely? Public policy reason is that the government does not want to incentivize people to sell assets simply to take advantage of some time period. Government wants people to continue holding these assets
		- E.g. I have a capital loss of $10k in 2000. If my time period for carrying forward a loss is 20 years, then by 2020, I will want to sell some assets to realize capital gains of $10l simple so I can apply my prior capital loss of $10k before it expires.
* Are only deductible against taxable capital gains – **s. 111(1.1) (have to have an amount in 3(d); from the same year)**
* Losses from older years must be used before net capital losses from more recent years – **para 111(3)(b)**

## Nexus Between a Taxpayer and a Source of Income

* Income tax should be assessed according to an individual’s “ability to pay”
* Therefore, individuals should be taxed only on that income from which they benefit or over which they have control
	+ Income from **employment** is taxable to the individual who receives it, which implies that it is the individual who earns the employment income that is taxable on it
	+ Income from a **business** is the profit therefrom, which implies it is the provider of the goods or services that is taxable on such profit
	+ Income from **property** is also the profit therefrom, which implies it is the owner of the property that is taxable on such profit
	+ A **capital gain** of a taxpayer is defined as the gain from the disposition of property, which implies that it is the owner of the property (I.e. the person who benefits from the gain) that is taxable on such gain
* However, there are ways we can manipulate who receives the benefit and who is taxed
	+ Dividend sprinkling
		- You can restructure a company in a way that allows you to spread dividend income across your family by making them SH (must be over 18)
			* E.g. I can payout company dividends to my children instead of myself. Since they make less income, the dividends they receive will be taxed at a lower rate than me. Although I have paid those dividends to my family and not myself, such funds are, in a practical sense, still under my control, yet I am not the one being taxed on them,
			* E.g. If I earn more income than my spouse, I can allocate some of my income to my spouse, so we can pay a lower tax rate on that amount
		- Under the *ITA*, this is allowed, but has become severely limited

#### Peter D Field v The Queen (TCC), 2001

**Facts:**  The taxpayer’s estranged wife fraudulently withdrew $10, 815 from the taxpayer’s RRSP for her personal benefit. On lawyer’s advice, the taxpayer did not attempt to recover the funds. Minister reassessed the taxpayer to include the amount in his income as a receipt from his RRSP.

**Issue:** Was the $10, 815 income of the taxpayer? Was it taxable under s.146(8)?

**Relevant Legislation:** Subsection 146(8) – “There shall be included in computing a taxpayer’s income for a taxation year the total of all amounts **received by the taxpayer** in the year as benefits out of or under registered retirement savings plans…”

**Held:** No. the taxpayer never “received” the $10, 815 as “benefits out of or under” an RRSP, within the meaning of subsection 146(8). When discussing nexus, the idea of use is very important. May have been legally entitled to it, but did not pursue that, and never received it.

**Reasons:** Court applied the ordinary meaning of the language used in subsection 146(8) concluding that taxpayer had not received that amount as a benefit from his RRSP. Court focused on the fact that the taxpayer’s wife was not authorized to withdraw the funds and that she forged the taxpayer’s signature on the withdrawal form. Given that the amount was never received by the taxpayer and was withdrawn without his consent, it could not be said to have been “received” by the taxpayer as a benefit from his RRSP

**Ratio:** An estranged wife that withdraws a payment from the taxpayer’s RRSP for her personal benefit is not a benefit received by the taxpayer and should not be a source of income taxed to the taxpayer.

#### Buckman v M.N.R. (TCC), 1991

**Facts:** Buckman, a lawyer, embezzled money from clients. Minister reassessed him and included in his income the value of these funds.

**Taxpayer’s Argument:** In appealing the reassessment, the taxpayer argued the embezzled funds could not be characterized as income from a source or best would be characterized as income from business. However, even if the funds did constitute income from business, they would not be taxable since the taxpayer did not have an absolute right to them. This is because the taxpayer’s clients retained the legal right to the embezzled funds and therefore the taxpayer’s right to use the funds was never absolute.

**Issue:** Were the embezzled funds income? Does a taxpayer who embezzles funds have sufficient control over the funds to justifiably be taxed?

* Also, does this type of activity count as a source of income?

**Held:** Yes. Appeal dismissed. Taxpayer appropriated the amounts for personal benefit. He never treated them as loans he intended to repay.

**Reasons:** The embezzled funds were income from a business. The fact that the taxpayer did not have a legal right to them not determinative.

**Ratio:** A taxpayer who has embezzled funds for his personal benefit exhibits control over such funds, so it is a source of income taxed to the taxpayer. 🡪 Embezzled funds (not legal control over it but appropriated for his personal benefit (never treated as loans, no intent to repay) 🡪 Yes; sufficient control over the $.

# Income Splitting

## What is Income Splitting?

* Involves the transfer of income from one person (high tax individual) to another person who is taxed at a lower marginal tax rate
	+ Transferee is usually someone in the same economic unit as the transferor such as family members, corporations controlled by family members, family trusts etc. (otherwise it would just be giving up income)
	+ Transferor gives up legal entitlement to the income but commonly still benefits from the use of the income
		- E.g. transferring income to a child to pay for expenses the parent would otherwise be responsible for (i.e. groceries, video games, sports team, etc.), or transferring to spouse
* If successful, the tax payable on the income is lower because the income is taxed at a lower marginal rate
* The *ITA* contains numerous anti-avoidance rules (commonly referred to as attribution rules) designed to minimize or eliminate income splitting behaviour
* However, the Act also permits certain types of income splitting
	+ I.e. a pensioner is permitted to split up to half of their pension income with a spouse or common law partner by filing a joint election under **section 60.03**
	+ Income splitting is also permissible though a spousal RRSP where an individual can contribute to the RRSP of their spouse or common law partner and take a deduction for that contribution
* There are four basic techniques that are commonly used to transfer income from one taxpayer to another
	+ Direction – this means directing that the income be paid to another taxpayer
		- Directing a payment to go to someone else directly. **56(2)** essentially precludes this from being effective.
	+ Assignment of a right to income
		- Assign a right to receive a stream of income to someone else
	+ Transfer of income earning property to the other taxpayer
		- Income from property is taxed in the hands of the owner of the property
		- Most attribution rules are designed to regulate this kind of behaviour
		- 56(4) deals with transferring
	+ Shifting income by using low or no-interest loans
		- This loan is then used to buy property. Essentially same situation as the previous

## Direction - Indirect Payments

* Can simply direct that the income be paid to someone else
	+ i.e. I ask my employer to write cheque for my income to my child instead of myself, so it can be taxed at a lower rate
* no longer possible because section 52(6) causes the directed payment to be included in the taxpayer’s taxable income
* **Subsection 56(2)**
	+ A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person… shall be included in computing the taxpayer’s income to the extent that it would be if the payment or transfer had been made to the taxpayer
		- ***Constructive receiving –*** where an amount would be paid to me and taxed in my hands and I transfer it to another individual to receive a benefit myself or to confer a benefit on them the amount will still be taxed in my hands instead of the ultimate receiver’s.
	+ **Here you divert the income itself**
	+ **\*\*Only applies where a taxpayer has directed the income to be received by the taxpayer is directed to another person**
	+ Says that even if transferring the money worked it will still be taxable against the person who transferred the amount so long as if that person had received that amount (and not transferred it) would have been taxed
	+ This section does not apply to dividend income since until a dividend is declared, the profits belong to the corporation as retained earnings and the taxpayer has no pre-existing entitlement to the amount of the dividend and cannot direct it’s payment to anyone else (*Neuman)*

#### Neuman v The Queen (SCC), 1998

**Facts:** Melville Neuman incorporated Melru Ventures Inc., in which he held one voting share. Distributions from Melru could be made selectively among the various classes of its shareholders. Neuman also owned 1, 285 shares in an operating company, Newmac Services (1973) Ltd. The Newmac shares were worth $120, 000. Neuman transferred his shares in Newmac to Melru in exchange for 1, 285 Class G shares in Melru (also worth approximately $120, 000). At the same time, 99 non-voting Class F shares of Melru were issued to Newman’s wife, Ruby, for $1 per share ($99 in total). Ruby was elected as the sole director of Melru. In 1982, Melru received $20, 000 in dividends on the Newmac shares. Ruby, as sole director, declared the payment of a dividend of $5, 000 on the Class G shares held by Neuman, and another dividend of $14, 800 on the Class F shares held by her. Ruby loaned $14, 800 she received as a dividend to Neuman. Ruby died in 1988. The loan had not been repaid. In reassessing Neuman, Minister applied subsection 56(2) to include in computing his income the dividend paid to Ruby.

**Issue:**  Did subsection 56(2) apply to the dividend paid to Ruby on the Class F shares?

**Held:** No, 56(2) did not apply.

* Neuman had no pre-existing entitlement to the amount of the dividend and could not direct its payment to Ruby. The corporation is making the decision to pay the dividend
* Does the language of subsection 56(2) require that the transferor have a “pre-existing” entitlement to the amount?
	+ There is no requirement that if dividend not paid to Ruby it would have gone to Melville. Is the SCC creating an extra requirement for the application?
* *This provision involves three parties – payor, payee and the substitute payee that direction is given to. In this scenario there is only the payor and the payee*
	+ *MacArthur- doesn’t think it makes sense unless you read in requirement of the right to the payment. Need that control to make the choice thus with the company it is the company’s choice. Melville has no say – also having Ruby as director means that he is even more removed.*

**Ratio:**  In order for income to be captured under 56(2), taxpayer must have been entitled to it in the first place. Keep this in mind for the spousal attribution rules and how the courts have treated it. Subsection 56(2) of the Act does not apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings. Four requirements in subsection 56(2):

1. The payment must be to a person other than the reassessed taxpayer;
2. The allocation must be at the direction or with the concurrence of the reassessed taxpayer;
3. The payment must be for the benefit of the reassessed taxpayer or for the benefit of another person whom the reassessed taxpayer wished to benefit; and
4. The payment would have been included in the reassessed taxpayers’ income if it had been received by him or her

**Reasons:** Neuman had no pre-existing entitlement to the amount of the dividend and could not direct its payment to Ruby.

**Question:** Does the language of subsection 56(2) require that the transferor have a “pre-existing” entitlement to the amount?

* The language of this subsection does not require this, but Court read one in
* Purpose of s. 56(2) is to prevent income splitting, more specifically, to prevent shifting of income from one taxpayer to another by directing an amount that would be income of the first taxpayer to be paid to another taxpayer. If this is the case, it should only apply where it would be income of the first taxpayer if the direction had not been made. But for the direction, the amount would have been income of the taxpayer. The problem is that this is not exactly what subsection 56(2) says. The section provides that the amount shall be included in the taxpayer’s income to the extent it would be if the payment had been paid to the taxpayer. This language has led some to believe that it is not a requirement that the payment would have been made to the taxpayer simply that if it had been made to the taxpayer, it would be treated as income. However, this interpretation would lead to absurd results.
* MacArthur believes court was correct to read in requirement that the transferor must have a “pre-existing” entitlement to amount
* The problem with reading in this requirement is that it renders the provision unnecessary because even without subsection 56(2), it is likely the taxpayer who directs a payment of income to another person would continue to be taxable on the amount. This is because of the doctrine of constructive receipt which provides that a person who does not take possession of an amount is still considered to have received it once they have an unrestricted right to it. As such, once they have a “pre-existing” entitlement to an amount, they also would have constructive receipt of that amount. If you direct payment of the amount to another person, it will still be treated as your income under the doctrine of constructive receipt and resort to subsection 56(2) is likely not necessary.

## Direction - Indirect Payments – Assignment of a Right to Income

* Assigns the right to receive income to another person
	+ E.g. I transfer the right to receive income from dividends paid on shares I own to my child, so it can be taxed at a lower rate
* No longer possible because section 56(4) causes any amount transferred to a party not at arm’s length under a right to receive the taxpayer’s income to be included in the taxpayer’s taxable income
* **Subsection 56(4)**
	+ Where a taxpayer has, at any time before the end of a taxation year, transferred or assigned to a person with whom the taxpayer was not dealing at arm’s length the right to an amount… that would, if the right had not been so transferred or assigned, be included in computing the taxpayer’s income for the taxation year, the part of the amount that relates to the period in the year throughout which the taxpayer is resident in Canada shall be included in computing the taxpayer’s income for the year unless the income is from property and the taxpayer has also transferred or assigned the property
		- This section does not apply if the taxpayer also transfers or assigns the right to the property that generates the income. This is because there are other rules that apply where this is the case
			* Ex: if your transfer the right to income of property then its taxed back to you but if entire right to property has also been transferred then not taxed back
		- It also does not apply if the taxpayer was not resident in Canada during period in which income was generated
		- Only applies where transfer or assignment is made to a person, not dealing at arm’s length with transferor/assignor
		- Assignment of a right to receive income without the transfer of the corresponding property. i.e. assign the interest from a bond to someone but keep the bond as your own property
		- **Not at arm’s length for exam purposes generally is limited to persons the taxpayer is related to… factual determination otherwise (e.g. business partners)**

#### Boutilier v The Queen (TCC), 2007

**Facts:** Taxpayer was a financial planner who worked as an independent contractor for a registered investment dealer. Taxpayer sold mutual funds in respect of which he was entitled to receive a commission and a trailer fee. The commission was received by the taxpayer. The trailer fee was paid overtime and was calculated as a percentage of the value of mutual fund units that were retained with the investment dealer and not redeemed by clients. These trailer fees were initially paid to the taxpayer directly. Eventually, the taxpayer incorporated a corporation. Shares of the corporation were held by the taxpayer and by a family trust the beneficiaries of which were the taxpayer’s family members. The taxpayer was the trustee of the trust, controlled the corporation and was the director and officer of the corporation. Following incorporation, the trailer fees were paid to the corporation and reported by the corporation for income tax purposes. The taxpayer continued to provide services to mutual fund clients (allegedly acting on behalf of the corporation) and continued to personally pay (and deduct for income tax purposes) all of the expenses incurred in connection with the provision of client services. The taxpayer received no renumeration from the corporation other than a bonus in 1 year which appeared to have been paid for the sole purpose of lowering corporation’s income to the small business limit. Minister reassessed taxpayer pursuant to 56(4) and included the trailer fees received by corporation in the taxpayer’s income.

**Issue:**  Did subsection 56(4) apply? (Income splitting 🡪 transferring)

**Held:** Yes 56(4) applies. The “beneficial entitlement test” was met because it was the taxpayer, not his corporation, who was beneficially entitled to trailer fees. He was transferring the right to income to corporation. He didn’t properly show he transferred to corporation the right to earn income (no real income earning activities from corporation) so it was merely the right to receive income and 56(4) applies.

**Reasons:** Campbell, J.

* “Although I believe, given the right set of circumstances, a company could be engaged in the active business of providing services to earn trailer fees, that is not the case here… The Appellant argued that the opportunity to earn trailer fees was transferred to the corporation and the Appellant’s role was to provide the necessary services on behalf of the Corporation. The Appellant’s argument therefore is that the Corporation was engaged in the business of providing services to earn the fees. The Transfer Agreement … references in the preamble only the transfer of the “trailer fees” to the Corporation… It is significant that the Transfer Agreement does not reference an “opportunity” to earn trailer fees, as the Appellant suggests, or list the services to be provided but simply references a transfer of the fees themselves. Based on my earlier conclusions, that the nature of trailer fees involves the provision of ongoing services, I believe it would be possible to transfer an opportunity to service clients and earn trailer fees, but that is not what happened here. **The language used in the Transfer Agreement clearly supports my finding that the Appellant transferred to the Corporation the right to receive trailer fee income from his personal investment business and not the opportunity to provide the services to earn these fees.”**
	+ Corporation did nothing to earn the fees. If you structured it better they could’ve been taxed in the hands of the corporation (i.e. as the right to earn the fees, initial sales done by the individual but the corporation would then earn the fees and then also hire him as an employee)

**Ratio:** Where a taxpayer transfers a right to receive money to non-arm’s length person, 56(4) may require taxpayer to include it in their income.

## Property Transfers And Income Attribution

* Using transfer and loans is the most common way to income split within a family (minors and spouses)
* These rules are unique in that they do not have a purpose test like most anti-avoidance principles
	+ It will not matter whether you were intending to split your income
* **Transfers or Loans to Minors – Subsection 74.1(2)**
	+ “If an individual has transferred or lent property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who was under 18 years of age… and who
1. Does not deal with the individual at arm’s length, or
2. Is the niece or nephew of the individual,

Any income or loss, as the case may be, of that person (minor) for a taxation year from the property or from property substituted for that property, that relates to the period in the taxation year throughout which the individual is resident in Canada, is deemed to be income or a loss, as the case may be, of the individual and not of that person unless that person has, before the end of the taxation year, attained the age of 18 years.”

* + - Captures cases where family members transfer property, directly or through trust to person under age of 18, it taxes any income or loss (from property or substituted property) back to transferor
		- **DOES NOT APPLY TO CAPITAL GAINS, applies to substituted property but not income on income**
	+ **251(1) – Arm’s Length**
		- For the purposes of this Act,
1. Related persons shall be deemed not to deal with each other at arm’s length;
2. A taxpayer and a personal trust are deemed not to deal with each other at arm’s length if the taxpayer, or any person not dealing at arm’s length with taxpayer, [is a beneficiary of the trust]; and
	1. For the purposes of this course, you can assume that where a taxpayer transfer property to a personal trust including when they settle the trust by transferring property to it, that the taxpayer and the personal trust do NOT deal with each other at arm’s length
3. In any other case, it is a question of fact whether persons not related to each other are, at a particular time, dealing with each other at arm’s length
	1. We wont be dealing with (c) in this course. If neither paragraph (a) nor (b) apply, we can assume that the persons deal at arm’s length
	* “**Related persons”** is defined in subsection 251(2) to include “individuals connected by blood relationship, marriage or common-law partnership or adoption”
	* Subsection 251(6) provides that for the purposes of the *Income Tax Act,* “persons are connected by
4. Blood relationship if one is the child or other descendant of the other or one is the brother or sister of the other;
* You are connected by blood to all your lineal ascendants and descendants (I.e. grandparents, great grandparents, parents, children, grandchildren and great grandchildren, brothers and sisters)
* Not connected by blood to a niece or nephew which is why 74.1(2) specifically refers to them
1. Marriage if one is married to the other or to a person who is so connected by blood relationship to the other;
* You are connected by marriage to your spouse and anyone your spouse is connected to by blood
* i.e. spouse’s parents, grandparents, brothers & sisters, kids, grandchildren etc.

(b.1) Common-law partnership if one is in a common-law partnership with the other or with a person who is connected by blood relationship to the other; and

1. Adoption if one has been adopted… as the child of the other or as the child of a person who is so connected by blood relationship (other than as a brother or sister) to the other.”
* The exclusion for brothers and sisters is necessary to deal with situations where your brother or sister adopts a child. Even though you are connected by blood to your brother or sister, you are not connected by blood relationship to your niece or nephew and are therefore not related to them
* Where your brother or sister adopts a child, they should be treated the same as a niece or nephew that is their biological child. As such, you are not connected by adoption to a person when they have been adopted by your brother or sister
	+ Section 252(1) – A child of a taxpayer includes…
		- (a) a person of whom the taxpayer is the legal parent
		- (b) a person who is wholly dependent on the taxpayer for support and of whom the taxpayer has, or immediately before the person attained the age of 19 years had, in law or in face, the custody and control
		- (c) a child of the taxpayer’s spouse or common law partner
		- (e) a spouse or common law partner of a child of the taxpayer
	+ Applies to direct or indirect transfers or loans including property transferred or loaned to a trust
	+ Income paid to a minor from a trust derived from transferred or lent property is attributed to the transferor – s. **74.3**
	+ Income received on a substituted property is also attributed (taxed back)
		- This catches scenarios where the recipient buys property from the proceeds of property transferred to them
	+ Income on income is not attributed
		- This section would not apply to income earned on reinvested income (I.e. Capital gains)
		- I.e. if property is transferred to a minor and that property earns $100 of income, that income will be attributed back to the transferor. Now assume, the minor invests the $100 and earns $10 of income on that investment in the next year, this $10 of income is not attributed back to the transferor. This is because the income was not earned on the transferred property or property subsisted for it, it was earned on the reinvested income

**Where it does not apply**

* Only applies when the transferor is resident in Canada during the period when the income or loss was realized
* Does not apply in the year the minor turns 18 years old
	+ I.e. if a minor received $100 of income from transferred property in February and turned 18 in November, the rule would not apply. This is the case even though the income was received when the minor was only 17 years old
* Does not apply in respect of a transfer of property for fair market value consideration, including indebtedness where interest is charged at prescribed rates and paid within 30 days following the end of the taxation year – **subsection 74.5(1)**
* Does not apply in respect of a loan where interest charged at prescribed rates and paid within 30 days following the end of the taxation year – **subsection 74.5(2)**
	+ The prescribed rate is determined quarterly and is based on a formula tied to the yield on the Government of Canada Three Month treasury bills
	+ The current prescribed rate for these purposes is set at 1% and is expected to remain low. Given this, there is some opportunity to income split using low interest loans
		- i.e. assume a high rate taxpayer could invest $100,000 and earn a return of 4%. If the taxpayer did this, the $4,000 of income earned on the investment would be taxable at a higher rate. Now assume the taxpayer lends the $100, 000 to a related minor or a trust for their benefit and charges interest of 1% on the loan. The $100,000 is again invested at 4% and generates $4, 000 of income. $1, 000 is paid to the taxpayer as interest and the remaining $3, 000 is distributed to the related minor and taxed at lower rates. As such, $3, 000 that would otherwise have been taxable at a high rate is now subject to very little, if any, tax in the hands of the related minor
* Only applies to attribute income or loss from property (i.e. not business or employment income) – *Nathan Robins v. MNR*
	+ E.g. If I give my daughter $100 to make a lemonade stand and she profits $200, this is income from a business, not property, so it does not get caught. The $200 in profit does not get attributed back to the transferor
* Does not apply to attribute capital gains or losses
	+ Capital gains are not income from property
	+ No second rule that attributes capital gains (Income on income is not attributable)
* **Sample Problem**
	+ On December 10, 2016, Bill gave his nephew Sam $5,000 for his 16th birthday. Sam used the $5, 000 to purchase government bonds. Sam received $250 interest on the bonds on June 1, 2018 and another $500 on June 1, 2019.
		- Who is taxable on the interest income?
			* The first step is to determine the relationship between the transferor and the transferee. Here, Same is Bill’s nephew. Subsection 74.1(2) specifically applies to the niece or nephew of the transferor. As such, subsection 74.1(2) will apply if Sam is under 18 years old.
				+ Since this was not a fair market value transfer, the exception in subsection 74.5(1) also does not apply
				+ In determining Sam’s age – Remember the problem states that Bill gave Sam the money for his 16th birthday. From this we can assume that Sam turned 16 in 2017. As such, subsection 74.1(2) is applicable.
			* The next question to ask is whether Sam received any income from the transferred property or property substituted for it
				+ Yes. The bond purchased by Sam is substituted property for the $5,000 and Sam received $250 of interest on June 1, 2018 and another $500 on June 1, 2019
			* Finally, you need to determine who is taxable on the income
				+ Remember 2 things: (1) Subsection 74.1(2) only applies to income earned in the period that Bill was resident in Canada. Since the problem does not state otherwise, we will assume Bill was resident in Canada; (2) Income for a particular year is only attributed to Bill if Sam has not turned 18 years of age before the end of that year. Sam turned 16 in 2017. This means that Sam will turn 17 in 2018 and 18 in 2019. As such, any income earned on the bond before 2019 will be attributed back to Bill. Any income earned during 2019 or after will be included in Sam’s income.
				+ Sam received $250 of interest income during 2018. This amount is attributed to Bill
				+ Sam received another $500 of interest income in 2019. This amount is included in Sam’s income.

This is even though Sam was only 17 when he received $500 on June 1, 2019

* + **Does 74.1(2) Apply**
1. Was it a direct transfer or through a trust? (of property or money)?
2. Is the recipient under 18 **for the entire tax year**?
3. It is a person at non-arm’s length (a close person), or a niece or nephew
	1. Para 251(1)(a) **related persons (also defined)** are deemed not to deal with each other at arm’s length, para 251(2): related persons 🡪 individuals connected by blood relationship, marriage or common-law partnership or adoption
	2. 251(6) persons are connected by (a) blood relation (b) marriage (b.1) common law (includes same sex) (c) adoption)
	3. 252(1) child of a taxpayer
	* What is taxed back into (attributed back) the hands of the transferor (note this only happens IF the transferee remains under 18 for the ENTIRE taxation year)
4. Any income/loss from that year from the property or substituted property (things bought with the money)
5. Income on income is not attributed back (so shares purchased with the after-tax dividend money)
* **Transfer or Loans to Spouses**
	+ **Rule:** If a taxpayer transfers or loans property, directly, indirectly, or by a trust, to a spouse, any income or loss from that property or property substituted is attributable to the transferor
	+ **Subsection 74.1.(1) Income**
		- Where an individual has transferred or lent property…, either directly or indirectly, by means of a trust or by any other means whatever to or for the benefit of a person who is the individual’s spouse or common-law partner or who has since become the individual’s spouse or common-law partner, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that related to the period in the year throughout which the individual is resident in Canada and that person is the individual’s spouse or common-law partner, shall be deemed to be income or a loss, as the case may be, of the individual for the year and not of that person
		- Does 74.1(1) Apply?
			* 1. Transfer directly or through trust
			* 2. To spouse or common law
				+ A. Spouse (not defined in the act)

Common law: s.. 248(1) cohabitate, congeal, (a) 1 year OR (b) if living with someone you have had a child with (even if for less than 1 year – you have a child you are CL) (includes same sex etc)

* + - What is taxed back to transferor (deemed as income of the transferor)
		- Any income or loss from that taxation year from property (money) or substituted property (things bought with money)
	+ **Subsection 74.2(1) – Capital Gains**
		- **Rule:**  If a taxpayer transfers or loans property, directly, indirectly, or by trust, to a spouse, any taxable capital gains that exceed the recipient’s allowable capital losses are attributable to the transferor
		- “Where an individual has lent or transferred property (in this section referred to as “lent or transferred property”), either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person (in this subsection referred to as the “recipient”) who is the individual’s spouse or common-law partner or who has since become the individual’s spouse or common-law partner, the following rules apply for the purposes of computing the income of the individual and the recipient for a taxation year:
1. The amount, if any, by which

(i) the total of the recipient’s taxable capital gains for the year from dispositions of [lent or transferred] property…

 Exceeds

(ii) the total of the recipient’s allowable capital losses for the year from disposition … of [lent or transferred] property

1. The amount, if any, by which the total determined under subparagraph (a)(ii) exceeds the total determined under subparagraph (a)(i) shall be deemed to be an allowable capital loss of the individual for the year from the disposition of property…;
	* + A taxable capital gain refers to the taxable portion of a capital gain which is one half of a capital gain
			- A taxpayer realizes a capital gain when they sell capital property for more than they paid to acquire it
		+ An allowable capital loss refers to deductible portion of a capital loss which is one half of the deductible loss
			- Capital loss is realized when they sell capital property for less than what they paid to acquire it
		+ KEEP IN MIND THAT THERE WILL BE NO CONSEQUENCE ON FIRST TRANSFER IF SPOUSE (IF ROLLOVER)
			- **Under s. 74.2, if an individual transfers or loans a property to a spouse, and the spouse subsequently sells that property to a third party, resulting capital gain or capital loss is that of the individual not his or her spouse**
		+ E.g. If I transfer to my spouse shares in a company, and he sells those shares and makes capital gains, the amount of capital gains that exceeds his allowable capital losses will be attributable to me
		+ Attributed amount is calculated on an aggregate basis
			- Basically, all of the capital gains and losses up until the recipient’s allowable capital losses are attributable
			- But any capital losses will offset capital gains
* **Subsection 248(1)**
	+ **“Common law partner”,** with respect to a taxpayer at any time, means a person who cohabits at that time in a conjugal relationship with the taxpayer and
1. Has so cohabitated with the taxpayer for a continuous period of at least one year, or
2. Would be the parent of a child of whom the taxpayer is a parent, if this Act were read without reference to paragraphs 252(1)(c) and (e) and subparagraph 252(2)(a)(iii)

And for the purposes of this definition, where at any time the taxpayer and the person cohabit in a conjugal relationship, they are, at any particular time after that time, deemed to be cohabitating in a conjugal relationship unless they were not cohabitating at the particular time for a period at least 90 days that includes the particular time because of a breakdown of their conjugal relationship;

* + - In general terms, cohabitation means living together in a single dwelling and a conjugal relationship is one of sub-permanence where individuals are interdependent financially, socially, emotionally, and physically and have made a commitment to one another
* The language in 74.1 and 74.2(1) is very broad
	+ Both provisions apply to direct or indirect transfers or loans including property transferred or loaned to a trust where the spouse or common law partner is the beneficiary of the trust
	+ Income (or taxable capital gains) paid to a spouse or common-law partner from a trust which is derived from (or from the disposition of) transferred or lent property is also attributed to the transferor
	+ Income or loss realized on substituted property or taxable capital gain or allowable capital loss realized on the disposition of substituted property is also attributed
	+ Income on income is not attributed
	+ Neither provision applies in respect of a transfer of property for fair market value consideration, including indebtedness where interest is charged at prescribed rates and paid within 30 days following the end of the taxation year, provided the transferor elected out of the spousal rollover in subsection 73(1) – **subsection 74.5(1)**
		- In the case of a transfer of property to a spouse or common law partner, it is necessary for the transferor to elect out of the spousal rollover in subsection 73(1) for this exception to apply
		- The spousal rollover would allow a spouse to defer gains that would otherwise be realized on the transfer of capital property to their spouse or common law partner
	+ Neither provision applies in respect of a loan where interest is charged at prescribed rates and paid within 30 days following the end of the taxation year – **subsection 74.5(2)**
	+ Neither provision applies if the person ceases to be the transferor’s spouse or common law partner
	+ Neither provision applies during any period the transferor and their spouse or common-law partner are living separate and apart due to a break down of the marriage or common-law partnership – **subsection 74.5(3)**
		- **Note:** In the case of subsection 74.2(1), the transferor and their spouse or common-law partners must jointly elect for attribution to not apply
		- **S. 74.5(3) – test for ceasing a common law partnership:**
			* No longer cohabitating for at least 90 days because of a breakdown of their conjugal relationship = no longer common law partner
			* E.g. if you moved out 90 days ago to take a job in a different city, you are still in common law partnership because the reason for your move-out was because of a job, not a breakdown in relationship
	+ The provisions only apply when the transferor is resident in Canada
	+ 74.1(1) only applies to attribute income from property (I.e. not business or employment income) - *Nathan Robins v MNR*
	+ Income or capital gains paid to a spouse/common law partner from a trust which is derived from (or from the disposition of) transferred or lent property is also attributed to transferor (**s. 74.3)**

**Not Attributable from spouse:**

* Income from a transferor who is not resident in Canada is not attributable – same as minors.
* Income from employment or business is not attributable (*Nathan Robins v MNR*) – same as minors.
* Income on income is not attributable – same as minors.
* FMV loans are not attributable.
	+ A loan where interest is charged at prescribed rates and paid within 30 days following the end of the taxation year (s.74.5(2))
	+ Provided the transferor elected out of the spousal rollover in section 73(1)…
		- A transfer of property for FMV consideration, including indebtedness where interest is charged at prescribed rates and paid within 30 days following the end of the taxation year (s. 74.5(1))
	+ This includes debt
	+ There are limitations on interest 🡪 “prescribed rate” or higher paid within 30 days following the tax year
	+ If you meet this, the loan is qualifying and will be attributed to the spouse.
	+ Essentially carves out situations where the spouse has bought property from you and this is clearly not a loan for the purposes of income splitting.
* If the spouse/common law partner is living separate and apart due to a breakdown of the marriage or common law partnership (s. 74.5(3)).
	+ In the case of capital gains, in order for attribution to not apply, the spouses must jointly elect and agree that capital gain attribution does not apply.
* **Sample Problem:**
	+ On January 10, 2019, Peter transferred $10, 000 to his boyfriend, John. Peter and John have been living together for the last 18 months and plan to get married next year. John used the $10, 000 to buy shares of Royal Bank. On November 18, 2019, John received $500 of dividends on the Royal Bank shares. On December 15, 2019, John sold the Royal Bank shares for $12, 000 and used the $12, 000 to purchase shares of TD Bank. On June 12, 2020 John received $600 of dividends on the TD Bank shares
		- Who is taxable on the dividend income and taxable capital gains?
			* First step is to determine the relationship between the transferor and the transferee.
				+ Peter and John are common law partners. We can assume they are in a conjugal relationship and have been living together for the last 18 months. Therefore, subsection (a) of the definition of common law partner under 248(1) is satisfied. As such, subsection 74.1(1) and subsection 74.2(1) are applicable
				+ Since this was not a fair market value transfer, the exception in 74.5(1) does not apply
			* The next question to ask is whether John realized any income or capital gain from the transferred property or property substituted for it
				+ The answer is yes. The Royal Bank shares purchased by John are substituted property and John received $500 of dividends on the shares.
				+ John also realized a capital gain on the disposition of the Royal Bank shares. This is because John purchased the shares for $10, 000 and sold them for $12, 000. The difference, $2, 000, is John’s capital gain. Half of this amount, or $1, 000, is John’s taxable capital gain.
				+ John also received $600 of dividends on the TD Shares. The TD shares are substituted property because they were bought with the $12, 000 received by John on the sale of the Royal Bank shares. All the TD shares are considered substituted property, not just the $10, 000 of TD shares that is equivalent in value to the $10, 000 originally received from Peter. This is because the $12, 000 received by John in exchange for the Royal Bank shares is property substituted for the Royal Bank shares. When the $12, 000 is used to purchase TD shares, the TD shares become property substituted for the $12, 000. This is different than the $500 of dividends received on the Royal Bank shares. The $500 dividend is not a substitute for the Royal Bank shares which John still owned after he received the dividend, it is something now owned by John in addition to the Royal Bank shares.
			* Finally, we need to determine who is taxable on the amount of income
				+ Need to remember two things: (1) subsection 74.1(1) and 74.2(1) only apply during the period Peter was resident in Canada. Since the problem does not state otherwise, we will assume Peter is resident in Canada; (2) Subsection 74.1(1) and 74.2(1) do not apply if Peter and John are no longer common law partners and pursuant to subsection 74.5(3), may not apply where Peter and John are living apart due to a breakdown in their relationship. Since this is not the case, subsection 74.1(1) and 74.2(1) will apply.
				+ The $500 dividend received on the Royal Bank shares, the $1, 000 capital gain realized on the disposition of the Royal Bank shares and the $600 dividend received on the TD shares are all attributed to Peter
			* Why the $600 John received from dividends on TD is taxed – it comes down to why is income on income not taxed. The TD shares were substituted for the $12, 000 in cash which was a substitute for the Royal Bank Shares which was substituted for the $10, 000 given. Therefore, the TD bank shares are substituted for the original $10, 000 given.
			* If John was reinvesting dividends or interest then that is reinvested income and income on income is not taxed but if what you are investing is the proceeds of property then that is substituted property and would be taxed
* **Back-to-Back Loans and Transfers- Subsection 74.5(6)**
	+ The attribution rules apply in respect of a loan or transfer of property from a third party to an individual’s spouse or common-law partner or to a related minor (or niece or nephew), where the individual has made a loan or transferred property to any person on condition that the third party make a loan or transfer property to the individual’s spouse or common-law partner or a related minor (or niece or nephew)
		- E.g. A loans money to B. B loans money to A’s child
* **Guarantees- Subsection 74.5(7)**
	+ The attribution rules apply in respect of loans from third parties where the individual guarantees a loan made to his or her spouse or common-law partner or to a non-arm’s length minor (or niece or nephew)
	+ E.g. your neighbor loans your child $100, which you guarantee. Income made on that loan is attributed back to you
* **Tax Motivated Loans – Subsection 56(4.1)**
	+ Attributes income earned on property loaned (or acquired with property loaned) from one individual to another non-arm’s length individual where it can reasonably be considered that one of the main reasons for making the loan was to reduce or avoid tax by shifting income from the lender to the borrower
		- Not confined to minor children. Difficult for government to prove this rule (e.g. you give to adult child)
		- Applies where a taxpayer makes a loan to another individual. The other individual does not deal with the taxpayer at arm’s length and one of the main reasons for making the loan was to reduce or avoid tax by shifting income from the taxpayer to the other individual
		- Where this section applies, the income realized for the property loaned or acquired with the loan is attributed back to the taxpayer
		- There are three important differences between tax motivated loans and the other attributions outlined above:
			* (1) It only applies to a loan
			* (2) It is not restricted to minors or spouses and applies to any arm’s length individual
			* (3) The loan must be made for the purpose of reducing or avoiding tax. In the other rules, the tax motivation is presumed, but in the case of 56(4.1), it must be proven
* **Revocable Trusts – Subsection 75(2)**
	+ The idea here is you transfer money into a trust to avoid paying tax, but the terms of the trust allow that income to be transferred back to you
	+ Attributed income (or loss) and capitals gains (or losses) realized on property transferred to a trust by a person resident in Canada on condition that the property (or property substituted for it)
		- May revert back to the person
		- May pass to persons to be determined by the person at a time after the creation of the trust; or
		- During the existence of the person, the property shall not be disposed of except with the person’s consent or in accordance with the person’s direction
	+ Thus have it so that you are 1 of 3 (cant have 2) trustees where there is a vote by majority to determine who benefits from the trust because then you are considered to NOT have a revocable trust
	+ **To avoid this rule, DO NOT be a beneficiary of the trust, ensure if you are a trustee there are at least 3 of you, and your consent is not required for distribution**
	+ Where this section applies, any income, loss, capital gain or capital loss realized on the transferred property or substituted property is attributed back to the transferor
	+ Does not apply where the transfer results from
		- A genuine sale to a trust – *Sommerer v. The Queen,* 2012 FCA 207
		- A *bona fide* loan to a trust – *Howsom v. The Queen,*  2006 TCC 644
	+ If the transferor is a beneficiary of the trust, 75(2) will likely apply since as a beneficiary, the property could be transferred back (i.e. revert) to the taxpayer
		- For the purposes of this course, we can assume that all beneficiaries of a trust are capital beneficiaries
	+ If the transferor is the sole trustee of the trust, 75(2) will likely apply since as sole trustee the transferor will have power to:
		- Determine who property is transferred to after the creation of the trust; or
		- Control the disposition of property
	+ As such, where the transferor is a trustee it is prudent for him or her to be one of three trustees and to provide that the trustee act by majority decision

## Other Attribution Rules - \*Not on Exam!\*

* Corporate Attribution – **section 74.4**
* Tax on Split Income (“TOSI”) – **section 120.4**
* These rules were primarily enacted to limit or prevent income splitting using private corporations

### Corporate Attribution

* **Section 74.4**
	+ Applies where an individual resident in Canada transfers or lends property to a corporation
	+ One of the main purposes of the transfer or loan may reasonably be to reduce the income of the individual and to benefit a “designated person”:
		- The individual’s spouse or common-law partner
		- A minor who does not deal at arm’s length with the individual
		- A minor who is the niece or nephew of the individual
	+ The benefited individual owns 10% of any class of shares of the corporation or a related corporation
	+ Although it is commonly referred to as corporation attribution, section 74.4. does not operated to attribute income
	+ Where applicable, it deems the transferor to have received phantom income equal to an amount computed at a prescribed rate on the value of the “outstanding amount” of the loan or transferred property
	+ The phantom income is reduced by the amount included in the transferor’s income in respect of actual interest or dividends received in the year on the loan or any shares or debt (“excluded consideration”) issued by the corporation in exchange for the transferred property
		- It is phantom income because unlike the other attribution rules which generally operate to deem income actually received by a transferee to be income of the transferor, the income created by section 74.4 would not have otherwise existed but for the application of the section
	+ In very general terms, the “outstanding amount” is equal to:
		- In the case of a transfer of property, the amount by which the FMV (“fair market value”) of the transferred property exceeds
			* **Note:**  We will always be told what the FMV is, we won’t have to determine it
			* The consideration (other than “excluded consideration”, i.e. shares or debts) paid by the corporation for the transferred property; and
			* Any consideration paid by the corporation (or a person who deals at arm’s length with the transferor) in exchange for excluded consideration
		- In the case of a loan of money or property, the unpaid portion of the loan
	+ Section 74.4 does not provide any other offsetting deduction for phantom income and therefore often results in double taxation
	+ It applies to direct or indirect transfers
	+ It does not apply id the corporation is a “small business corporation”.
		- Specifically defined in the *Income Tax Act* but generally refers to a private corporation that is controlled by Canadian shareholders and that devotes substantially all of it’s property to carrying on an active business

### Tax on Split Income (“TOSI”)

* **Section 120.4**
	+ Imposes tax at the heist marginal rate on certain types of income (“split income”) derived directly or indirectly from a related business including
		- Dividends on private company shares
		- Interest paid on debt of private companies
		- Shareholder benefits
		- Income from certain trusts or partnerships
		- Taxable capital gains from the disposition of shares or debt of a private company or an interest in a trust or partnership
	+ The rules are highly complex and include many technical rules and exceptions

## What is a Transfer?

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

**Facts:** Two brothers, Barry and Brian Romkey, controlled a corporation through voting Class A preferred shares. They caused non-voting Class B common shares to be issued to trusts for the benefits of their minor children. The corporation paid dividends on these Class B shares. At the time they were issued the trusts did not pay for the shares. At the time of transfer, the corporation had not commenced activity and had no real assets. The evidence given by the brothers in support of the fact that FMV consideration was paid for the shares and that the source of the consideration was family allowance payments was rejected by the Tax Court. Minister assessed the brothers under 74.1(2) to include in their income the value of the dividends paid to the trusts. Minister argued that by causing the shares to be issued to trusts, the brothers affected an indirect transfer of property to children and divested themselves of the right to receive a measure of future dividends.

**Issue:** Did the issuance of Class B shares to the trust constitute an indirect transfer of property within the meaning of subsection 74.1(2)?

**Held:** Yes. Taxpayer’s appeal was dismissed.

**Reasons:** The decision of the Tax Court of Canada was based on *The Queen v. Kieboom*, 92 DTC 6382 (FCA). In *Kieboom* the taxpayer allowed his spouse to acquire non-voting common shares in a corporation for nominal (i.e. less than FMV) consideration. Since fair value had not been paid for the shares, it was concluded that an indirect transfer had occurred. The decision created some confusion since it implied that 74.1(2) could apply in this type of situation even where fair value consideration was paid for the shares.

**Note:** While this decision seemed to be in line with *Kieboom,* it also suggested that 74.1(2) could apply even where fair value consideration was paid for the shares. This was a serious concern for tax planners since the success of a common estate planning technique (known as an “estate freeze) was dependent on their not being a transfer where fair market value is paid for the shares.

* Canada Revenue Agency issued a document in response to these concerns: CRA Document No. 2001-0072705, May 8, 2001
	+ “It is our view that subsection 74.1(2) will generally not apply to attribute, to a freezer, dividends paid on shares held by a trust for minor children as part of a typical estate freeze, provided that the shares held by the trust are issued for an amount equal to their fair market value and are paid for with funds that are not obtained from the freezor.”
	+ MacArthur thinks this is the correct interpretation since it is consistent with the scheme of the *Act* which provides an exception for fair market value transfers in subsection 74.5(1)

**Note:**  Subsection 74.5(1) – exception for fair market value transfers

# Capital Gains

## Capital vs. Income

* Capital and income are mutually exclusive
	+ Where something is taxed as income, it cannot be taxed as a capital gain and vice versa
	+ A disposition of property is either income from business/employment or a capital gain, but never both
* *Eisener v Macomber:* “The fundamental relation of ‘capital’ to ‘income’ has been much discussed by economists the former being likened to the tree of the land, the latter to the fruit or the crop…”
	+ Fruit keeps replenishing but if you cut down the tree to sell the wood that is it (like a capital disposition)
	+ We didn’t pay tax on CGs till 1972, now are taxed preferentially (50%)
* The *Income Tax Act* distinguishes between income from a source and capital gains
	+ This distinction is reflected in section 3 which distinguishes between the taxpayer’s income from a source in paragraph 3(a) and the taxpayer’s net taxable capital gains in paragraph 3(b)
	+ The distinction is also reflected in subsection 9(3)
	+ The distinction is important because only 50% of a capital gain is subject to tax. Where a taxpayer realizes a gain on the disposition of property, it is therefore necessary to determine if the gain is income from a source or a capital gain. If the gain is income from a source, it is fully included in computing the taxpayer’s income. If the gain is characterized as a capital gain, only 50% of the capital gain is included in income and subject to tax
* **Section 3 – Computation of Income:**
	+ 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:
1. determine the total of all amounts each of which is the taxpayer’s **income for the year (other than a taxable capital gain from the disposition of a property) 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,
2. determine the amount, if any, by which

(i) the total of

1. all of the **taxpayer’s taxable capital gains** for the year from dispositions of property other than listed personal property, and
2. the taxpayer’s taxable net fain for the year from dispositions of listed personal property,

exceeds

(ii) … the taxpayer’s **allowable capital losses** for the year from dispositions of property other than listed personal property….,

* **Subsection 9(3)**
	+ In this Act, “income from a property” does not include any capital gain from the disposition of that property and “loss from a property” does not include any capital loss from the disposition of that property
* How to determine if a gain realized in the disposition of property is income from a source or a capital gain? The starting point is 39(1)(a)
	+ **Subsection 39(1)**
		- For the purposes of this Act,
1. … a taxpayer’s capital gain for a taxation year from the disposition of any property is the taxpayer’s gain for the year … (to the extent of the amount thereof that would not [otherwise] be included in computing the taxpayer’s income for the year or any other taxation year) from the disposition of any property… other than…
* This provision means that a taxpayer’s capital gain from the disposition of property is the amount of the taxpayer’s gain provided that the gain has not already been considered in computing the taxpayer’s income. As such, a gain realized in the disposition of property is a capital gain unless the gain is already included in computing the taxpayer’s income under a specific provision under section 56 or more generally as income from a source pursuant to paragraph 3(a)
* When is a gain realized by a taxpayer on the disposition of property included in computing the taxpayer’s income under 3(a)?
	+ Paragraph 3(a) specifically lists business as one of the enumerated sources of income and many businesses generate income by selling property. A taxpayer’s income from a business is the taxpayer’s profit from that business. In basic terms, profit is the amount by which the receipts from a business (revenue) exceed the expenses paid by the taxpayer to earn those receipts
		- I.e. Assume a taxpayer owns a car dealership and earns money from the sale of cars. These cars are considered inventory of the taxpayer’s business. When the cars are sold, they generate profit which is included when computing the taxpayer’s income pursuant to paragraph 3(a). As such, where a taxpayer sells a property in the course of carrying on a business, the gain or profit realized on the disposition of that property is included in the taxpayer’s income under 3(a) and is therefore NOT a capital gain of the taxpayer within the meaning of 39(1)(a)
* But what if a taxpayer is not carrying on a business?
	+ When a taxpayer who is not carrying on a business realizes a gain on the disposition of property is it always a capital gain?
		- No, this is because there is a further distinction between a taxpayer who is carrying on a trade or a business and a taxpayer engaged in an adventure or concern in the nature of trade

### Characterization of a Transaction as an Adventure or Concern in the Nature of Trade

* + Where a taxpayer habitually does a thing that can produce a profit, such taxpayer is carrying on a trade or business, even if the activities are separate and apart from the taxpayer’s ordinary occupation
	+ If the profit generating activities are done only infrequently (or even once) the taxpayer may still be engaged in a business transaction if it is found that the taxpayer is engaged in “an adventure or concern in the nature of trade” and is therefore engaged in a “business” as defined in subsection 248(1) of the *Income Tax Act*
		- This is because the definition of business in subsection 248(1) includes an adventure or concern in the nature of trade. As such, if a taxpayer is engaged in an adventure or concern in the nature of trade in relation to the disposition of a property any gain realized on the disposition of that property will be characterized as income from a business and not a capital gain
		- **Subsection 248(1)**
			* “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”
	+ Whether a taxpayer is engaged in an adventure or concern in the nature of trade depends on the facts and circumstances. In making this determination, the courts have generally looked at three principled criteria, known as the **Facts and Circumstances Test (can be used for one-off transactions) (are they selling inventory or income producing property)**
		- Conduct of the Taxpayer
			* Does the taxpayer conduct themselves in relation to the property in a way that a trader or dealer would?
				+ Did the taxpayer actively seek out potential buyers?
				+ Was the property bought and sold within a short period of time?
				+ Did the taxpayer make improvements to the property?
				+ Does the taxpayer possess specialized knowledge?
		- Nature of the Property
			* Is the property held by the taxpayer for personal use and enjoyment?
				+ Where it is, the disposition is less likely to be characterized as an adventure or concern in the nature of trade
				+ Where it is not, and is only capable of producing income from it’s sale, it is more likely that a disposition of the property will be characterized as an adventure or concern in the nature of trade
			* Is the property capable of producing income from ownership or only on disposition?
				+ When the taxpayer can earn income from the ownership of the property, it is more likely that the property is an investment or source of income, the disposition of which generally gives rise to a capital gain
				+ The disposition of certain types of property are more likely to raise characterization issues

Shares

Commodities

Vacant land

* + - * *Irrigation Industries Limited v MNR*, [1962] SCR 346 – **disposition of shares**
				+ **Facts:** Taxpayer purchased 4, 000 shares of a mining company using borrowed money. Taxpayer did not hold the shares long before selling them at a gain. Minister reassessed the taxpayer on the basis that the disposition of the shares was an adventure in the nature of trade and therefore, subject to tax.
				+ **Held:** Disposition of shares was not an adventure in the nature of trade. It was not part of his regular business and he was not expected to hold the shares indefinitely
				+ **Reasons:** Two questions were considered: (1) Whether the taxpayer had dealt with the property in the same way as a trader or dealer would have and (2) whether the nature and quantity of the property would exclude the possibility that it’s sale was the realization of an investment and therefore of a capital nature. Both questions were answered in the negative. For the first question, the court noted that the activities undertaken by the taxpayer was not the sort of trading that would be undertaken ordinarily by those engaged in the business of trading. In the court’s view, what the taxpayer had done was acquire a capital interest in a new corporate business venture in a manner which had the characteristics of making an investment and then subsequently dispose of that interest by sale. On the second issue, the court concluded that shares of a corporation are in a different position because they constitute something the purchase of which is, in itself, an investment. Court also concluded that the fact that there was no immediate likelihood of dividends being paid on the shares was not significant. In the court’s view, it is common for corporations, particularly start ups to not pay regular dividends and the mere fact that a dividend was not likely to be paid did not alter the conclusion that the share was purchased as an investment. Even assuming the taxpayer’s purchase of the shares was speculative, the mere fact that the taxpayer had purchased the shares with the intention of disposing of them at a profit as soon as possible did not, in itself, lead to the conclusion that the disposition was an adventure in the nature of trade. It would be hard to conceive of any situation where a taxpayer who purchases securities does not have at least some intention to sell them when their value appreciates.
				+ **Dissenting Judgement:** Taxpayer’s gain should be taxable as profits from a business. In support of this conclusion, Justice Cartwright cited the majority decision in the *Regal Heights* case.
			* *M.N.R. v James A. Taylor*  56 DTC 1125 (Exch. Ct.) – **purchase and sale of land**
				+ Court was asked to consider whether the purchase and sale of lead was an adventure or concern in the nature of trade
				+ **Facts:** Taxpayer was President in a company engaged in the fabrication of products from non fearess metals including lead. The company regularly faced shortages of the raw materials used to fabricate products. When the market price of lead dropped sharply, taxpayer executed various contracts to purchase imported lead for future delivery. Taxpayer purchased a large quantity of imported lead and sold it to the company at a profit.
				+ **Held:** The sale of the lead was an adventure or concern in the nature of trade.
				+ **Reasons:** Court concluded that the nature and quantity of the property (15 tonnes of lead) excluded any possibility that it was of an investment or capital nature. The fact that only a single transaction was undertaken also had no bearing on the determination of whether the transaction was an adventure or concern in the nature of trade. In assessing the taxpayer’s conduct, the court noted that the taxpayer had dealt with the lead in the same manner that any dealer would have dealt with it. The taxpayer could not have done anything with the lead except sell it to the company which is the reason the taxpayer purchased the lead in the first place.
				+ There will be times when the nature and quantity of the subject matter will exclude the possibility that its sale was the realization of an investment or otherwise of a capital nature.
		- Taxpayer’s Intention
			* Did the taxpayer acquire the property with the intention or secondary intention of selling it for a profit?
				+ The existence of a secondary intention is significant if there is evidence to suggest that there was little likelihood of the property being held by the taxpayer and used to fulfill the taxpayer’s primary intention

i.e. this could be the case where the taxpayer lacks financial resources to fully develop the property or their primary intention is otherwise unrealistic

* + - * Was the taxpayer’s principal intention unrealistic?
			* While courts initially look to the taxpayer’s intention when acquiring the property, the taxpayer’s intention at the time of disposition may also be relevant.
			* The taxpayer’s secondary intention was the basis for the decision in the *Regal Heights* case
			* *Regal Heights Limited v MNR,* 1960 [SCC]
				+ **Facts:** Taxpayer purchased vacant land with intention of building a shopping center. When another company announced plans to build another shopping center 2 miles away, taxpayer sold the land and treated it as a gain. Minister said that the gain was profit derived from an adventure or concern in the nature of trade.
				+ **Reasons:** SCC accepted the taxpayer’s primary intention was to build a shopping center, but also found that the taxpayer had a secondary intention to sell the vacant land at a profit if the taxpayer was unable to carry out its primary intention. In considering the activities undertaken by the taxpayer in fulfilling its primary intention, the court noted that the taxpayer’s efforts were of a promotional character. In particular, the taxpayer did not take any real steps to secure a major department store as a tenant which was a precondition to building a shopping mall. Furthermore, there was no evidence on which to conclude that that taxpayer intended to build the shopping mall regardless of the outcome of negotiations with department stores. There was also no evidence the taxpayer had any assurance that it could secure a department store as a tenant. Court found the taxpayer’s purchase of the vacant land speculative. At best, taxpayer was hopeful that he land could be used for a shopping mall but also had the secondary intention to sell at a profit if it couldn’t be
				+ **Held:** The disposition of the vacant land was an adventure in the nature of trade.
				+ The court’s reliance on the taxpayer’s secondary intention is curious. MacArthur thinks that it was not clear that the court truly believed the taxpayer had a genuine intention to build a shopping mall.
				+ **Ratio:**  Where a taxpayer’s primary intention is merely speculative, it is not enough, and the CRA/court will look at their secondary intention
			* *Irrigation Industries Ltd. v MNR*, [1962] SCR 346
				+ **Ratio:** Intention alone is not sufficient. The sale of shares was not an adventure in nature of trade notwithstanding the taxpayer’s intention to sell at a gain. The disposition of shares is always treated as a capital gain/loss, unless the taxpayer is in the business of trading securities. The intention to dispose of property for profit was not sufficient to establish an adventure in the nature of trade.
				+ **Reasons:** Court acknowledged that it would be hard to conceive of any situation where a taxpayer who purchases securities does not have at least some intention to sell them when the value appreciates.
				+ Although Justice Martland was specifically referring to the purchase of securities, it is likely that in most instances where taxpayer has a primary intention for the purchase of a property that they also have the secondary intention of selling that property if they are unable to carry out their primary intention

suggests that judges will look at taxpayer’s secondary intention when they don’t believe the primary

* + - * + Also, notable that this was an isolated occasion and not part of regular business
				+ It is not a sufficient test to ask whether the transaction was entered wit the intention of disposing of the shares at a profit so soon as there was a reasonable opportunity in doing so

## Basic Statutory Framework

* **Part I, Division B – Computation of Income**
* **Paragraph 3(b)** – this is the starting point
	+ 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:

(b) determine the amount, if any, by which

 (i) the total of

(A) All of the taxpayer’s taxable capital gains for the year from dispositions of property other than listed personal property, and

(B) the taxpayer’s taxable net gain for the year from dispositions of listed personal property,

 Exceeds

 (ii) …the taxpayer’s allowable capital losses for the year from dispositions of property other than listed personal property….

* The taxpayer’s net taxable capital gain is the amount, if any, by which the aggregate of the taxpayer’s capital gains and net gain from listed personal property exceeds the taxpayer’s allowance capital losses
* **Subdivision c -Taxable Capital Gains and Allowable Capital Losses**
* **Section 38**
	+ For the purposes of this Act,

(a)… a taxpayer’s taxable capital gain for a taxation year from the disposition of any property is ½ of the taxpayer’s capital gain for the year from the disposition of the property…

(b) a taxpayer’s allowable capital loss for a taxation year from the disposition of any property is ½ of the taxpayer’s capital loss for the year from the disposition of that property; and

(c) a taxpayer’s [*small business investment*] allowable business investment loss for a taxation year from the disposition of any property is ½ of the taxpayer’s business investment loss for the year from the disposition of that property.

* **Subsection 39(1)**
	+ For the purposes of this Act,

(a) … a taxpayer’s capital gain for a taxation year from the disposition of any property is the taxpayer’s gain for the year… (to the extent of the amount thereof that would not [otherwise] be included in computing the taxpayer’s income for year or any other taxation year) from the disposition of any property… other than…

* I.e. This would be the case if the amount of the gain is already included in computing the taxpayer’s income under section 56 or more likely as income from a source pursuant to paragraph 3(a)
* Thus, income from a business that is included in income from business and thus is taxed under section 3(a) thus does not become a capital gain because it is included in computing income gain and thus is not capital property
* Capital property is defined by the nature of the disposition of that property
	+ i.e. The property only becomes capital property if there is a capital gain/loss flowing from the disposition of that property.
* **Paragraph 40(1)(a)**
	+ Except as otherwise expressly provided in this Part

(a) a taxpayer’s gain for a taxation year from the disposition of any property is the amount, if any, by which

(i) … the taxpayer’s proceeds of disposition exceed the total of the adjusted cost base to the taxpayer of the property immediately before the disposition and any outlays and expenses to the extent that they were made or incurred by the taxpayer for the purpose of making the disposition…

* + Basically it is the amount that your proceeds from the disposition less your adjusted cost base
* **Subsection 40(2)(f)**
	+ Deems the taxpayer’s gain or loss to be nil where the gain or loss results from the disposition of a chance to win or a right to receive an amount as a prize in connection with a lottery scheme
	+ Lottery winnings are not considered income from a source and therefore not taxable – therefore why is this provision even necessary?
		- Need this because lottery winnings are windfall games and are therefore not taxable
		- Makes it clear that you will not have a loss or gain on the disposition of the lottery ticket
* **The triggering event for a realization of a gain is a disposition of property**
* **Subsection 248(1)**
	+ “**disposition**” is, in general terms, defined to include any transaction or event entitling a taxpayer to proceeds of disposition of the property, a gift and certain other transactions that may not otherwise constitute dispositions and to generally **exclude a transaction where there has been no change in beneficial ownership**
		- A common example of this is where you transfer legal title to property (i.e. real estate) into the name of your agent or nominee. Although your agent or nominee is on title as the legal owner of the property, they hold that property subject to your direction or control. Accordingly, this does not result in a disposition since you continue to be the beneficial owner of that property
		- A transfer of property to a trustee does result in a disposition. This is the case even where there is technically no real change in beneficial ownership for trust law purposes because the definition of disposition specifically includes the transfer of property to a trust
* **Section 54**
	+ “**proceeds of disposition**” is defined broadly to include:
		- The sale price of property that has been sold
		- Compensation for property unlawfully taken, damaged, destroyed or taken under statutory authority
		- An amount paid under an insurance policy in respect of property that has been lost, damaged or destroyed
		- Excludes compensation payable for property damages to the extent that such compensation is used within a reasonable time to repair the damage
			* If I use the compensation to repair the damage, such compensation is NOT a proceed of disposition
			* If I do not use the compensation to repair the damage, such compensation is a proceed of disposition
		- Includes cash and non-cash or “in-kind” consideration
			* i.e. Assume I sell my watch to someone for $1, 000. My proceeds of disposition are the sale price or $1, 000. Now assume I sell the same watch for a diamond ring worth $1, 000. My proceeds of disposition are still $1, 000 which is the value of the diamond ring
* **Paragraph 69(1)(b)**
	+ Deems the proceeds of disposition to be the fair market value of the property where the property is disposed of
		- By way of gift – **subparagraph 69(1)(b)(ii);** or
		- To non-arm’s length person for less than fair market value consideration – **subparagraph 69(1)(b)(i)**
	+ **Note:**  If a non-arm’s length person pays more than fair market value consideration, the normal rules apply, and the proceeds of disposition are equal to the consideration paid
	+ Basically, if you sell your property for less than it is worth to a non-arm’s length person, the proceeds of disposition will be deemed to be (for tax purposes) as if you had sold the property for FMV
		- E.g. if I sell land to my sister for $1 then she sells it to Party A for $1 million and gifts that $1M to me
			* *ITA* says that I am deemed to have sold it for FMV ($1M)
* **Section 68**
	+ Where an aggregate amount is received as consideration for the disposition of two or more properties, the proceeds of disposition for each property is deemed to be the amount of the consideration that can reasonable be attributed to each such property:
		- *The Queen v Golden,* 86 DTC 6138 (SCC)
* **Section 54**
	+ “**adjusted cost base”** to a taxpayer of any property at any time means, except as otherwise provided,

(a) where the property is depreciable property of the taxpayer, the capital cost to the taxpayer of the property as of that time,

(b) in any other case, the cost to the taxpayer of the property adjusted, as of that time, in accordance with section 53, ….

(d) in no case shall the adjusted cost base to a taxpayer of any property at any time be less than nil;

* Here the adjustments in s. 53 exceed the cost of the property the difference is deemed to be a gain from the disposition of the property – **subsection 40(3)**
* The ACB can never be below zero. Anything that it is less than zero, you will have a gain on the cost base

## Cost

* Not defined in the *Income Tax Act*
	+ When you pay to acquire a thing (purchase price) and maybe a commission
	+ ACB and cost can be the same thing, but when they are different ACB is what matters
* Generally, includes full amount of any capital expenditure incurred by the taxpayer in connection with acquiring or improving the property
* The capital expenditure must be in money or money’s worth
	+ i.e. if a taxpayer restored a classic car the value of the time spent by the taxpayer restoring the car would not be added to the cost of the car. If, however the taxpayer paid another person to do the restoration work for them, the amount paid to that person would be added to the cost of the car
* The cost of property acquired in a barter transaction is the value of the property given-up in exchange
	+ i.e. the cost of the diamond ring acquired in the previous example would be $1, 000. This is because the watch that was given up acquiring the diamond ring was worth $1, 000
* The cost of property acquired as a gift is deemed to be the fair market value of the property – **subsection 69(1)(c)**
	+ As such, where property is transferred by way of gift, both the transferor’s proceeds of disposition and the transferee’s cost of acquisition are deemed to be the fair market value of the property
	+ Does not include lottery winnings – lottery winnings are not a gift
* Lottery prizes are deemed to be acquired at a cost equal to FMV – **s. 52(4)**
	+ Why do we need the rule, especially considering the above provision in 69(1)(c)?
		- Lottery prize isn’t a gift, you bought a ticket
		- If you receive a house, cost $0, if you sold it you would be taxed on the gain, by having the provision deeming it worth FMV you would only be taxed on the gain between the winning and the selling
* Where a taxpayer has acquired property from a non-arm’s length person for consideration greater than its fair market value, the taxpayer’s cost of the property is deemed to be the fair market value of the property – **subsection 69(1)(a)**
	+ E.g. my sister’s property is worth $1M. She sells it to me for $2M but my cost of the property is deemed to be $1M
* However, where a taxpayer has acquired property from a non-arm’s length person for consideration less than the fair market value of the property, no special rules apply, and the taxpayer’s cost is the amount expended by the taxpayer to acquire the property
	+ E.g. my sister sells me property for $1 – I acquire it for less than FMV – my costs are $1
	+ No rule to increase cost back to FMV – penalized me for taking party in this scheme, now I cannot benefit by inflating costs
	+ This may result in double taxation – How?
		- Government doesn’t want this to happen, almost creating disincentive to not sell at FMV
		- Because the $1000 be taxed at $500 gain from first brother who acquired it for $500; then sold to brother for $500, then brother sold it for $1000. That $500 will be taxed in both brothers hands because the cost for the brother it was sold to will only be $500 because it is not a gift or lottery

## Sample Problems

* **Problem #1**
	+ Simone gives her sister Marci a diamond ring. The diamond ring has a fair market value of $2,500. Simone originally paid $1,000 when she purchased the diamond ring
		- Simone’s proceeds of disposition = $2, 500 (because this is a gift, the proceeds of disposition are deemed to be equal to the fair market value of the ring)– **subparagraph 69(1)(b)(ii)**
		- Simone’s gain = $2, 500 - $1, 000= $1, 500
			* This is because her adjusted cost base is $1, 000 – what she paid to acquire the ring
	+ Marci sells the diamond ring to an arm’s length purchaser for $2, 500
		- Marci’s cost = $2, 500 – **paragraph 69(1)(c)**
			* Since she acquired the ring as a gift, her cost is deemed to be the fair market value of the ring
		- Marci’s gain = $2, 500- $2, 500= 0
			* She would not realize a gain or a loss since her proceeds of disposition are equal to her adjusted cost base
* **Problem #2**
	+ Simone tells Marci the diamond ring for $2,000
		- Simone’s proceeds of disposition = $2, 500 – **subparagraph 69(1)(b)(i)**
			* Even though she sold the ring for less than fair market value, her proceeds of disposition are deemed to be equal to the fair market value of the ring or $2, 500 because she sold the ring to a non-arm’s length person (her sister) for consideration less than fair market value
		- Simone’s gain = $2, 500- $1, 000 = $1, 500
	+ Marci sells the diamond ring to an arm’s length purchased for $2, 500
		- Marci’s cost = $2, 000 – **paragraph 69(1)(c)**
			* Since she paid less than fair market value, her cost is calculated in accordance with the rules. Therefore, her cost is what she paid for the ring which was $2, 000
		- Marci’s Gain = $2,500 - $2, 000 = $500
			* This would be if she sold the ring to a non-arm’s length purchase for $2, 500
			* Her gain would be $500 because in this situation Marci’s adjusted cost base is only $2, 000
* **Problem #3**
	+ Simone sells Marci the diamond ring for $3, 000
		- Simone’s proceeds of disposition = $3, 000
			* No special rules apply. Simone’s proceeds of disposition are equal to the value of the consideration paid by Marci of $3,000
		- Simone’s gain = $3, 000 - $1, 000 = $2, 000
			* This is $500 more than if she had given Marci the ring
	+ Marci sells the diamond ring to an arm’s length purchaser for $2,500
		- Marci’s cost = $2, 500 – **paragraph 69(1)(a)**
			* Since the consideration paid by Marci was greater than the FMV her cost of acquisition is deemed to be the FMV of the ring or $2, 500
		- Marci’s Gain = $2, 500 - $2, 500 = 0
	+ **Note:**  If Simone sold the ring to March for FMV consideration of $2, 500 her gain would have only been $1, 500 and Marci would not have realized a gain nor loss when she sold the ring to the arm’s length purchase for $2, 5000. As such, in Problems 2 and 3 the application of deeming rules is punitive and results in an additional $500 of gain realized by Simone or Marci.

## Cost

* Where an aggregate purchase price is paid for 2 or more properties, it is necessary to allocate the purchase price between those properties in a reasonable manner (the cost of each property is deemed to be the amount of consideration that can reasonably be attributed to each such property)
	+ Section 68
	+ *The Queen v Golden*, 86 DTC 6138 (SCC)
	+ Only applies in the circumstances where you are clearly trying to make a bona fide fair market valuation
* Lottery prizes are deemed to be acquired at a cost equal to fair market value of the prize – **subsection 52(4)**  - Why?

## Personal Use Property

* **Section 54**
	+ “**personal use property**” of a taxpayer include
		- Property owned by the taxpayer that is used particularly for the personal use or enjoyment of the taxpayer or a person related to the taxpayer,
		- Any debt owing to the taxpayer in respect of the disposition of property that was the taxpayer’s personal-use property, and
* **Subsection 46(1) -*De minimis rule;***
	+ Where a taxpayer disposes of a personal-use property, the adjusted cost based of personal-use property is deemed to be the greater of $1, 000 and its adjusted cost base otherwise determined; and the taxpayer’s proceeds of disposition are deemed to be the greater of $1, 000 and the taxpayer’s proceeds of disposition of the property otherwise determined
	+ This is an example of a provision that was included in the Act to achieve simplicity
	+ i.e. Assume that a taxpayer purchases a personal use property for $500. If the taxpayer later sells that property for $1, 000, the taxpayer is better off by $500.
	+ **Any gain realized on the disposition of personal use property with a value below $1, 000 is exempt from tax**
		- When there are transactions for personal use property for <$1000, there are not tax consequences (because would be deemed cost of 1000 and deemed sale of 1000)
* Where properties that normally form a set are sold individually for aggregate proceeds of more than $1, 000, the set is deemed to be a single property -  **subsection 46(3)**
	+ This section limits the application of the *de minimis rule* in certain circumstances
	+ This provision prevents taxpayers from breaking up a set of properties and effectively multiplying the benefit of this rule
	+ i.e. Assume Priya owns an antique chess set that she purchased at a yard sale for $100. If she sells the chess set for $3,500 subsection 46(1) will deem her adjusted cost base to be $1, 000 and she will realize a gain of $2, 500.
	+ Now assume Priya does not sell the chess set as a single property but enters into a separate sales transaction for each of the separate 32 chess pieces and the chess board. In total, Priya is selling 33 properties. If Priya sells each chess piece for $100 and the board for $300 she still receives the same aggregate price of $3, 500.
	+ if each sale is considered the disposition of as separate property subsection 46(1) will apply separately to each of the dispositions. In this case, the proceeds of disposition and adjusted cost base is deemed to be $1, 000 for each of the 33 properties disposed of and Priya does not realize any gain on the sale of her chess set.
* A loss from the disposition of personal-use property (other than listed personal property) is deemed to be nil – **subparagraph 40(2)(g)(iii)**
	+ Unlike 46(1) that only applies if the value of the property is below a de minimis threshold, this deems the loss on all personal use property to be nil
	+ You can never claim a loss on the disposition of personal use property (except for listed personal property)
	+ Public policy reason for taxing gains, not losses on the disposition of personal use property is that the government does not want consumption to equate to a loss
	+ E.g. If I buy a car for $10,000, use it for a few years and then sell it for $5, 000 I cannot claim a loss of $5000

## Listed Personal Property

* It is a form of capital property
* **Paragraph 3(b)**
	+ 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:

(b) determine the amount, if any, by which

 (i) the total of

(A) all of the taxpayer’s taxable capital gains for the year from dispositions of property other the listed personal property, and

(B) **the taxpayer’s taxable net gain for the year form dispositions of listed personal property,**

 Exceeds

 (iv) … the taxpayer’s allowable capital losses for the year from dispositions of property other than listed personal property…

* **Section 54**
	+ **“listed personal property”** of a taxpayer means the taxpayer’s personal-use property that is all or any portion of, or any interest in or right to, any

(a) print, etching, drawing, painting, sculpture, or other similar work of art

(b) jewelry

(c) rare folio, rare manuscript or rare book

(d) stamp; or

(e) coin;

* + unique because unlike other personal use property a loss realized by a taxpayer on a disposition of listed personal property is useable to offset the taxpayers gain from dispositions of listed personal property. As such, it is only the taxable net gain from dispositions of all listed personal property that is included in computing the taxpayer’s net taxable gain in paragraph 3(b).
	+ The special status given to listed personal property is in recognition of the fact that these properties have a quasi-investment character and are more likely to appreciate in value over time. It is because these properties have a mixed personal and investment use that the scheme of the act permits taxpayers to recognize a loss on their disposition. Such losses are only usable to offset a taxpayer’s gains from the disposition of other listed personal property
* **Subsection 41(1)**
	+ For the purposes of this Part, a taxpayer’s taxable net gain for a taxation year from dispositions of listed personal property is ½ of the amount determined under subsection (2) to be the taxpayer’s net gain for the year from dispositions of such property
* A loss realized on the disposition of listed personal property **can be carried back 3 years or forward 7 years** for the purpose of computing the taxpayer’s taxable net gain – **subsection 41(2)**
	+ This is different from other capital property whose losses can be carried forward indefinitely
* **NOTE:** The *de minimis* rule in subsection 46(1) applies to listed personal property – Why?
	+ any loss to disposition of personal property is nil BUT it doesn’t apply to listed personal property; instead you get to use this loss to offset the disposition of gains on listed personal property
	+ listed property – probably acquired so that it increases in value. Quasi investment character and the fact they typically go up in value it is more likely you will realize gains on these items thus seems appropriate that there is relief for the losses
* **Taxable Net Gain = 50% \* (Capital gains from disposition of listed personal property – Listed personal property losses from the next 3 years and the last 7 years)**

## Deemed Dispositions

* Sometimes even when you have not disposed of property, the *ITA* will deem you to have disposed of it
* **Change in Use** (from personal to income earning or from income earning to personal)
* **Subsection 45(1)**
	+ For the purposes of this subdivision the following rules apply:
		1. Where a taxpayer,
1. Having acquired property for some other purpose, has commenced later to use it for the purpose of gaining or producing income, or
2. Having acquired property for the purpose of gaining or producing income, has commenced at a later time to use it for some other purpose,

The taxpayer shall be deemed to have

1. Disposed of it at that later time for proceeds equal to its fair market value at that later time, and
2. Immediately thereafter acquire it at a cost equal to that fair market value;
* Why is this rule necessary?
	+ Because the tax treatment of income earning and non-income earning (or personal use property) is not always the same. The property used for income earning purposes is often deductible in computing income. The cost of personal use property is generally not deductible in computing income.
	+ i.e. Assume Zander pays $1, 000 to purchase personal use property. The $1, 000 is not deductible in computing his income. But what if he later decides to use this property in his busines. If the tax rules state that he can deduct in computing his business income the cost of property used in his business is he now entitled to deduct the $1, 000 he paid for the property? If the value of the property is still $1, 000 when he starts using it in his business this seems like a reasonable result. But, what if the value of the property is only $200 at that time. Should Zander still be allowed to deduct the full $1, 000? Wouldn’t the $800 difference reflect Zander’s personal consumption of the property during the period he held it for personal use? As we discussed earlier, a taxpayer is not entitled to deduct a loss realized on personal use property so how do your resolve this problem? – you resolve it by applying the rule in subsection 45(1). When Zander changes the use of the property from personal to income earning, subsection 45(1) deems him to have disposed of the property for proceeds of disposition equal to its FMV and to have reacquired it at cost equal to its FMV. Since this is personal use property at the time of disposition, it does not matter that Zander realizes a loss on the deemed disposition because the loss is deemed to be nil pursuant to 40(2)(g)(iii). Zander is also required to reacquire the property for the income earning use at a cost of $200. As a result, $800 of the overall cost has been allocated to Zander’s personal use and $200 has been allocated to his income earning use.
* General Rule:
	+ Where there is a transition from one use to another, the *ITA* will generally treat it as a disposition of property
		- E.g. I use my car and the value reduces from $10k to $5k, then I transition to use it for my uber business. I must record it’s expense to my business as the FMV at the time, which is $5k, not $10k, to prevent inflating business expenses
* Deemed disposition of capital property on death – **subsection 70(5)**
	+ When you die, you dispose of all capital assets at FMV. Therefore, dead person only taxed to extent that they have accrued gains
* Deemed disposition of capital property held by trust every twenty-one years – **subsection 104(4)**
	+ I can put property in a trust forever. By changing the beneficiary of the trust, I can transfer who has legal control over the property without ever disposing of the property
	+ To avoid this, *ITA* requires that every 21 years there is a deemed disposition and acquisition by trustee
* ~~Deemed disposition of property on a change in residence –~~ **~~section 128.1~~**
	+ ~~Canada taxes people on the basis of residency. It does not tax non-residents.~~
	+ ~~In order to ensure the government receives taxes, the~~ *~~ITA~~* ~~sets the cost at FMV when someone comes to Canada because we don’t want tax accrued wealth from another country~~

## Partial Dispositions

* **Subsection 43(1)**
	+ For the purpose of computing a taxpayer’s gain or loss for a taxation year from the disposition of part of a property, the adjusted cost base to the taxpayer, immediately before the disposition, of that part is the portion of the adjusted cost based to the taxpayer at that time of the whole property that can reasonably be regarded as attributable to that part
		- Recognizes that individuals can sell interests in their property
		- I.e. Assume Jasmine owns a property with a FMV of $6, 000 and an adjusted cost based of $4, 000. Jasmine sells a 50% interest in that property to Blake for FMV consideration of $3, 000. Jasmine proceeds of disposition are $3, 000, the price paid to her by Blake and her adjusted cost base is $2, 000 which is the portion of the $4, 000 total adjusted cost base that is reasonably attributable to the 50% interest she sold. As such, Jasmine realizes a capital gain of $1, 000. Half of this, or $500, would be her taxable capital gain.
		- Gain: PoD – ACB
		- Taxable capital gain: Gain – 50% (because only 50% of capital gain is taxable)

## Replacement Property Rules

* There are some cases where it is not reasonable to tax the gains where there is an actual disposition of property
* **Subsection 44(1)**
	+ Provides a full or partial deferral of the gain realized on the disposition of:
		- A **capital property** (other than a share of the capital stock of a corporation) because of the property being **involuntarily taken or destroyed,** or
		- A “**former business property**”
			* Generally defined in 248(1) to mean capital property that is real property (other than a rental property) used by the taxpayer or a related person for the purpose of gaining or producing income from a business
	+ In circumstances where a replacement property is purchased
	+ Public policy reason is that if you are given a gain to replace an asset that was taken from you or destroyed, that tax will limit your ability to replace the asset. This isn’t fair and you should be able to replace it
* **Subsection 44(5)**
	+ For the purposes of this section, a particular capital property of a taxpayer is a replacement property for a former property of the taxpayer, if

(a) it is reasonable to conclude that the property was acquired by the taxpayer to replace the former property;

(a.1) it was acquired by the taxpayer and use by the taxpayer or a person related to the taxpayer for a use that is the same as or similar to the use to which the taxpayer or a personal related to the taxpayer put the former property; and

(b) where the former property was used by the taxpayer or a person related to the taxpayer for the purpose of gaining or producing income from a business, the particular capital property was acquired for the purpose of gaining or producing income from that or a similar business or for use by a person related to the taxpayer for such a purpose

* **Paragraph 44(1)(d)**
	+ In the case of a “former business property” the replacement must be purchased before the end of the first taxation year following the year of disposition
	+ This is because it would interfere with business decisions to relocate if there was a likelihood of realizing a huge capital gain because with that taxation how will you be able to buy a new bigger property
	+ Limited to real property other than rental
* A “**former business property**”
	+ Defined in section 248(1) to mean capital property that is real property (other than a rental property) used by the taxpayer or a related person for the purpose of gaining or producing income from a business.
		- Land used for the purposes of gaining or producing income from a business
		- Ex: factory, office building
	+ Ex: I voluntarily sold my old factory and bought a new one
	+ Why do replacement property rules apply to voluntary replacements?
		- The public policy reason for allowing replacement property rules to apply to voluntary replacements is that we do not want tax rules/consequences to impact/change your business decisions with respect to reallocating/expanding/etc. You should be able to choose where to do business.
		- This only applies to when you replace property. If you simply sell business property and do not buy new business property, your proceeds from selling will be taxed.
* **Paragraph 44(1)(c)**
	+ In the case of any other property the replacement property must be purchased before the end of the second taxation year following the year of disposition
* **44(1)(d)** In the case of any other property, the replacement property must be purchased before the end of the second taxation year following the year of disposition (before the end of the year + 24 months).
	+ Catches involuntary dispositions.
* **44(1)(e)** Where a replacement property is acquired, capital gain otherwise realized on the disposition is generally equal to **the lesser of**:
	+ (i)(A) The gain otherwise realized on the disposition of the former property, and
		- Ex: My house cost me $5k, but is now worth $12k. It burnt down, so insurance proceeds are $12k. I buy a replacement property for $10k. $12k - $5k = $7k gain.
	+ (i)(B) The amount, if any, by which the proceeds of disposition of the former property exceed the cost of the replacement property
		- Ex: My house cost me $5k, but is now worth $12k. It burnt down, so insurance proceeds are $12k. I buy a replacement property for $10k. $12k - $10k = $2k gain.
			* Therefore, the capital gain is $2k, which I am taxed on immediately.
* **44(1)(f)** The cost to the taxpayer of the replacement property is deemed to be the cost otherwise determined less the amount of the deferred gain
	+ Ex: My house cost me $5k, but is now worth $12k. It burnt down, so insurance proceeds are $12k. I buy a replacement property for $10k. Price of replacement property – (A – B) = cost of replacement property. $10k – ($7k – $2k) = $5k.
	+ Therefore, the cost of the replacement property is $5k. When I eventually sell my replacement property for FMV $10k, it will trigger the deferred gain of $5k, which I will be taxed on at that future time.
* **Subsection 44(2)**
	+ Where the property was **involuntarily taken or destroyed,** the date of disposition is generally deemed to be the earlier of:
		- The day the taxpayer agrees to the amount of compensation for the loss of property; or
		- The day the taxpayer’s compensation is finally decided by a tribunal or court
		- As such, where there is a dispute as to the amount the taxpayer is to receive as compensation for the property that was involuntarily taken or destroyed, the date of disposition of the property is generally delayed until the dispute is resolved. The one exception is where the taxpayer fails to bring a claim. If no claim or suit has been filed by the taxpayer within 2 years of the date of loss, the date of disposition is deemed to be the day of the loss.
	+ Applies for all purposes of the *Act*. As such, when it applies, the recognition of any gain or loss the taxpayer may realize on the disposition of the property is also deferred until the deemed date of disposition
* **Sample Problem**
	+ Assume a taxpayer owns a capital property with an ACB of $10, 000 and a fair market value (“FMV”) of $15, 000
	+ The property is destroyed by fire and the taxpayer receives $15, 000 in compensation from their insurance company
	+ What are the tax consequences if the taxpayer purchases a replacement property for $12, 000 in the same year the former property was destroyed?
		- **Step 1: Determine the gain realized on the disposition of the former property**
			* The gain is equal to the lesser of:
				+ The gain otherwise realized on the disposition of the former property – clause 44(1)(e)(i)(A):

**$15, 000 (taxpayer’s proceeds of disposition) - $10, 000 (adjusted cost base) = $5, 000**

This is the amount by which the taxpayer’s proceeds of disposition exceed the adjusted cost base of the former property

The term proceeds of disposition are broadly defined in section 54 to include an amount paid under an insurance policy in respect of property that has been lost, damaged or destroyed

* + - * + The amount, if any by which the proceeds of disposition exceed the initial cost of the replacement property – clause 44(1)(e)(i)(B):

**$15, 000 (proceeds of disposition of former property)- $12, 000 (what taxpayer paid to purchase the replacement property)= $3, 000**

* + - * + Since taxpayer’s gain is deemed to be the lesser of these two amounts, that would be $3,000
		- **Step 2: Determine the cost of the replacement property**
			* The cost to the taxpayer of the replacement property is deemed to be the initial cost less the amount of the deferred gain – Paragraph 44(1)(f):
				+ Initial Cost = **$12, 000**

This is the amount paid by the taxpayer to acquire the replacement property

* + - * + Deferred Gain = **$5, 000 - $3, 000 = $2, 000**

This is the amount, if any, by which the gain otherwise realized on the disposition of the former property exceeds the deemed gain determined in accordance with paragraph 44(1)(e)

The taxpayer’s gain otherwise realized on the disposition of the former property is $5, 000 and the taxpayer’s deemed gain determined in accordance with paragraph 44(1)(e) is $3, 000. As such, the deferred gain is $2, 000 which is the amount by which $5, 000 exceeds $3, 000

* + - * + Cost = **$12, 000- $2, 000 = $10, 000**

## Reserve for Future Proceeds

* Where a taxpayer disposes of a capital property but does not receive the full proceeds in the year of disposition they are normally permitted to claim a capital gains reserve and defer recognition of a portion of the capital gain until a future year when the remainder of the proceeds are paid – **subparagraph 40(1)(a)(iii)**
	+ E.g. where there is some sort of loan agreement, the taxpayer can defer the sale to when they actually realize all of the gain
* the maximum deferral period is 4 years – **clause 40(1)(a)(iii)(D)**
* The amount of any reserve taken in the immediately preceding year is treated as a capital gain from the disposition of the property in the current year – **subparagraph 40(1)(a)(ii)**
	+ The maximum reserve a taxpayer is permitted to claim in any year is determined in accordance with 40(1)(a)(iii)

**Section 40(1)**

Except as otherwise expressly provided in this Part

1. A taxpayer’s gain for a taxation year from the disposition of any property is the amount, if any, by which
	1. …
	2. If the property was disposed of before the year, the amount, if any, claimed by the taxpayer under para (iii) in computing the taxpayer’s gain for the immediately preceding year from the disposition of the property,
		* the amount of the reserve from the preceding year is taken into account when determining the taxpayer’s gain on the disposition of property in the current taxation year.

Exceeds

* 1. Subject to section 40(1.1), such amount as the taxpayer may claim
1. In the case of an individual (other than a trust) in prescribed form filed with the taxpayer’s return of income under this Part for the year, and
2. In any other case, in the taxpayer’s return of income under this Part for the year,

As a deduction, not exceeding **the lesser of**

1. A reasonable amount as a reserve in respect of such of the proceeds of disposition of the property that are payable to the taxpayer after the end of the year as can reasonably be regarded as a portion of the amount determined under para (i) in respect of the property, and
	* + - Ask yourself: what PORTION of the gain relates to the unpaid purchase price? That is your reasonable reserve
2. An amount equal to the product obtained when 1/5 of the amount determined under para (i) in respect of the property is multiplied by the amount, if any, by which 4 exceeds the number of preceding taxation years of the taxpayer ending after the disposition of the property
	* + - This is a statutorily defined limit on the reasonable reserve.
		+ The reserve is the lesser of C and D
		+ The maximum deferral period is 4 years
			- If you structure the gain the right way, it can be spread over the 4 years and be taxed at a lower rate.
* Essentially, you take the gain into your income, but get a deduction (a reserve) from the amount of your return. Then the reserve amount is put into the next year and goes forward until the amount is put off proportionately.
* **Sample Problem**
	+ Assume a taxpayer holds a capital property with an adjusted cost based of $100
	+ The taxpayer sells the capital property for $300
	+ In the year of sale (Year 1) and the next taxation year (Year 2) the taxpayer receives $75 of the purchase price
	+ The remaining $150 of the purchase is not payable until Year 10
	+ Assuming the taxpayer claims the maximum reserve available, how much capital gain do they need to recognize in each of Years 1 through 10?
		- **Year 1**
			* Initial Capital Gain = **$300 (PoD) - $100 (ACB) = $200**
				+ This is the amount by which the PoD exceed the adjust cost base (ACB) of the property
			* The maximum capital gains reserve the taxpayer can claim in Year 1 is the lesser of two amounts: the reasonable reserve and the statutory reserve
			* Clause 40(1)(a)(iii)(C) – The reasonable reserve for Year 1 is computed by multiplying the initial capital gain by the proportion of the proceeds of disposition that are not payable until after the end of Year 1
				+ **$200 x [$225/$300] = $150**
				+ Since the taxpayer received $75 in Year 1, $225 is payable after Year 1. As such, the reasonable reserve is $200 multiplied by the ratio 225/300, The reasonable reserve is therefore $150
			* Clause 40(1)(a)(iii)(D) – limits the maximum reserve in each year to an amount equal to 1/5 of the initial capital gain x (4 - # of years after disposition)
				+ **= [$200 x1/5] x [4-0] = $40 x 4 = $160**
				+ 1/5 of initial capital gain is $200 divided by 5 or $40. Since Year 1 is the year of disposition the number of years after disposition is 0. As such, maximum statutory reserve is $40 x 4-0 or $160
			* The maximum reserve for Year 1 is the lesser of these two values or **$150**
			* Although the taxpayer is permitted to claim any amount as a reserve up to the maximum, the problem assumes the taxpayer claims the maximum reserve for the year
			* The taxpayer’s capital gain in the year of disposition is the initial capital gain (**$200)** less the capital gains reserve claimed by the taxpayer (**$150**)
			* Taxpayer’s capital gains is **$50** in Year 1. Half of this amount or $25 is the taxpayer’s taxable capital gain
		- **Year 2**
			* Starting Capital Gain = **$150** (Year 1 reserve) – **subparagraph 40(1)(a)(ii)**
				+ The starting capital gain for Year 2 is equal to the amount of reserve claimed in Year 1 or $150
			* Clause 40(1)(a)(iii)(C) – The reasonable reserve for Year 2 is an amount equal to initial capital gain in Year 1 multiplied by proportion of the proceeds of disposition that are not payable until after end of Year 2
				+ Since the taxpayer received another $75 in Year 2, only $150 remains payable after Year 2. As such, the reasonable reserve is $200 multiplied by the ratio $150/$300. The reasonable reserve for Year 2 is therefore $100
				+ **$200 x [$150/$300] = $100**
			* Clause 40(1)(a)(iii)(D) – limits the maximum reserve in each year to an amount equal to 1/5 of the initial capital gain in Year 1 x (4- # of years after disposition)
				+ **[$200 x 1/5] x {4-1] = $40 x 3 = $120**
			* **Note:**  When calculating the reasonable reserve and the maximum statutory reserve, you always use the initial capital gain from the year of disposition which is Year 1
			* The maximum reserve is the lesser of these two values or **$100**
			* The taxpayer’s capital gain in Year 2 is the starting capital gain (**$150)** less the capital gains reserve claimed by the taxpayer (**$100**)
			* As such, the taxpayer’s capital gains are **$50** in Year 2
				+ Half of this amount or $25 is the taxpayer’s taxable capital gain
		- **Year 3**
			* Starting Capital Gain: **$100** (Year 2 reserve) – **subparagraph 40(1)(a)(ii)**
			* Clause 40(1)(a)(iii)(C) – The reasonable reserve for Year 3 is an amount equal to the initial capital gain in Year 1 multiplied by proportion of the proceeds of disposition not payable until after the end of Year 3
				+ **$200 x [$150/$300] = $100**
				+ Since no more of the purchase price was received by the taxpayer in Year 3, the reasonable reserve for Year 3 is the same as the reasonable reserve for Year 2 or **$100**
			* Clause 40(1)(a)(iii)(D) – limits the maximum reserve in each year to an amount equal to 1/5 of the initial capital gain x )4- # of years after disposition)
				+ **[$200 x 1/5] x [4-2] = $40 x 2 = $80**
				+ Since Year 3 is two years after disposition the number of years after disposition is 2
			* The maximum reserve is the lesser of these two values or **$80**
			* The taxpayer’s capital gain in Year 3 is the starting capital gain (**$100)** less the capital gains reserve claimed by the taxpayer (**$80**)
			* As such, the taxpayer’s capital gains is **$20** in Year 3
				+ Half of this amount or $10 is the taxpayer’s taxable capital gain
		- **Year 4**
			* Starting Capital Gain = **$80** (Year 3 reserve) – subparagraph 40(1)(a)(ii)
			* Clause 40(1)(a)(iii)(C) – The reasonable reserve for Year 4 is an amount equal to the initial capital gain in Year 1 multiplied by proportion of the proceeds of disposition not payable until after the end of Year 4
				+ **$200 x [$150/$300] = $100**
				+ since no more of the purchase price was received by the taxpayer in Year 4, the reasonable reserve for Year 4 is the same as the reasonable reserve for Year 3 or **$100**
			* Clause 40(1)(a)(iii)(D) – limits the maximum reserve in each year to an amount equal to 1/5 of the initial capital x (4- # of years after disposition)
				+ **[$200 x 1/5] x [4-3] = $40 x1 = $40**
			* The maximum reserve is the lesser of these two values or **$40**
			* The taxpayer’s capital gain in year 4 is the starting capital gain (**$80)** less the capital gains reserve claimed by the taxpayer (**$40**)
			* As such, the taxpayer’s capital gains is **$40** in Year 4
				+ Half of this, or $20, is the taxpayer’s taxable capital gain
		- **Year 5**
			* Starting Capital Gain = **$40** (Year 4 reserve) – **subparagraph 40(1)(a)(ii)**
			* Clause 40(1)(a)(iii)(C) – The reasonable reserve for Year 5 is an amount equal to the initial capital gain in Year 1 multiplied by the proportion of the proceeds of disposition that are not payable until after the end of Year 5
				+ **$200 x [$150/$300] = $100**
				+ since no more of the purchase price was received by the taxpayer in Year 5, the reasonable reserve for Year 5 is the same as the reasonable reserve for Year 4 or **$100**
			* Clause 40(1)(a)(iii)(D) – limits the maximum reserve in each year to an amount equal to 15 of the initial capital x (4- # of years after disposition)
				+ **[$200 x 1/5] x [4-4] = $40 x 0 = $0**
			* The maximum reserve is the lesser of these two values or **$0**
			* The taxpayer’s capital gain in Year 5 is the starting capital gain (**$40)** less the capital gains reserve claimed by the taxpayer (**$0**)
			* As such, the taxpayer’s capital gains are **$40** in Year 5
				+ Half of this, or $20, is the taxpayer’s taxable capital gain
		- **Years 6 – 10**
			* Notwithstanding that the final payment of $150 is not due until Year 10, no portion of the capital gain is recognized in Years 6 through 10
			* This is because the full amount of capital gain ($200) is realized in Years 1-5 as a result of the statutory limit in clause 40(1)(a)(iii)(D):
				+ Year 1 - $50
				+ Year 2 - $50
				+ Year 3 - $20
				+ Year 4- $40
				+ Year 5- $40
				+ = **$200**
			* The statutory limit in clause 40(1)(a)(iii)(D) requires the taxpayer to recognize the full capital gain over a maximum period of 5 years

## Rollovers

* Term used to describe a transfer or other disposition of a capital property which is deemed to occur at proceeds of disposition equal to adjusted cost base
* Since the proceeds of disposition are equal to the transferor’s adjusted cost base, the transferor does not realize a gain (but in some circumstances may realize a loss) as a result of the disposition
* The person to whom the capital property is transferred acquires the capital property at an adjusted cost base generally equal to the transferor’s adjusted cost base
* Any unrealized gain on the property will therefore be realized on a subsequent disposition that does not qualify as a rollover
* Example: Property with a cost base of $100 but value of $1000 is transferred to another person where the cost base remains at $100
	+ Distinct from a regular sale where the cost base of the purchaser would be the value of the property (in this case $1000)
* ONLY APPLIES TO CAPITAL GAINS

## Spousal Rollover

* The rule states that it doesn’t matter what the other rules say, the proceeds of disposition are deemed to be the cost of the property
* Rollovers just deem the proceeds of disposition to be equal to the cost and the cost of acquisition of the other party to be equal to the deemed proceeds of disposition
	+ It is deemed proceeds of disposition and deemed costs of acquisition equal to the transferor’s cost of the property
	+ E.g. (from the capital gains problems) – When Adam transfers the painting to John. Adam bought the painting for $500 so Adam’s cost is $500. He gives it as a gift to John at a time when the painting is worth $1, 200. 69(1)(b) would say that if you give property to someone you are deemed to have PoD of FMV so if Adam was giving it to anyone else he would have FMV PoD equal to $1,200 and the person who acquires it would be deemed under 69(1)(c) would have acquired it at FMV so they would have a cost of $1, 200. However, because Adam was giving it to his spouse, 73.1 overtakes these general rules and says that the deemed proceeds of dispositions are your costs ($500) and John’s deemed cost of acquisition is $500 EVEN THOUGH under a gift, the proceeds should have been $1,200 and the cost should have been $1,200. The spousal rollover provision supersedes.
* **Subsection 73(1)**
	+ [W]here… any particular capital property of an individual (other than a trust) has been transferred in circumstances to which subsection (73(1.01)) applies and both the individual and the transferee are residents in Canada at that time, unless the individual elects in the individual’s return of income under this Part of the taxation year in which the property was transferred that the provisions of this subsection not apply, the particular property is deemed

(a) to have been disposed of at that time by the individual for proceeds equal to,

…

(ii) … the adjusted cost base to the individual of the particular property immediately before that time; and

(b) to have been acquired at that time by the transferee for an amount equal to those proceeds

* + For this subsection to apply, both the transferor and the transferee must be resident in Canada at the time of the transfer
	+ Subsection 73(1) automatically applies to the transfer of property unless the transferor elects out of its application in their tax return for the year the property was transferred
	+ **Result:**
		- The recipient is deemed to acquire the property at a cost= to the giver’s ACB (so the giver experiences no gain, as proceeds of disposition are also equal to original cost) at the time of the transfer
		- The capital gain or loss at the time of disposition (when the new spouse actually disposes) = difference between the proceeds of disposition and the deemed cost (will include the gains/losses of both parties terms of ownership) 🡪 “rollover” of the acquire gains/losses
	+ Spouse then turns around and sells it – the attribution rule will attribute the capital gains back to the transferor. Prevents using a spouse to split income. But there is an exception in that rule for FMV transfers, but there is a further requirement – if you elect out of the attribution rule you also must elect out of the spousal rollover election
* **Subsection 73(1.01)**
	+ … property is transferred by an individual in circumstances to which this subsection applies where it is transferred to
1. the individual’s spouse or common-law partner;
2. a former spouse or common-law partner of the individual in settlement of rights arising out of their marriage or common-law partnership; or
	1. even if the spouses are no longer married, if the transfer occurred as the result of a divorce then these rules would apply
3. a trust created by the individual under which
4. the individual’s spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse’s or common-law partner’s death and no person except the spouse or common-law partner may, before the spouse’s or common-law partner’s death, receive, or otherwise obtain the use of any of the income or capital of the trust,
* Where a trust is set up to benefit a taxpayer’s spouse during their lifetime but the capital will not ultimately flow to the spouse, the rollover rules would still apply
* The rollover benefits end at the time of the beneficiary spouse’s death
	+ If you transfer property to your spouse, you will be deemed to have transferred that property at ACB (no accrued gain) and your spouse will be deemed to have acquired that property at ACB
	+ Only applies to individuals, not trusts
	+ Public policy reason is that spouses are usually part of one economic unit

## Other Rollover Provisions

* Transfers by individuals 65 years of age and older to a joint spouse or partner trust or an alter-ego trust – **subsection 73(1), subparagraphs 73(1.01)(c)(ii) and (iii) and subsection 73 (1.02)**
* Transfers of farm or fishing property by a transferor to his or her Canadian resident child – **subsection 73(3)**
* Transfers of shares in a family fishing or farming corporation or an interest in a family fishing or farming partnership by a transferor to his or her Canadian residence child – **subsections 73(4) and (4.1)**
* Transfer of capital property to a corporation in exchange for shares of the corporation – **subsection 85(1)**
	+ Allows business people to transfer capital to their corporations so there is not a deemed disposition of something they paid for before incorporating

## Principle Residence Exemption

* If an individual would otherwise realize a capital gain on the disposition of a resident property owned by them, the individual may be able to reduce or eliminate this gain by designating the property as his or her principal residence for any or all of the years during which the property was owned
* In practice, this normally exempts the full amount of the gain from tax
* A “**principle residence”** of the taxpayer is defined in 54 to be a housing unit, leasehold interest or shares of a cooperative housing corporation
* A “**housing unit**” includes a house, duplex, apartment building or condominium, cottage, mobile home, trailer or houseboat
* **Paragraph 40(2)(b)**
	+ In general terms, the capital gain realized by an individual on the disposition of a residential property will be the amount, if any, determined by the following formula:
		- A – (AxB /C), where:
			* A is equal to the capital gain otherwise determined;
			* B is equal to the sum of one plus the numbers of years the property is designated as the individual’s principal residence and during which the individual was resident in Canada; and
			* C is equal to the number of years the property has been owned by the individual
		- **Note:** If the individual was not a resident of Canada during the year the principal residence was acquired, variable “B” is equal to the number of years the property is designated as the individual’s principal residence and during which the individual was resident in Canada
* **Sample Problem**
	+ An individual acquired a residential property in 2009 for $100,000
	+ The property has a current market value of $250, 000 and an adjusted cost base of $100,000
	+ During the entire period the individual owned the property he or she used it as a principal residence
	+ If the individual disposes of the property in 2020 for $250, 000, and does not designate the property as their principal residence, what is their capital gain?
		- Capital Gain = Proceeds of Disposition – Adjusted Cost Based
		- Capital Gain = $250, 000 - $100, 000 = **$150, 000**
	+ If the individual designates the property as their principal residence for the years 2009 through 2019, the individual will be deemed to have realized a capital gain on the disposition of the property equal to:
		- A – (AxB / C),
			* A is equal to the capital gain otherwise determined or $150, 000
			* B is equal to the sum of one plus the number of years the property is designated as the individual’s principal residence and during which the individual was resident in Canada; and
				+ B would be equal to 12 which is 1 + 11 (the number of years the property was designated as the individuals principal residence)
			* C is equal to the number of years the property has been owned by the individual
				+ C is equal to 12, the number of years the property has been owned
		- = $150, 000 – [$150, 000 x (11+1) / 12]
		- = $150, 000 – $150, 000
		- = **$0**
			* Accordingly, the application of the principle residence exemption in paragraph 40(2)(b) has eliminated the capital gain
			* The individual only needed to designate the property as their principle residence for 11 of the 12 years they owned the property. This is because variable B is the sum of 1 plus the number of years the property is designated. As such, the taxpayer’s gain is eliminated even though they did not designate the property as their principle residence for each year they owned it. Is this odd? What is the reason for the plus 1 in variable B, why is the plus 1 removed from variable B if the individual was a non-residence when they purchased the property?
				+ It is added in there to compensate for transition time – if you buy a new property you may not move into it right away
* In order to designate a residential property as a “**principle residence”** for any particular taxation year
	+ It must have been ordinarily inhabited by an individual or by his or her spouse, common-law partner or child, throughout the year; and
	+ No other property can have been designated as a principal residence for the particular year by the individual or the individual’s spouse, common-law partner or minor child
* The principal residence is deemed to include the land on which the housing unit (other than a share of the capital stock of a co-operative housing corporation) is situated, the land subjacent to the housing unit and such portion of any immediately contiguous land as can reasonably be regarded as contributing to the use and enjoyment of the housing unit as a residence
* If the total area of the land exceeds one-half hectare (about 1.2 acres), the excess land is deemed not to have contributed to the use and enjoyment of the housing unit as a residence unless the individual establishes that it was necessary to such use and enjoyment
	+ **Note:** Where the zoning laws restrict residential lot sizes to a minimum size greater than one-half hectare, the excess land is generally considered necessary to such use and enjoyment – *Cassidy v. The Queen,* 2011 FCA 271; *Canada v. Yates*
* The principal residence does not have to be the individual’s primary residence and can be a recreational property, such as a cottage, even if the residence is only inhabited for short periods of time, provided the individual’s main purpose for owning the property is personal use and not to earn income
	+ A cottage that is used primarily as a rental property WOULD NOT qualify as a principal residence
* Where an individual owns more than one property, there may be some benefit in electing two or more of those properties as their principal residence in order to maximize tax savings
* If part of your principal residence is used to earn or produce income, CRA’s normal practice is to treat the entire property as a principal residence, where all the following conditions are met:
	+ The income-earning use is secondary to the main use of the property as a residence;
	+ There is no structural change to the property in relation to the income earning use; and
	+ No capital cost allowance (CCA) is claimed on the property
* Where the above conditions are not met, the partial use of your principal residence for an income-earning purpose may result in a change in use and a deemed disposition of the part of the property converted to an income earning use
* Special rules apply in respect of a change in use of a property from a principal residence to an income earning property or from an income earning property to a principal residence – See subsections 45(3), 45(3), 45(4) and the definition of principle residence in section 54- **These rules will not be discussed in this course**
* If only a portion of the property qualifies as a principal residence, it is necessary to reasonably apportion the proceeds of disposition and that adjusted cost base between the part that qualifies as a principal residence and the part that does not
* The principal residence exemption only applies to a disposition of capital property
	+ As such, if a residence is disposed of while carrying on a business or as an adventure or concern in the nature of trade, the principal residence exemption does not apply
* It is necessary to report the disposition in your tax return for the taxation year in which the property was sold. **Note:** prior to 2016, CRA did not require this
* *Income Tax Folio S1-F3-C2*, Principal Residence

## Allowable Capital Losses

* **Paragraph 3(b)**
	+ 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:

(b) determine the amount, if any, by which (this is the **net taxable capital gain**)

1. the total of
	* 1. all of the taxpayer’s taxable capital gains for the year from dispositions of property other than listed personal property, and
		2. the taxpayer’s taxable net gain for the year from dispositions of listed personal property,

Exceeds

1. … the taxpayer’s **allowable capital losses** for the year from dispositions fo property other than listed personal property
* **Allowable Capital Loss – Paragraph 38(b)**
	+ For the purposes of this Act,

…

(b) a taxpayer’s allowable capital loss for a taxation year from the disposition of any property is ½ of the taxpayer’s capital loss for the year from the disposition of that property…

* **Capital Loss – Paragraph 39(1)(b)**
	+ For the purposes of this Act,

(b) … the taxpayer’s capital loss for a taxation year from the disposition of any property is the taxpayer’s loss for the year… (to the extent of the amount thereof that would not [otherwise] be deductible in computing the taxpayer’s income for the year or any other taxation year) from the disposition of any property…”

* + - This would be the case where the loss is deductible in computing the taxpayer’s income from a business
* **Paragraph 40(1)(b)**
	+ Except as otherwise expressly provided in this Part,

(b) a taxpayer’s loss for a taxation year from the disposition of any property is the amount, if any, by which

(i) … the total of the adjusted cost base to the taxpayer of the property immediately before the disposition and any outlays and expenses to the extent that they were made or incurred by the taxpayer for the purpose of making the disposition, exceeds the taxpayer’s proceeds of disposition…

* A taxpayer’s gain or loss from the disposition of a chance to win or a right to receive an amount as a prize in connection with a lottery scheme is deemed to be nil – **subsection 40(2)(f)**
* A loss from the disposition of personal-use property (other than listed personal property) is deemed to be nil – **subsection 20(2)(g)(iii)**

## Net Capital Losses

* “**net capital loss”** of a taxpayer for a taxation year is defined in **subsection 111(8)**
	+ A taxpayer’s net capital loss for the year is the amount by which the taxpayer’s allowable capital losses for that year exceed the aggregate of the taxpayer’s taxable capital gains and taxable net gains from the disposition of listed personal property
* Can be carried back 3 years or forward indefinitely – **paragraph 111(1)(c)**
	+ Carrying a loss forward means that you can deduct the loss in a future taxation year
	+ Carrying a loss back required the taxpayer to file an amended tax return fort the previous taxation year and deduct the loss in that amended return
* Are only deductible if the taxpayer has realized a net taxable capital gain in the year- **subsection 111 (1.1)**
* Losses from older year must be used before net capital losses from more recent years – **para 111(3)(b)**

# ~~Jurisdictional Bases for Income Taxation and Determining Residence for Canadian Income Tax~~

## ~~Jurisdictional Bases for Taxation~~

* ~~There are 4 common bases used for income tax purposes: Citizenship, Domicile, Residence and Source of Income~~
* ~~Taxation based on citizenship, residence or domicile is a tax on “world-wide income” meaning income earned anywhere in the world~~
	+ ~~These are justified by the connection the taxpayer has to the country imposing the tax~~
	+ ~~Tax on “world-wide” income is consistent with the ability to pay principle~~
		- ~~Doesn’t matter if money is earned, stored, or located elsewhere, if it is your income, you will be taxed on it in Canada~~
* ~~In contrast, when a person does not have sufficient nexus to a country to justify taxation of their world-wide income based on citizenship, domicile or residence, the person may still be liable to income that is earned in the country or derived from a source in the country~~

### ~~Citizenship~~

* ~~Justification to tax is based on the notion of~~ **~~political allegiance~~** ~~–idea that individuals who are citizens of a country have an obligation to support the State through taxation no matter where they live in the world~~
* ~~Even non-resident citizens benefit from their citizenship because individuals continue to receive many of the rights and benefits of citizenship even when they are residing outside the country~~
* ~~Easy to determine who is/is not taxed because it is easy to determine citizenship relative to their place of citizenship or domicile~~
* ~~Uncommon basis of taxation and is used by a few countries (US- citizen must pay taxes regardless if they live there b/c they still benefit)~~

### ~~Domicile~~

* ~~Domicile refers to a taxpayer’s permanent, legal address; the place they intend to make their home for an indefinite period~~
	+ ~~It does not mean where you are living at the time, but rather where is your permanent home?~~
* ~~Loosely based on concepts of social and economic connections between the taxpayer and taxing jurisdiction~~
* **~~A person may have only one domicile at a single point in time (unlike residency)~~**
* ~~Difficult to administer and easy to abuse; determining the intention of the taxpayer raises difficult questions of proof and an individual who is residing but not domiciled in a country that uses domicile as a basis for taxation is generally only taxable on income and gains owned outside the country on a remittance basis. So, individual who leaves their investment offshore may be able to avoid tax on them~~
	+ ~~If you are resident of another country, but domicile in UK, only taxed on money you bring into UK, so can park money offshore~~
	+ ~~Can say that you intend to live permanent in UK, but live elsewhere for 20 years, never bring money into UK and never pay tax~~
	+ ~~If you are resident in UK, but not domicile in the UK, you are only taxed on the income you bring in. Therefore, you could keep a lot of money offshore. As a result, the UK has introduced many anti-avoidance rules such as the deemed domicile rules in 2017~~
* ~~May exclude individuals who have lived in the country for a long period of time but do not intend to stay permanently~~

### ~~Residence~~

* ~~Most common basis for domestic taxation (Canada and most countries use this)~~
* ~~Justification to tax is based on the social and economic connection between the person and the taxing jurisdiction~~
* ~~Can be determined using more or less objective criteria~~
* ~~The stated intention of the taxpayer is of limited relevance~~
* **~~A taxpayer can be resident in more than one country at the same time~~** ~~(~~*~~Thomson)~~*
	+ ~~The Canadian rules treat you as a resident of that jurisdiction for tax purposes and non-resident in others.~~
	+ ~~There are a series of tests to apply where you are “ultimately” resident~~
* ~~Canada taxes primarily based on residence~~
	+ ~~This is reflected in subsection 2(1) of the~~ *~~Income Tax Act~~*
		- ~~“An income tax shall be paid on the taxable income for each taxation year~~ **~~of every person resident in Canada~~** ~~at any time in the year~~

### ~~Source of Income (or “Source Taxation”)~~

* ~~Even if a person does not have a sufficient nexus to a country to justify taxation of their world-wide income based on citizenship, domicile or residence, the person may still be liable to tax on any income that is earned in the country or derived from a source in the country~~
* ~~Justification to tax is based on the connection between the income and the taxing jurisdiction~~
	+ ~~Corporation pays dividends to non-resident SH. Although SH not resident, corporation is, and so, income has a connection.~~
* ~~When you are not a resident, source of income becomes especially important for establishing that connection~~
* ~~Source of income can impose tax on a taxpayer where he does not have a sufficient nexus to the country in which the income is earned~~

## ~~Taxation of Non-residents~~

* ~~Non-residents can be taxed in a variety of ways pursuant to the following rules:~~

### ~~Subsection 2(3)- Tax payable by non-resident persons~~

* ~~Where a person who is not taxed under subsection (1) for a taxation year,~~
	+ ~~Was employed in Canada,~~
	+ ~~Carried on a business in Canada, or~~
	+ ~~Disposed of a taxable Canadian property,~~

~~at any time in the year or previous year, an income tax shall be paid on the person’s taxable income earned in Canada for the year~~

###  ~~Part XIII~~

* ~~Withholding tax on payments of certain types of Canadian source income to non-residents (e.g. dividends, interest) paid to them by a person in Canada~~
* ~~Where taxpayer is a non-resident, Part XIII may require the resident to remit that tax on behalf of non-resident to ensure collection~~
	+ ~~E.g. A non-resident earns dividends from a Canadian corporation. The corporation pays the non-resident the dividend less withheld tax. The non-resident then claims a tax credit for that amount in the foreign jurisdiction.~~

## ~~Residence of Individuals~~

* ~~The term “resident” is not defined in the~~ *~~Income Tax Act~~*
* **~~Subsection 250(3)-~~** ~~reference to a person resident in Canada includes a person who was at the relevant time ordinarily resident in Canada~~
* **~~Subsection 250(3)~~** ~~has been interpreted as an expansion of the term “resident” to include an individual who is not at the relevant time physically present in Canada –~~ ***~~The Queen v K.F. Reeder~~*~~, 75 DTC 5160 (FCTD)~~**
	+ **~~Issue:~~** ~~Whether a Canadian resident, who temporarily moved to France, was still resident in Canada while he was living in France~~
	+ ~~Comes down to social & economic connections. If someone not physically present in Canada has not socially and economically separated themselves from Canada, they may be found to be “ordinarily resident” and as a result, required to pay taxes~~
	+ ~~It is for this reason that treaties exist to break ties for taxation purposes.~~
* ~~“It is my opinion that subsection 250(3) of the Act is not a deeming clause and the plain meaning of the words used therein bespeaks an intention to extend any narrow or limited signification of residence in the sense of actual physical presence at any given time to the circumstantial concept of the person who has centralized his ordinary mode of living at some place in Canada or has maintained a sufficient nexus or connection therewith as to be logically regarded as being ordinarily resident in Canada, even though physically absent therefrom.” (McNair, J. in~~ *~~Robert Leslie Midyette v The Queen~~*~~)~~
	+ ~~You do not have to be physically present to be ordinary resident of Canada~~

#### ~~Thomson v MNR, 1946 (SCC) – meaning of “resident” in ITA~~

**~~Facts:~~** ~~Thomson was a wealthy Canadian living in New Brunswick. He sold his home in 1923 and declared his intention to be a resident of Bermuda. After leaving Canada, he spent most of his time in the US and spent little time in Bermuda. He built a house in the US, which he always kept available for occupancy. In 1932, he started taking frequent trips to New Brunswick, staying all summer. He eventually built a second house in New Brunswick, which he always kept available for his use. He always spent less than 183 days in Canada a year. His wife and child travelled with him to Canada.~~

**~~Issue:~~** ~~Was the taxpayer liable to pay tax pursuant to s. 9 of the~~ *~~IWTA~~*~~?~~

* **~~Section 9 of the~~ *~~Income War Tax Act~~***
	+ ~~There shall be assessed, levied, and paid upon the income during the preceding year of every person~~
		1. ~~Residing or ordinarily resident in Canada during such year; or~~
		2. ~~Who sojourns in Canada for a period or periods amounting to one hundred and eighty-three days during such year~~
* ~~Since Thompson had not spent 183 days or more in Canada that year, the issue for the court was whether he was ordinarily resident~~

**~~Held:~~** ~~Yes, he was ordinarily resident in Canada.~~

**~~Reasons:~~**

* ~~“A reference to the dictionary and judicial comments upon the meaning of these terms indicates that one is~~ **~~“ordinarily~~****~~resident”~~** ~~in the place where in the settled routine of his life he regularly, normally or customarily lives. One~~ **~~“sojourns”~~** ~~at a place where he unusually, casually, or intermittently visits or stays. In the former the element of permanence, in the latter that of the temporary predominates. The difference cannot be stated in precise and definite terms, but each case must be determined after all relevant factors are taken into consideration, but the foregoing indicates in a general way the essential difference. It is not the length of the visit or stay that determined the question… It is well established that a person may have more than one residence…” (Estey J.)~~
	+ ~~Fact dependent analysis. All factors will be taken into consideration, with some factors weighing more than others.~~
* ~~“The expression~~ **~~“ordinarily resident”~~** ~~carries a restricted signification, and although the first impression seems to be that of preponderance in time, the decisions on the English Act reject that view. It is held to mean residence in the course of the customary mode of life of the person concerned, and it is contrasted with special or occasional or causal residence. The general mode of life is, therefore, relevant to a question of its application.”~~
	+ ~~Ordinarily resident is not a temporary stay or vacation. It is where you have strong social and economic connections.~~
* ~~“… in the different situations of so-called ‘permanent residence’, ‘temporary residence’, ‘ordinary residence’, ‘principal residence’ and the like, the adjectives do not affect the fact that there is in all cases residence;~~ **~~and that quality is chiefly a matter of the degree to which a person in mind and fact settled into or maintains or centralizes his ordinary mode of living, with its accessories in social relations, interests and conveniences at or in the place in question~~**~~. It may be limited in time from the outset, or it may be indefinite, or so far as it is thought of, unlimited. On the lower level, the expressions involving residence should be distinguished, as I think they are in ordinary speech, from the field of ‘stay or visit’”.~~
	+ ~~Residency has nothing to do with citizenship or legal right to be in a jurisdiction, it is about your centralized social and economic connections. If you establish those social and economic connections, then you will be a resident.~~
* ~~“For the purpose of income tax legislation,~~ **~~it must be assumed that every person has at all times a residence~~**~~. It is not necessary to this that he should have a home or a particular place of abode or even a shelter. He may sleep in the open. It is important only to ascertain the spatial bounds within which he spends his life or to which his ordered or customary living is related…” (Rand J.)~~
* **~~Meaning of Resident~~**
	+ ~~1.5 – Resident is not defined in the Act, however, its meaning has been considered by Courts. Leading decision on the meaning of resident is~~ *~~Thomson v Minister of National Revenue~~*~~, [1946] SCR 209, 2 DTC 812. In this decision, Rand J. of Supreme Court of Canada held residence to be “a matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question.”~~
		- ~~Income Tax Folio – S5-F1-C1: Determining an Individual’ Residence Status~~

#### ~~Denis M. Lee v. MNR, 1990 (TCC)~~

**~~Facts:~~** ~~Lee was a UK citizen employed by a non-resident corporation performing work outside Canada. Employment income was deposited directly into a bank account in Canada. Lee regularly returned to Canada as a visitor because he was not legally allowed to work or permanently reside there. He eventually married a Canadian citizen and resident, Cathy Lewis, who had no income and was dependent on Lee. Lewis purchased a house in Canada as their matrimonial home with money Lee provided. Lee acted as guarantor for a mortgage on the house. In connection with obtaining the mortgage, Lee swore an affidavit stating he was not a non-resident of Canada. Minister reassessed Mr. Lee as a resident of Canada.~~

**~~Issue:~~** ~~Was Mr. Lee resident in Canada for income tax purposes even though he was not legally allowed to work or permanently reside in Canada?~~

**~~Held:~~** ~~Yes, Lee was ordinarily resident in Canada~~

**~~Reasons:~~** ~~“[Mr. Lee] claims that he did not want to be a resident of Canada during the years in question. Intention, or free choice is an essential element in domicile, but is entirely absent in residence.”~~

* + ~~We do not consider subjective intention, but rather we look at objective intention based on the facts~~
* ~~“After considering all relevant factors and applying the law, I am satisfied that the appellant at the beginning of 1981 was a resident of Canada. The appellant was obviously a resident of Canada on September 13, 1982 not only because he swore he was not a non-resident but he also on that day guaranteed the mortgage on the residence that became on marriage the matrimonial residence. The question for determination is at what time between January 1, 1981 and September 13, 1982 did the appellant become a resident of Canada. Although marriage can be a neutral factor, in this case it is the additional factor that tips the scales from one of non-residency to one of residency.”~~

**~~Ratio:~~** ~~Determining residency depends on the specific facts and circumstances. There are numerous indicia that are relevant in determining whether an individual is resident in Canada. No single factor, nor any group of them, is alone determinative of the issue. These factors include:~~

* ~~Past and present habits of life~~
* ~~Regularity and length of visits to Canada (or the jurisdiction asserting residence)~~
* ~~Ties within the jurisdiction and elsewhere~~
* ~~Ownership of a dwelling in Canada or rental on a long-term basis~~
* ~~Residence of a spouse, children and other dependent family members in a dwelling maintained by the individual in Canada~~
* ~~Memberships with Canadian churches or synagogues, recreational and social clubs, unions and professional organizations~~
* ~~Registration and maintenance of automobiles, boats and airplanes in Canada~~
* ~~Holding credit cards issued by Canadian financial institutions and other commercial entities including stores, car rental agencies, etc.~~
* ~~Local newspaper subscriptions sent to a Canadian address~~
* ~~Rental of Canadian safe deposit box or post office box~~
* ~~Subscriptions for life or general insurance including health insurance through a Canadian insurance company~~
* ~~Mailing address in Canada~~
* ~~Telephone listing in Canada~~
* ~~Stationary including business cards showing a Canadian address~~
* ~~Canadian bank accounts other than a non-resident bank account~~
* ~~Active securities accounts with Canadian brokers~~
* ~~Canadian driver’s license;~~
* ~~Membership in a Canadian pension plan~~
* ~~Holding directorships of Canadian corporations~~
* ~~Membership in Canadian partnerships~~
* ~~Frequent visits to Canada for social or business purposes~~
* ~~Burial plot in Canada~~
* ~~Will prepared in Canada~~
* ~~Legal documentation indicating Canadian residence~~
* ~~Filing a Canadian income tax return as a Canadian resident~~
* ~~Ownership of a Canadian vacation property~~
* ~~Active involvement in business activities in Canada~~
* ~~Employment in Canada~~
* ~~Maintenance or storage in Canada of personal belongings including clothing, furniture, family pets, etc.~~
* ~~Obtaining landed immigrant status or appropriate work permits in Canada~~
* ~~Severing substantially all ties with former country of residence~~

**~~Significance:~~** ~~An individual’s citizenship, nationality or immigration status are generally not relevant in determining if they are resident in Canada.~~

## ~~Deemed Residence – Subsection 250(1)~~

* ~~Even if an individual is not considered resident under the common law test, they may still be deemed resident under~~ **~~s. 250(1)~~**
* ~~For the purposes of this Act, a person shall … be deemed to have been resident in Canada throughout a taxation year if the person~~
	+ ~~(a) sojourned in Canada in the year for a period of, or periods the total of which is, 183 days or more;…~~
* **~~Subsection 250(1)~~** ~~also generally applies to deem an individual to be resident in Canada if that individual:~~
	+ ~~Is a member of the Canadian Forces (even throughout their deployment) –~~ **~~paragraph 250(1)(b)~~**
	+ ~~Holds one of several appointments or employments within the federal or provincial government and was resident in Canada immediately prior to their appointment or employment -~~**~~paragraph 250(1)(c)~~**
	+ ~~Provided services outside of Canada under specified assistance programs funded by Canadian government –~~**~~paragraph 250(1)(d)~~**
	+ ~~Or was a dependent child of an individual referred to above –~~ **~~paragraph 250(1)(f)~~**

### ~~“Sojourn”~~

* ~~Oxford Canadian Dictionary – “a temporary stay”~~
* ~~“One ‘sojourns’ at a place where he unusually, casually or intermittently visits or stays” (~~*~~Thomson v MNR~~*~~)~~
* ~~“In the Shorter Oxford English Dictionary, the meaning of ‘sojourn’ is given as ‘to make temporary stay in a place; to remain or reside for a time’. In pursuing numerous cases decided by the Canadian & British Courts, it is obvious that coming from one country to work for the day at a place of business in another country and thereafter returning to one’s permanent residence in the evening, is not tantamount to making a temporary stay in the sense of establishing even a temporary residence in the country where the business enterprise is situated”~~
	+ *~~R&L Food Distributors v MNR~~* ~~(TRB)~~
		- **~~Facts:~~** ~~Whether 2 individuals commuting to work daily from US were sojourning and deemed to be resident in Canada~~
		- **~~Held:~~** ~~The individuals were not sojourning in Canada~~

## ~~Part-Time Residents~~

* **~~S. 2(1)-~~** ~~Income tax shall be paid on the~~ **~~taxable income~~** ~~for each taxation year of every person resident in Canada~~ **~~at any time in the year~~**~~.~~
* **~~S. 2(2)- taxable income~~** ~~of a taxpayer is taxpayer’s income for the year + additions and minus deductions permitted by Division C.~~
* ~~Therefore, an individual is liable to tax for their taxable income for the whole year if they were resident in Canada at any time during the year. What happens if they become resident in Canada or seizes to be resident in Canada at some point during the year? Are they liable to tax for all income they earned during the year including any income they earned during the part they were not resident? -~~**~~NO~~**
* **~~Section 114- Part-Time Residents~~**
	+ **~~Notwithstanding subsection 2(2)~~**~~, the taxable income for a taxation year of an individual who is resident in Canada throughout part of the year and non-resident throughout another part of the year is the amount…~~
		- ~~S. 114(a) to (c) operate to compute the part-time resident’s taxable income as an aggregate of their taxable income computed accordance with the normal rules applicable to residents for the period they were resident and computed in accordance with the special rules for non-residents in section 115 for the period they were not resident~~
	+ ~~This issue usually only comes up for immigrants~~
	+ ~~Does not apply to sojourners who aren’t deemed residents, even though they are present in Canada for part of year (~~*~~Schujahn~~*~~)~~

## ~~Sojourning and Section 114~~

* **~~P. 250(1)(a)~~** ~~deems an individual to be resident in Canada~~ **~~throughout a taxation year~~** ~~if they sojourn in Canada for 183 days or more~~
* ~~As such, a deemed resident is not entitled to relief under section 114 even though they may only be in Canada for part of the year~~
	+ ~~S.114 only applies if the individual was resident in Canada throughout part of the year and non-resident during another part~~
* ~~If the individual is also resident in a country with which Canada has an income tax treaty, the treaty tie breaker rules and~~ **~~subsection 250(5)~~** ~~will normally operate to override the application of paragraph 250(1)(a)~~

## ~~Who is a Part-Time Resident?~~

* ~~To determine if an individual is a part-time resident, the relevant facts and circumstances must indicate that the individual became or seized to be a resident of Canada throughout the year.~~

#### ~~Schujahn v. MNR. 1962 (Exch. Ct.)~~

**~~Facts:~~** ~~Schujahn was an American citizen and a senior executive of US company. He moved to Canada with wife and son in 1954 to take charge of a Canadian subsidiary. On August 2, 1957 he left Canada and returned to the US. Although he had listed his house in Canada for sale, it had not sold by the time he left. He relocated to the US, leaving his wife and son behind to facilitate the sale of the home which occurred February of 1958. He took his personal belongings with him but left a second car in Canada for his wife’s use and two Canadian bank accounts, which remained open until his family joined him in the US. He cancelled the membership he held in an athletic club in Toronto and renewed his membership at a club in the US. Prior to his family joining him he lived in temporary accommodations. He returned to Canada only a few times in 1957 to visit his family.~~

**~~Issue:~~** ~~Did Mr. Schujahn cease to be a resident of Canada on August 2, 1957?~~

**~~Held:~~** ~~Yes, S became a non-resident of Canada when he returned to the US on August 2, 1957~~

**~~Reasons:~~** ~~This case was not decided based on his subjective intentions, but rather the objective evidence. The only social and economic connection that S maintained in Canada was his house which was still up for sale. To finalize the sale of his house, it was practical to leave behind his wife and child and have a car and bank account for them. On the totality of the facts, S had sufficiently severed his connections to Canada~~

* ~~“The majority of the cases reviewed dealt with taxpayers whose original abode was either in the UK or Canada and who took up residence in other countries… In the present instance we are dealing with the case of a man whose original residence was in US; he was sent to Canada to take charge of a new operation for his company and once the Canadian company was properly set up and running smoothly, he was called back to the parent company to take over new responsibilities and there and then, but for the sale of his house in Toronto, severed himself entirely from Canada.”~~
* ~~“From the evidence, I am satisfied that the only reason why the appellant’s wife and son remained in Toronto until February 1958 was for the sole purpose of ensuring the sale of the house and that the remaining two bank accounts, one for the mortgage payments and the other for his wife’s household expenses, as well as the use of one of his cars by his wife, was a logical consequence of the necessary means taken by him to sell his house in Toronto.”~~
* ~~“Had the retention of the house in Toronto and the fact that the appellant’s wife and child remained there been indicative of something other than that of wishing to sell the house without sustaining too great a loss, I would be inclined to hold as a matter of fact that the appellant had two residences for taxation purposes… However, such is not the case, indeed from the evidence it appears that as of August 2, 1957 the house in Toronto became, as far as the appellant is concerned, merely a house to sell and his wife and son remained there for that sole purpose, departing as soon as it was sold.”~~

**~~Question:~~** ~~If S was present in Canada from January 1~~~~st~~~~, 1957, until August 2~~~~nd~~~~, 1957 (213 days) why was he not deemed to be resident in Canada?~~

* ~~Remember, Section 250(1)(a) says that someone who sojourns in Canada for 183 days is deemed to be a resident in Canada~~
* ~~The notion of part time resident is that if you cease to be resident during the year, you are subject to tax during the part of the year you are resident as a resident of Canada and you are subject to tax for the part you are non-resident in Canada as a non-resident of Canada~~
* ~~You cannot be a resident and a sojourner at the same time. They are mutually exclusive.~~
	+ ~~On January 1, 1957, S became a resident of Canada, regardless of how many days he was present in Canada, because he had sufficient social and economic ties to the country. Therefore, there is no need to deem him a resident under Section 250(1).~~
	+ ~~On August 2, 1957, S severed his ties and became a non-resident, regardless of how many days he was present in Canada because he was never a deemed resident.~~
	+ ~~After August 2, 1957, when S was a non-resident, he became a sojourner whenever he would visit his family. If he had then visited for 183 days or more, then he would have become a deemed resident.~~
* ~~S. 114 does not apply to sojourners who are not deemed residents, even though they are present in Canada for part of the year~~
	+ ~~However, if sojourner is resident in a country that has an income tax treaty with Canada, then treaty will normally provide relief.~~

## ~~Provincial Residence~~

* ~~Determining individual’s province of residence is done using same common law rules. However, unlike federal income tax where individual is only taxable in Canada on income earned during any period of the year individual was/was not deemed to be resident, individual is generally liable for provincial tax on income for entire year in the province where individual was resident on last day of the taxation year~~
* **~~Regulation 2601~~**
	+ **~~(1)~~** ~~Where an individual resided in a particular province on the last day of a taxation year and has no income for the year from a business with a permanent establishment outside the province, his income earned in the taxation year in the province is his income for the year (where you live and earn income in one province)~~
		- ~~As such, if an individual is resident in more than one province throughout the taxation year, they are taxable on their income earned in that taxation year only in the province of residence on the last day of the taxation year~~
		- ~~Normal scenario: If you are in ON on the last day of the year and you have earned no business income from another jurisdiction, then all of your income for the year is provincially taxed in ON~~
		- ~~Exception of business income: Business income is apportioned among provinces in which it is earned through a permanent establishment (i.e. a physical place or person; shopping orders is not enough). The main exception to this is where the individual has, in the year, earned income from a business with a permanent establishment outside the province where they are resident on the last day of the year~~
	+ **~~(2)~~** ~~Where an individual resided in a particular province on the last day of a taxation year and had income for the year from a business with a permanent establishment outside the province, his income earned in the taxation year in the province is the amount, if any, by which~~
		- ~~(a) his income for the year exceeds (b) the aggregate of his income for the year from carrying on business earned in each other province….~~
			* ~~Income in ON = Total income – Income in BC – Income in AB~~
	+ **~~(3)~~** ~~Where an individual, who resided in Canada on that last day of a taxation year and who carried on business in a particular province at any time in the year, did not reside in the province on the last day of the year, his income earned in the taxation year in the province is his income for the year form carrying on business earned in the province…~~
		- ~~Where you live in one province, but earn income in multiple provinces, what do you pay in those other provinces?~~
			* ~~E.g. Income in BC= BC Income~~
* **~~Regulation 2603~~**
	+ **~~(1)~~** ~~Where, in a taxation year, an individual had a permanent establishment in a particular province and had no permanent establishment outside that province, the whole of his income from carrying on business for the year shall be deemed to have been earned therein.~~
	+ **~~(2)~~** ~~Where, in a taxation year, an individual had no permanent establishment in a particular province, no part of his income for the year from carrying on business shall be deemed to have been earned therein~~
		- **~~Difference between Reg 2601 and 2603:~~** ~~Where an individual carried on business in multiple provinces, Regulation 2603 provides rules for allocating the income among those provinces~~
			* ~~Regulation 2603 only applies to business income~~
* **~~Regulation 2600~~**
	+ **~~(2)~~** ~~In this Part,~~ **~~“permanent establishment”~~** ~~means a fixed place of business of the individual, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse, and~~
		- ~~(a) where individual carries on business through an employee/agent, established in particular place, who has authority to contract for his employer/principal or who has a stock of merchandise owned by his employer/principal from which he regularly fills orders which he receives, individual shall be deemed to have a permanent establishment in that place;~~
		- ~~(b) where an individual uses substantial machinery or equipment in a particular place at any time in a taxation year, he shall be deemed to have a permanent establishment in that place; and~~
		- ~~(c) the fact that an individual has business dealing through a commission agent, broker or other independent agent or maintains an office solely for the purchase of merchandise, shall not of itself be held to mean that the individual has a permanent establishment….~~

## ~~Corporate Residence~~

* **~~Subsection 250(4)- Deemed Residence~~**
	+ ~~For the purposes of this~~ *~~Act~~*~~, a corporation shall be deemed to have been resident in Canada throughout a taxation year if~~
		- ~~(a) in the case of a corporation incorporated after April 26, 1965, it was incorporated in Canada~~
		- ~~(c) in the case of a corporation incorporated before April 27, 1965… it was incorporated in Canada, and at any time in the taxation year or at any time in any preceding taxation year of the corporation ending after April 26, 1965, it was resident in Canada or carried on business in Canada~~
			* ~~(c) means there is an exception to the deemed residence of a corporation for any corporation that was incorporated before April 27, 1965 unless that corporation was found to be resident in Canada or to have carried on business in Canada during any taxation year after April 26, 1965~~
* **~~Common Law Residence~~**
	+ ~~If the residence of a corporation is not deemed under~~ **~~subsection 250(4),~~** ~~the residence of the corporation is determined by the common law meaning the residence of corporation is in the place where its central management and control (~~*~~“mind and management test”~~*~~) is exercised –~~ *~~De Beers Consolidated Mines Limited v Howe~~*
	+ ~~This will normally be the place where the corporation’s board of directors meets~~
	+ ~~The management and control of a company can be exercised otherwise than by its directors and otherwise than under or according to the authority of its Constitution -~~ *~~Unit Construction Co. Ltd. v Bullock~~*
	+ ~~A corporation can have more than one residence if its central management and control is located in more than one country. A corporation can have more than one residence for tax purposes (~~*~~Landbouwbedriif Backx BV v The Queen~~*~~, 2018 TCC)~~
		- ~~Tie breaker rules also exist here to determine residency between jurisdictions~~

#### ~~De Beers Consolidated Mines Limited v. Howe, [1906] T.C. 198 (H.L.)~~

**~~Facts:~~** ~~A company was incorporated in South Africa, had its Head Office in South Africa and carried on mining operations in South Africa. A majority of its board of Directors lived in England, and they always met in England to make decisions about the important business of the company.~~

**~~Issue:~~** ~~Was the company resident in the United Kingdom for tax purposes?~~

**~~Held:~~** ~~The company was found to be resident in the United Kingdom for tax purposes~~

**~~Ratio:~~** ~~Outlined the “~~*~~mind and management test”.~~*~~House of Lords concluded that the appropriate basis for determining the residence of a corporation is not its “country of incorporation”, but rather, “where the central management and control “actually abides”.~~

**~~Reasons:~~** ~~Since directors’ meetings which were held in UK were where the control was exercised, company was a resident of the UK for tax purposes.~~

#### ~~Unit Construction Co. Ltd. v Bullock, [1960] A.C. 351~~

**~~Facts:~~** ~~3 companies incorporated in Kenya, carried on business in Kenya and directors resided & held meetings in Kenya. Companies shared a parent company in UK. Directors of parent company managed and controlled Kenyan companies, although irregularly and not authorized by Constitutions.~~

**~~Held:~~** ~~Companies were found to be resident in the United Kingdom~~

**~~Reasons:~~** ~~The companies were found to be resident in the UK because they were in fact managed and controlled from UK by the directors of parent company even though such management and control was exercised irregularly and was not authorized by the constitutions of the companies.~~

## ~~Residence of Trusts~~

* ~~The residence of a trust is a question of fact and depends on the circumstances of each particular case~~
* ~~Like individuals and corporations, a trust can also be resident in more than one country at the same time~~
* ~~Before 2009 a trust was normally found to be resident where majority of its trustees were resident –~~ *~~Thibodeau Family Trust v. The Queen~~*
* ~~In a 2009 decision, Justice Woods disagreed with the commonly accepted position that the decision in~~ *~~Thibodeau~~* ~~supports a test for trust residence based solely on the residence of the trustees:~~
	+ ~~“The preferrable approach to a test based on the resident of trusts is to apply the same test applicable to the determination of a corporation’s residence, namely “where the central management and control actually abides”~~
		- *~~Garron Family Trust v. The Queen~~*~~, 2009 TCC 450~~
* ~~The decision in~~ *~~Garron~~* ~~was affirmed by the FCA and the SCC~~
	+ *~~St. Michael’s Trust Corp. v. Canada,~~* ~~2010 FCA 309~~
	+ *~~Fundy Settlement v. The Queen~~*~~, 2012 SCC 14 -~~**~~leading case on determining the residence of a trust~~**
* **~~Income Tax Folio S6-F1-C1: Residence of a Trust or Estate~~**
	+ ~~1.1 The residence of a trust in Canada, or in a particular province or territory within Canada,~~ **~~is question of fact~~** ~~to be determined according to the circumstances of each case~~
	+ ~~1.2 The SCC (~~*~~Fundy Settlement v Canada~~*~~) has clarified that the residence of a trust will be determined by the principle that~~ **~~a trust resides where its real business is carried on, which is where the central management & control of trust actually takes place.~~**
	+ ~~1.3~~ **~~Usually the management and control of the trust rests with, and is exercised by, the trustee, executor, liquidator, administrator, heir or other legal representative of the trust.~~** ~~Trustee refers to any such person in relation to a trust. In~~ *~~Fundy Settlement~~*~~, the SCC affirmed the view that the residence of a trustee does not always determine the residence of a trust.~~

## ~~Tie Breaker Rules in Tax Treaties~~

* ~~Because most countries levy tax on residents and non-residents it is not uncommon that a taxpayer will be liable for tax on the same amount of income in 2 different countries. It is often the case where they are taxable on their income on the basis of residence in one country and on the basis of source in the other country~~
* ~~Taxpayer may also be found to be resident in more than one country during the same year and therefore potentially liable for tax on their world-wide income in each country they are resident~~
* ~~Where a taxpayer is liable for tax on their income in more than one country, this is commonly referred to as~~ ***~~double taxation~~***
* ~~To resolve issues of double taxation, countries often enter into bilateral income tax treaties which generally operate to determine which country has the right to tax an amount of income or where both countries retain the right to tax, limit the tax that can be imposed~~
* ~~The application of an income tax treaty is premised on the assumption that a taxpayer is resident in only 1 of the country’s signatories to the treaty. As such, where a taxpayer is resident in both countries, it is first necessary to determine in which country the taxpayer is resident for the purpose of applying the treaty. This determination is normally made by applying a set of tie breaker rules within the treaty~~
* **~~Article IV(2) of the~~ *~~Canada-US Treaty~~*~~, 1980~~**
	+ ~~Where an~~ **~~individual~~** ~~is a resident of both Contracting States, then his status shall be determined as follows:~~
		- ~~(a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both states or in neither State, he shall be deemed to be a resident of the Contracting state with which his personal and economic relations are closer (center of vital interests);~~
		- ~~(b) If the Contracting State in which he has the center of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has a habitual abode;~~
		- ~~(c) If he has a habitual abode in both state or in neither State, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and~~
		- ~~(d) If he is a citizen of both states or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement~~
			* ~~“competent authority” refers to the office or agency that has authority to resolve treaty disputes. In Canada this is the Minister of National Revenue or the Minister’s authorized representatives~~
* ~~Canada’s income tax treaties also include tiebreaker rules for corporations and trusts~~

### ~~Habitual Abode~~

* ~~The meaning depends on the facts and circumstances of each case~~
* ~~Generally refers to the place where the taxpayer regularly, customarily or usually lives~~
	+ ~~Physical time spent in a location~~
	+ ~~Frequency of stay is a relevant consideration but is not determinative~~
* ~~“It would be unwise to attempt to set out a rule or a series of criteria which could fit all situations. The determination in each case will depend on the facts and circumstances of each case. The concept of “habitual abode”, as evidenced by the clearer French version of the text (~~*~~sejourne de facon habituelle~~*~~) involves notions of frequency, duration and regularity of stays of a quality which are more than transient. The concept refers to a stay of some substance in the jurisdiction as a matter of habit so that the conclusion can be drawn that this is where the taxpayer normally lives.” (~~*~~Lingle v. The Queen~~*~~, 2010 FCA 152)~~

### ~~Deemed Non-Residents~~

* ~~It is important to note that the determination of a taxpayer’s residence pursuant to the treaty tie breaker rules is only relevant for purposes of applying the provisions of the income tax treaty. As such, if a person resident in Canada is found to be resident in the other Contracting State and not resident in Canada under an income tax treaty, this determination does not, in itself, change the person’s status as a resident of Canada for purposes of the~~ *~~Income Tax Act~~*
* **~~Subsection 250(5)~~**
	+ ~~Notwithstanding any other provision of this Act…, a person is deemed not be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada~~
		- ~~Even if someone is resident in Canada, if a tax treaty deems them not to be resident, they are deemed a non-resident.~~

### ~~Relief from Double Taxation~~

* **~~Article XXIV of the Canada-US Treaty, 1980~~**
	+ **~~Elimination of Double Taxation~~**
		- ~~Requires Contracting States that are signatories to an income tax treaty to provide relief for tax properly paid to one State by a person resident in the other State~~
			* ~~But the functional relief is not found in the treaty, it is found in section 126(1) and (2) of the~~ *~~ITA~~*
		- ~~The relief can take the form of a credit for tax paid or an exemption for the income earned~~
			* ~~Canada offers a credit system which provides credit for any foreign tax paid. This allows tax to be applied at a higher rate. Essentially, taxpayer will pay the higher rate of tax in both jurisdictions~~
			* ~~Canada does not provide exemptions b/c that allows for taxation at lower rate. If income is exempt, it is not included in computation, and thus amount of income is lower and potentially falls into lower bracket~~
		- ~~In some situations, double taxation is not fully eliminated~~
		- ~~Normally, such relief is provided for in domestic tax legislation and reliance on treaty provision is often not necessary~~

### ~~Foreign Tax Credits – example of relief from double taxation~~

* ~~For example,~~ **~~s. 126 of~~ *~~ITA~~*** ~~generally permits a Canadian resident taxpayer to deduct from their tax otherwise payable the amount of foreign tax paid on income earned by the taxpayer~~
* **~~Non-Business Income –~~** ~~includes employment and property income~~
	+ **~~Subsection 126(1)~~**
		- ~~Provides a deduction in computing tax basically equal to the lesser of the foreign tax paid on non-business income and the amount of Canadian tax otherwise payable on such income~~
		- ~~The maximum foreign tax credit for income from property is generally limited to 15% of the gross foreign property income. Any foreign tax paid above this is generally deductible in computing taxpayer’s income pursuant to s. 20(11)~~
			* ~~E.g. if foreign jurisdiction taxes you 30% on property income, Canada will only credit you 15%~~
			* ~~E.g. dividends, rent, royalties~~
		- ~~Non-creditable foreign tax on property income is deductible under subsection 20(11)~~
		- ~~No carry-forward is available for the unused foreign tax and it is therefore lost – if you don’t use it in a year, its lost~~
* **~~Business Income~~**
	+ **~~Subsection 126(2)~~**
		- ~~Provides a deduction in computing tax basically equal to the lesser of the foreign tax paid on business income and the amount of Canadian tax otherwise payable on such income~~
		- ~~Unused foreign tax credits on business income can be carried forward 10 years or back 3 years~~
			* ~~Applied on the basis that there is insufficient Canadian tax to cover the credit. For our purposes, since we are assuming there is always sufficient Canadian tax, we will never need to carry forward/back the tax credit~~

## ~~Tax on Change in Residence (Immigration and Emmigration)~~

* **~~Subsection 128.1(1) – Immigration~~**
	+ ~~For the purposes of this Act, where… a taxpayer becomes resident in Canada…~~
		- ~~(b) taxpayer is deemed to have disposed of each property owned by taxpayer other than, if the taxpayer is an individual,~~
			* ~~(i) …taxable Canadian property,~~
			* ~~(ii)…inventory of a business carried on by the taxpayer in Canada…,~~

~~for proceeds equal to its fair market value at the time of disposition.~~

* + - ~~(c) the taxpayer shall be deemed to have acquired… each property deemed by paragraph (b) to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property;~~
			* ~~E.g. You are a US resident who owns shares currently trading at a loss. Instead of immigrating to Canada, selling the shares at a loss, and then applying that loss to future taxes, s. 128.1(1) deems me to have sold those shares at FMV in US, thereby realizing a loss in US, and then coming to Canada and reacquiring those shares at FMV, so my ACB is FMV – that way, I can’t import my loss from US to create a tax cushion in Canada~~
			* ~~There is one exception to this rule: Canadian real property~~
				+ ~~Where a non-resident holds real property in Canada, Canada has always had a right to tax them on it under s. 2(3) [non-residents], so if the non-resident becomes a resident of Canada, there is no deemed disposition or reacquisition.~~
	+ ~~When s. 128.1(1) applies, it resets ACB of property owned by a person to its FMV when that person becomes resident in Canada.~~
	+ ~~A gain or loss on property is generally only realized on the disposition of the property, As such, absent s. 128.1(1), a person who realized a gain or loss on the disposition of property after becoming resident in Canada would be required to include the gain or permitted to deduct the loss in computing their income for Canadian tax purposes even if that gain or loss had accrued during the period was not resident in Canada~~
	+ ~~S. 128.1(1) reflects a policy choice to limit the taxation of gains or the realization of losses on the disposition of property to that portion of the gain or loss accrued when the person was a resident of Canada. The same policy considerations do not apply with respect to gains or losses realized on the disposition of property where Canada otherwise has the right to tax a non-resident on such gain. Because of this, s. 128.1(1) does not apply to certain types of property held by an individual including taxable Canadian property and property that is included in the inventory of a business carried on by the taxpayer in Canada~~
* **~~Subsection 128.1(4) – Emigration~~**
	+ ~~For the purposes of this Act, where… a taxpayer ceases to be resident in Canada, …~~
		- ~~(b) taxpayer is deemed to have disposed of each property owned by the taxpayer other than, if taxpayer is an individual,~~
			* ~~(i) real property situated in Canada, a Canadian resource property or a timber resource property,~~
			* ~~(ii) capital property used in,… or… inventory of, a business carried on by the taxpayer through a “permanent establishment”…in Canada…,~~
			* ~~(iii) an excluded right or interest [defined in s. 128.1(10)]~~
			* ~~(iiii) if the taxpayer was not, during the 120- month period… [prior to the date of emigration]… resident in Canada for 60 months, property that was owned by the taxpayer at the time the taxpayer last became resident in Canada or that was acquired by the taxpayer by inheritance or bequest after the taxpayer last became resident in Canada, and~~

~~For proceeds equal to its fair market value at the time of disposition…;~~

* + - ~~(c) the taxpayer shall be deemed to have reacquired…each property deemed by paragraph (b) to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property;~~
			* ~~E.g.: You are a resident in Canada who owns shares that are currently trading at a gain. Instead of emigrating from Canada, become resident in a new location, selling the shares at a gain, and avoiding paying Canadian capital gain taxes, section 128.1(4) deems me to have sold those shares at FMV in Canada, thereby realizing a capital gain in Canada, getting taxed, and then reacquiring the shares at FMV in my new location – that way, I cannot avoid paying Canadian capital gain tax~~
	+ ~~Where s. 128.1(4) applies, it results in the deemed realization of all gains or losses on property held by a person immediately before that person ceases to be resident in Canada~~
	+ ~~Absent s. 128.1(4), a person who realized a gain or loss on the disposition of property after ceasing to be resident in Canada, would generally not be required to include the gain, nor be permitted to deduct the loss in computing their income for Canadian tax purposes even if that gain or loss had accrued during the period that person was resident in Canada~~
	+ ~~S. 128.1(4) also reflects a policy choice that Canada should have a right to tax a gain and, as a consequence, should permit the deduction of a loss to the extent that gain or loss accrued during the period the owner of the property was resident in Canada. If the goal is to ensure that Canada retains the right to tax gains or permit the deduction of losses that accrued on property while the owner of the property was resident in Canada, the application of s. 128.1(4) is not necessary where Canada retains the right to tax the property even after the person ceases to be resident in Canada. For this reason, s. 128.1(4) exempts certain types of property held by an individual, the gain or loss of which remains subject to tax in Canada even after the individual ceases to be resident. This includes real property situated in Canada, a Canadian resource property or a timber resource property and capital property used in, or inventory of, a business carried on by the taxpayer through a permitted establishment in Canada~~

# ~~Taxation of Non-Residents~~

## ~~Non-Resident Taxation~~

* ~~The~~ *~~Income Tax Act~~* ~~levies tax on non-residents in two principal ways:~~
	+ ~~(1) Pursuant to subsection 2(3) of the~~ *~~income Tax Act~~*
	+ ~~(2) In accordance with the provisions of Part XIII of the~~ *~~Income Tax Act~~*
* **~~Subsection 2(3) – Tax payable by non-resident persons~~**
	+ ~~Where a person who is not taxable under subsection (1) for a taxation year~~
		- ~~(a) was employed in Canada,~~
		- ~~(b) carried on a business in Canada, or~~
		- ~~(c) disposed of a taxable Canadian property,~~

~~at any time in the year or a previous year, an income tax shall be paid, on the person’s taxable income earned in Canada for the year~~

* **~~Part XIII-~~** ~~withholding tax on payments of certain types of Canadian source income to non-residents (e.g. dividends, interest, royalties)~~
	+ ~~Non-residents are liable for withholding tax on these certain amounts paid to them by a person resident in Canada~~
* **~~Subsection 248(1) – Taxable Canadian Property~~**
	+ ~~In very general terms, taxable Canadian property is defined to include:~~
		- ~~Property used in a business carried on in Canada;~~
		- ~~Real property situated in Canada; and~~
		- ~~An interest in a private corporation, partnership, or trust if more than 50% of the value of such interest is derived from:~~
			* ~~Real property situated in Canada~~
			* ~~Canadian resource properties or~~
			* ~~Timber resource properties,~~
	+ ~~For the purposes of this course we will restrict the meaning of taxable Canadian property to real property situated in Canada~~
* ~~A non-resident’s taxable income is computed under the rules in section 115~~
* **~~Section 115~~**
	+ ~~A non-resident’s taxable income earned in Canada is the amount, if any, by which the amount that would be the non-resident person’s income for the year under section 3 if the non-resident person had no income or losses other than:~~
		- ~~Income or losses from employment performed in Canada;~~
		- ~~Incomes or losses from businesses carried on in Canada; and~~
		- ~~Taxable capital gains or allowable capital losses from disposition of taxable Canadian property~~

~~Exceeds~~

* + - ~~The non-resident’s loss carryovers to the extent they relate to amounts included in computing the non-residents taxable income earned in Canada; and~~
		- ~~Other specified deductions~~
* **~~Subsection 212(1) – Tax payable by non-resident persons~~**
	+ ~~Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed … to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of…~~
		- **~~Management fees –~~** ~~paragraph 212(1)(a)~~
		- **~~Certain payments of interest –~~** ~~paragraph 212(1)(b)~~
			* ~~This provision tries to target multinational corporations making payments to subsidiary/affiliate bodies~~
			* ~~In general, only payments of interest to non-arm’s length non-residents and payments of participating debt interest are subject to withholding tax~~
				+ ~~Not arm’s length non-residents: subsidiary company~~
				+ ~~Participating interests are profit allocations (dividends, royalties) disguised as interest payments~~

~~Interest on a debt is supposed to be calculated by time value of money. But, there is a loophole where you can make interest on a debt equal to a proportion of profits. This provision closes this loophole.~~

* + - * **~~“Participating debt interest”~~** ~~is defined to generally mean interest all or any portion of which is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or other similar criterion or by reference to dividends paid or payable on shares of a corporation – subsection 212(3)~~
		- **~~Income from an estate or trust –~~** ~~paragraph 212(1)(c)~~
		- **~~Rents or royalties –~~** ~~paragraph 212(1)(d)~~
* **~~Subsection 212(2) – Tax on Dividends~~**
	+ ~~Every non-resident person shall pay an income tax of 25% on every amount that a corporation resident in Canada pays or credits, or is deemed… to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of,~~
		- ~~(a) a taxable dividend…; or (normal dividend)~~
		- ~~(b) a capital dividend~~
			* ~~A special form of dividend that are tax free for residents of Canada, but taxable for non-residents~~
	+ **~~Capital Dividends~~**
		- ~~Term used to describe dividends that are paid out of certain non-taxable amounts received by a corporation~~
		- ~~Capital dividends can be distributed to Canadian resident shareholders tax free –~~ **~~subsection 83(2)~~**
* ~~Although Part XIII tax is a tax on the resident, it is the Canadian resident payor that is generally required to deduct or withhold the tax from the payment and remit it to the government on behalf of the resident. Taxes levied under Part XIII referred to as withholding taxes~~
* ~~Where there is no treaty with such country, Canada withholds an income tax of 25%~~
* ~~Where there is a treaty with such country, the statutory rate is reduced by the treaty to 15%/10%/5%/0%~~
* **~~Subsection 215(1) – Withholding and Remittance of Tax~~**
	+ ~~“When a person pays, credits or provides, or is deemed to have paid, credited or provided, an amount on which an income tax is payable under Part XIII,… the person shall, notwithstanding any agreement or law to the contrary, deduct/withhold from it the amount of tax and forthwith remit that amount to Receiver General on behalf of non-resident person on account of the tax”~~
		- ~~This outlines the obligation to withhold and remit the tax~~
* **~~Subsection 215(6) – Liability for Failure to Withhold and Remit Tax~~**
	+ ~~“Where a person has failed to deduct or withhold any amount as required by this section from an amount paid or credited or deemed to have been paid or credited to a non-resident person, that person is liable to pay as tax under [Part XIII] on behalf of the non-resident person the whole of the amount that should have been deducted or withheld, and is entitled to deduct or withhold from any amount paid or credited by that person to a non-resident person or otherwise received from the non-resident person any amount paid by that person as tax under [Part XIII] on behalf thereof.”~~
		- ~~If you fail to withhold and remit the tax of the non-resident, you are jointly and severally liable for that tax~~
		- ~~Because collection of tax from non-residents is so difficult, the Canadian government incentivizes the resident payer to properly withhold and remit the non-resident’s taxes by placing the liability on the resident payer~~

## ~~Carrying On Business in Canada~~

* ~~A non-resident is generally taxable in Canada on any income they earn from a business carried on in Canada~~
* ~~The meaning, while first addressed in the case below, has been further extended by section 253 of the~~ *~~Income Tax Act~~*

#### ~~Grainger & Son v. Gough (Surveyor of Taxes), 1896 (HL)~~

**~~Facts:~~** ~~The appellants were wine merchants carrying on business in UK. They also acted for a French wine merchant, Mr. Roederer, for the purpose of canvassing orders for sale of his wine in UK. If wine was sold the appellants received a commission. The terms of their agreement were such that the appellants had no real authority to contract on behalf of Mr. Roederer, who had the right to accept or reject any particular order. Under the terms of the purchase agreement, the purchaser was responsible for paying shipping charges and accepted all risk during shipping.~~

**~~Issue:~~** ~~Was Mr. Roederer exercising a trade within the UK?, i.e. Was he carrying on business in the UK?~~

**~~Held:~~** ~~No, he was not carrying on a trade within the UK and is not subject to tax~~

**~~Reasons:~~** ~~The country placed significant weight on whether the contracts for the sale of wine were made in the UK under common law contract principles. The court held that the contracts were made in France and not in the UK. In reaching this conclusion, the court took into consideration that the appellants had no authority to conclude contracts in the UK on behalf of Mr. Roederer. All the appellants had done was solicit orders on behalf of Mr. Roederer and had not concluded any contracts on his behalf. Therefore, the contracts were concluded in France and delivery of the wine took place in France because the purchase agreement provided the purchaser was responsible for shipping charges and accepted all risk during shipping. As such, Mr. Roederer was trading with the UK and not carrying on a trade within the UK. There is a distinction between “trading with a country and carrying on a trade within a country”~~

* ~~Lord Herschell distinguished between “trading with a country and carrying on a trade within a country”~~

**~~Note:~~** ~~This result has been overridden in Canada by paragraph 253(b) of the~~ *~~Income Tax Act~~*

### ~~Section 253~~

* ~~“For the purposes of this Act, where in a taxation year a person who is a non-resident person…~~
	+ ~~(a) produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada whether or not the person exports that thing without selling it before exportation,~~
	+ ~~(b) solicits orders or offers anything for sale in Canada through an agent or servant,~~ **~~whether the contract or transaction is to be completed inside or outside Canada or partly in and partly outside Canada,~~** ~~or~~
		- ~~(b) only applies where a non-resident solicits orders or offers anything for sale in Canada through an agent or servant~~
		- ~~As such, where a non-resident sells good to Canadians it remains a question of fact as to whether the resident is carrying on business in Canada. If the non-resident sells goods in Canada and the contracts are completed in Canada, the non-resident will likely be carrying on business in Canada provided the non-resident is carrying on business in the first place. However, where non-resident sells good to Canadians, this is unlikely to constitute carrying on a business in Canada provided non-resident does not solicit business or offer anything for sale in Canada through an agent or servant and the contract for sale is completed outside of Canada~~
		- ~~Under these rules,~~ *~~Grainger & Sons~~* ~~would be caught here~~
		- ~~The application of this paragraph was considered in the~~ *~~Sudden Valley~~* ~~case~~
	+ ~~(c) disposes of [resource property, timber property or real property],~~

~~The person shall be deemed, in respect of that activity or disposition, to have been carrying on business in Canada in the year.”~~

#### ~~G.L.S. Leasco Inc., McKinlay Transport Ltd. v. MNR, 1986 (TCC)~~

**~~Facts:~~** ~~GLS was a US corporation that carried on a leasing business in the US. McKinlay was a Canadian corporation that carried on a business as a common carrier in Canada. GLS and McKinlay were related corporations. GLS leased transportation equipment to McKinlay for use in its Canadian business. Minister assessed McKinlay for failure to withhold Part XIII tax on the lease payments McKinlay made to GLS, a non-resident of Canada. GLS argued that it was carrying on business in Canada and should be taxable under Part I of the Act and not on the lease payments under Part XIII.~~

**~~Issue:~~** ~~Was GLS carrying on business in Canada?~~

**~~Held:~~** ~~Yes, GSL was carrying on business in Canada and is subject to tax~~

**~~Reasons:~~** ~~“There was a Canadian bank account, and the equipment was purchased in Canada. While there was no official agent in Canada, 2 employees of McKinlay were always available to help GLS in Canada. In addition, Mr. Mason, VP of the parent company, spent a great deal of time in Canada supervising the operation…. GLS in the United States did not have any employees, offices, signs, nor telephones yet carried on business there, as was admitted by the Minister. In Canada the office made available by McKinlay was used physically by Mr. Mason, all documentation used this address, mail was received there, such address was accepted by the Government, and a sales tax exemption permit was given to GLS treating the company as doing business in Canada. While perhaps not all the form was present, the substance of doing business in Canada was evident…”~~

* + ~~Court focused on the nature of the activities carried out by GLS through its representatives in Canada~~
	+ ~~GLS, although a US corporation, has no real activities in the US. Everything was being carried out in Canada.~~

**~~Note:~~** ~~Why did GLS want to be subject to tax in Canada under Part I?~~

* ~~If GLS was carrying in business in Canada, they would be taxed on profits~~
	+ ~~Ex: $100 Revenue - $90 Expenses = $10 profit \* 40% tax = $4 tax~~
* ~~If GLS not carrying on business in Canada, it would be subject to withholding tax on gross lease payments which are income on property~~
	+ ~~Ex: $100 income from lease payments \* 15% withholding tax = $15 tax~~

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

* ~~P. 253(b) deems a non-resident to be carrying on a business in Canada where they solicit orders or offer anything for sale in Canada through an agent or servant. It is necessary to determine if a non-resident is soliciting orders/offering something for sale in Canada.~~

**~~Facts:~~** ~~U.S. corporation, was engaged in business of selling land in Sudden Valley, in Washington. It commenced an advertising campaign in Vancouver to attract Canadian buyers. It leased office space in Vancouver and hired telephone operators, who would contact people in Vancouver to set up dinners and social gatherings for the purpose of enticing Canadians to visit Sudden Valley. The advertising did not state that there was land for sale but merely invited Canadians to visit Sudden Valley, which was proximate to and easily accessible from Vancouver. There was no evidence that any sales were concluded in Canada nor that any legally binding offers to purchase were obtained in Canada. The sale contracts were all drawn up and executed in the taxpayer’s sales’ office in the US and all payments were made directly to US office. No agent or representative in Canada had any authority to accept an offer or conclude a contract on behalf of the taxpayer. Over 70% of the lots were purchased by Canadian residents from Vancouver. Taxpayer claimed it was carrying on business in Canada and therefore taxable on its profits under Part I of the~~ *~~ITA~~*~~.~~

**~~Issue:~~** ~~Was the taxpayer deemed to be carrying on business in Canada pursuant to paragraph 253(b)?~~

**~~Held:~~** ~~No, the taxpayer was not carrying on business in Canada and therefore, not subject to tax. The TJ found this and the FCA dismissed the appeal.~~

**~~Reasons:~~** ~~“In considering whether the Plaintiff was “soliciting orders” in Canada,~~ **~~I do not agree that the words can be extended to include a ‘mere invitation to treat.’~~** ~~Soliciting orders means that orders must be sought and attempts made to obtain them within the jurisdiction and the word ‘offer’, in my view, must be given its ordinary meaning in contract law, that is, a binding offer which, if accepted, would create a contract between the offeror and the offeree. This becomes all the more evident when one considers that the question at common law depended specifically on the existence of a binding contract and that the section was intended to amend the former common law to the effect that the contract need not be made within the jurisdiction… [I]t is abundantly clear that no offer was obtained and no attempt was made to obtain any in Canada and it is equally clear that nothing was offered for sale in Canada either through an agent or otherwise. The real estate business of the plaintiff was not being carried on in Canada even within the extended meaning given to that term by s. 253(b). Only activity carried on in Canada by the Plaintiff was that of attempting to induce Canadians to visit Sudden Valley in the hope that some might eventually become interested in buying property there….”~~

* ~~The advertisement induced Canadians to visit Sudden Valley, not buy property in Sudden Valley. Then, once in Sudden Valley, they pitch Canadians to purchase land. Therefore, the advertisements are even less than an invitation to treat.~~

**~~Question~~**

* ~~Why did taxpayers in~~ *~~McKinlay~~* ~~and~~ *~~Sudden Valley~~* ~~argue they were carrying on business in Canada and therefore taxable under Part I?~~
* ~~Why would a non-resident argue that they are taxable in Canada under Part I?~~
* ~~Isn’t it preferable to avoid Part I tax when you are a non-resident?~~

#### ~~Tara Exploration and Development Co. Ltd. v MNR, 1970 (Exch. Ct.)~~

**~~Facts:~~** ~~Tara, a corporation resident in Ireland, disposed of shares of a corporation in Canada. It was assumed that Tara had engaged in an adventure in the nature of trade in Canada and therefore its income was income from a business since the definition of “business” in paragraphs 139(1)(e) [this definition is not found in subsection 248(1)] includes an adventure in the nature of trade.~~

**~~Issue:~~**  ~~Had Tara “carried on a business in Canada” within the meaning on subsection 2(2) [the current provision is subsection 2(3)]?~~

**~~Held:~~** ~~No, taxpayer was not carrying on a business in Canada. Tara engaged in “adventure in the nature of trade”, but not “carried on a business.”~~

**~~Ratio:~~** ~~Engaging in an “adventure in the nature of trade” in Canada is not carrying on a business in Canada~~

**~~Reasons:~~** ~~“In considering this question, it is worthy of note that the~~ *~~ITA~~* ~~does contain a provision that provides that, where a non-resident person does certain things in Canada, he shall be deemed “to have been carrying on business in Canada”. See S. 139(7) [section 253] which reads:~~

* + ~~139. (7) Where, in a taxation year, a non-resident person…~~
		- ~~(b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada,~~

~~He shall be deemed, for the purposes of this Act, to have been carrying on business in Canada in the year.~~

* + ~~It has never been suggested to my knowledge that an isolated purchase and sale falls within this subsection.”~~
* ~~“… I am of the opinion that section 139(1)(e) does not operate to make a non-resident person subject to Canadian income tax in respect of profit from an adventure that otherwise does not amount to, and is not part of, a ‘business’. With considerable hesitation, I have concluded that the better view is that the words ‘carried on’ are not words that can aptly be used with the word ‘adventure’. To carry on something involves continuity of time or operations such as is involved in the ordinary sense of a ‘business’. An adventure is an isolated happening. One an adventure as opposed to carrying on a business.”~~

## ~~Business Profits Under Tax Treaties~~

* ~~Even if a non-resident is found to be carrying on business in Canada they may be exempt from Canadian income tax if they reside in a country that has entered into an income tax treaty with Canada. Canada’s tax treaties generally provide that a non-resident’s profits are only taxable to the extent that the non-resident is carrying on business in Canada through a permanent establishment in Canada~~
* **~~Article VII of the Canada-US Treaty, 1980~~**
	+ **~~Business Profits~~**
		- ~~1. The business profits of a resident of a Contracting State shall be taxable only in that State unless the resident carried on business in the other Contracting State through a~~ **~~permanent establishment~~** ~~situated therein. If the resident carries on, or has carried on, business as aforesaid, the business profits of the resident may be taxed in the other State but only so much of them as is attributable to that permanent establishment.~~
			* ~~This provision in the Canada-US treaty limits the deeming for carrying on a business in Canada done under section 253 to only companies carrying on a business in Canada through permanent establishment in Canada~~

### ~~Permanent Establishment~~

* **~~Article V of the Canada-US Treaty, 1980~~**
	+ **~~Permanent Establishment~~**
		- ~~1. For the purposes of this Convention, the term~~ **~~“permanent establishment”~~** ~~means a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on.~~
		- ~~2. The term “~~**~~permanent establishment~~**~~” shall include especially;~~
			* ~~(a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources~~
		- ~~5. A person acting in a Contracting State on behalf of a resident of other Contracting State – other than an agent of an independent status to whom p. 7 applies – shall be deemed to be a permanent establishment in first-mentioned State if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the resident~~
			* ~~While paragraph 2 outlines permanent establishments as physical places, they can also be people~~
			* ~~A dependent agent (employee of the company) will be deemed to be a permanent establishment where that employee habitually exercises an authority to conclude contracts on behalf of the company in the State~~
				+ ~~Ex. US company hires an employee to set up operations in Canada and gives them the authority to exercise contracts on company’s behalf, but the company itself does not have its own operations in Canada. Employee will be deemed a permanent establishment in Canada of the US company.~~
			* ~~Independent agent (carrying on own business as agent for company) will not be permanent establishment.~~

## ~~Reduced Withholding Under Tax Treaties~~

* ~~Where a company resident in the Contracting State pays a dividend and the beneficial owner of that Dividend is resident of the other Contracting State then Article V will apply~~
* **~~Article V of the Canada-US Treaty, 1980~~**
	+ **~~Dividends~~**
		- ~~1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.~~
			* ~~If a company resident in US pays dividends to residents in Canada, those dividends may be taxed in Canada (or vice versa) at a rate of 5% for corporations owning at least 10% of voting stock and 15% in all other cases~~
		- ~~2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State; but if a resident of the other Contracting State is the beneficial owner of such dividends, the tax so charged shall not exceed:~~
			* ~~(a) 5% of the gross amount of the dividends if the beneficial owner is a company which owns at least 10% of the voting stock of the company paying the dividends…;~~
				+ ~~For corporations~~
			* ~~(b) 15% of the gross amount of the dividends in all other cases~~
				+ ~~For individuals~~
				+ ~~Convenient because~~ *~~ITA~~* ~~limits foreign tax credits for income from property to 15%~~
		- ~~This paragraph shall not affect the taxation of the company in respect of the profits out of which dividends are paid~~
		- ~~A beneficial owner does not include a person who receives a dividend as an agent or nominee for the other person. The requirement that the beneficial owner, and not just the recipient of the dividend, be a resident of the other Contracting State is necessary to prevent a shareholder who is not a resident of the other Contracting State from transferring their shares to an agent or nominee who is in the other Contracting State and have the agent or nominee claim the withholding tax exemption as the recipient of the dividend. In these circumstances, the original shareholder would continue to be the beneficial owner of the dividend and as such, Article V would not apply. This type of tax avoidance behavior is common referred to as~~ ***~~“treaty shopping~~***~~”~~
* **~~Article XI and XII of the Canada-US Treaty, 1980~~**
	+ ~~Article XI provides an exemption from withholding tax on payments of interest, except with respect to “participating” interest which is taxable at 15%~~
		- ~~For this purpose,~~ **~~participating interest~~** ~~means interest that is computed by reference to receipts, sales, income profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person~~
		- ~~Remember, “participating interest” are allocations of profit (like a dividend) that are disguised as interest payments~~
	+ ~~Article XII provides for a reduced rate of withholding (10% or in certain circumstances nil) on payments of royalties~~
	+ ~~Reduced rate of withholding only applicable where interest/royalties beneficially owned by resident of other contracting state~~
		- ~~The withholding rate is based off the beneficial owner, not the agent which may practically hold the shares~~

## ~~Taxation of Gains Under Tax Treaties~~

* **~~Article XIII of the Canada-US Treaty, 1980~~**
	+ ~~Generally, restricts the taxation of gains to:~~
		- ~~Gains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed in the other State~~
			* ~~Real property also includes certain rights in respect of real property and shares of a corporation or an interest in a partnership or trust that derives its value principally from real property~~
				+ ~~This is a look through rule (look through the form of shares to see the substance of real property)~~
				+ ~~We want to ensure that shares which may hold nothing but real property are also caught (otherwise, taxpayers could just buy real property indirectly through the form of shares)~~
			* ~~The country where that real property is located has the first right to tax~~
		- ~~Gains derived by a resident of a contracting state from the alienation of personal property forming part of the business property of a permanent establishment in the other contracting state may be taxed in the other state~~
		- ~~Gains derived from the alienation of any other property shall be taxable only in the Contracting State if which the alienator is resident.~~
			* ~~Where you have gains on business property which is part of a permanent establishment, those gains are taxable in the jurisdiction of the permanent establishment~~

# Income from Employment

## Legislative Framework

* **Part I, Division B – Computation of Income**
	+ **Paragraph 3(a)**
		- 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 (other than taxable capital fain from the disposition of a property) 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
* **Subsection 248(1)**
	+ **“employment”** means the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign) and “servant” or “employee” means a person holding such a position
	+ **“office”** means the position of an individual entitling the individual to a fixed or ascertainable stipend or renumeration and includes a judicial office, the office of a minister of the Crown, the office of a member of the Senate or House of Commons of Canada, a member of a legislative assembly or a member of a legislative or executive council and any other office, the incumbent of which is elected by popular vote or is elected or appointed in a representative capacity and also includes the position of a corporation director, and “officer” means a person holding such an office;
	+ **“employee”** includes officer
	+ **“employer”**, in relation to an officer, means the person from whom the officer receives the officer’s renumeration
* **Subdivision 1 – Income or Loss from an Office or Employment**
	+ **Subsection 5(1)**
		- Subject to this Part, a taxpayer’s **income** for a taxation year from an **office or employment** is the salary, wages and other renumeration, including gratuities, received by the taxpayer in the year
	+ **Subsection 5(2)**
		- A taxpayer’s **loss** for a taxation year from an **office or employment** is the amount of the taxpayer’s loss, if any, for the taxation year from that source computed by applying, with such modifications as the circumstances require, the provisions of this Act respecting the computation of income from that source
	+ **Subsection 6(1)**
		- There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable:
			* The value of benefits of any kind whatever – **paragraph 6(1)(a)**
			* Amounts received as an allowance – **paragraph 6(1)(b)**
			* Directors or other fees – **paragraph 6(1)(c)**
			* Allocations under profit sharing plans – **paragraph 6(1)(d)**
			* Standby charge for use of automobile – **paragraph 6(1)(e), 6(2)**
			* Employment insurance benefits – **paragraph 6(1)(f)**
			* Reimbursements – **paragraph 6(1)(j)**
			* Automobile allowances – **paragraph 6(1)(k)**
	+ **Retiring allowance**
		- Subparagraph 56(1)(a)(ii); subsection 248(1);
		- When computing income, taxpayer is required to include a retirement allowance (*Schwartz v The Queen)*
	+ **Subsection 6(3)**
		- An amount received during employment or in satisfaction of an obligation arising out of an agreement made immediately prior to, during or immediately after employment is deemed to be remuneration for the services unless it cannot reasonably be regarded as having been received
			* As consideration for accepting the employment
			* As remuneration for services; or
			* In consideration for a covenant given by the employee in connection with the termination of the employment
	+ Stock Options – **section 7**
	+ Deemed interest benefit on employee loans – **subsection 6(9) and 80.4(1)**
	+ Forgiveness of employee debt – **subsections 6(15), 6(15.1) and 80(1)**
	+ Housing losses – **subsections 6(19) to 6(23)**
	+ **Section 8 – Deductions –**deduction is limited to the amount that is applicable to taxpayer’s income from office or employment. Where only part of the amount is applicable to taxpayer’s income or employment the taxpayer’s deduction is limited to the amount reasonably applicable.
		- Generally denied – **subsection 8(2)**
		- Legal expenses – **paragraph 8(1)(b)**
		- Clergy residence – **paragraph 8(1)(c)**
		- Salesperson’s expenses – **paragraph 8(1)(f)**
		- Travelling expenses – **paragraph 8 (1)(h)**
		- Motor vehicle travel expenses – **paragraph 8(1)(h.1)**
		- Annual professional membership dues – **subparagraph 8(1)(i)(i)**
		- Office rent and assistant’s salary required under employment contract – **subparagraph 8(1)I)(ii)**
		- Supplies required under employment contract - **subparagraph 8(1)(i)(iii)**
		- Union dues - **subparagraph 8(1)(i)(iv)**
		- Professional board dues – **subparagraph 8(1)(i)(vii)**
		- Registered pension plan contributions – **paragraph 8(1)(m)**
		- Apprenticeship mechanics‘ tools – **paragraph 8(1)(r), 8(6), 8(7)**
		- Tradesperson’s tools – **paragraph 8(1)(s), 8(7)**
		- Limitation on Home office expenses – **subsection 8(13)**

## Who is an Employee?

* The term “**employee**” is defined in **subsection 248(1)** (i.e. an individual in the service of some other person)
* No help when distinguishing between an employee and an independent contractor (business person)
* Distinction between a contract of services (employee) and a contract for services (independent contractor). The main difference is that an employee is generally in the service and under the direction of the person who retains them (the employer) while the independent contractor is retained to perform a specific service and is generally subject to little or no direction by the person who retained them

### Why Do we Care?

* Different rules apply to employee who earns income from employment than independent contractor who earns income from a business
	+ Restriction on deductibility of expenses – **subsection 8(2)** – *principle rule for employee*
		- This is far more restrictive when computing income from employment
	+ Withholding by employers **– paragraph 153(1)(a)** – *principle rule for employer*
		- Could create a win-win situation for employee & employer by structuring relationship as an independent contractor
		- Employers required to withhold statutory amounts (income tax) from payments made to employees but not payments to independent contractors
	+ Method of accounting (cash vs. accrual**)- subsection 5(1)**
		- Employment income calculated on a cash basis which means in computing income you only include amounts that are received & deduct expenses that are paid. In contrast, business income is calculated on accrual basis which means you account for income when it is earned/receivable and deduct expenses when they have accrued even if not been paid
	+ Accounting period – **subsection 249(1) and 249.1(4)**
		- Individuals report by the calendar year
	+ Wages paid to employees are not subject to goods and services tax (“**GST”** or **“HST”** in Ontario), service fees generally are
* Employee or independent contractor?
	+ Partner in a law firm – independent contractor
		- Partnership generates profit. Partner gets proportion of profit for carrying on the business. Aka they are a businessperson. Businesspersons are not employees
	+ Associate in a law firm – employee
		- Hired as an employee for the partnership and paid salary/wages
	+ Judge or elected official – employee
		- Officer, therefore an employee by definition

### Historical Origins – The “Control Test”

* Determining if an individual is an employee is important in tort law bc an employer will normally be vicariously liable for torts of employees
* Historically, the essential criterion of the employer- employee relationship was the right of the employer to direct not only what work was to be done by the employee but the manner in which the work was to be carried out
	+ Therefore, whether someone was an employee depended on the degree of control you could exercise over them
* Application of control test consistent with the policy rational for making employer vicariously liable for torts committed by its employees
* Traditionally courts applied a “control test” when determining if an individual was an employee
* It did not matter if control was exercised only that the employer was in a position to do so
* **In assessing modern employment relationships, the use of a stand-alone control test is no longer appropriate or useful**
* Reliance on the control test has been abandoned in favour of an integrated assessment of all relevant factors
* Two commonly cited cases, which set out this modern approach are:
	+ *Wiebe Door Services Ltd. v. MNR*, 87 DTC 5025 (FCA); and
	+ *67122 Ontario Ltd. v. Sagaz Industries Canada Inc.,* [2001] 2 SCR 983
		- “The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account. In making this determination, the level of control the employer has over the worker’s activities will always be a factor. However, other factors to consider include whether the worker provides his or her own equipment, whether the worker hired his or her own helpers, the degree of financial risk taken by the worker, the degree of responsibility for investment and management held by the worker, the worker’s opportunity for profit in the performance of his or her tasks, and more. It bears repeating that the above factors constitute a non-exhaustive list, and there is no set formula as to their application. The relative weight of each will depend on the particular facts and circumstances of the case.”

### The Modern Approach (*Sagaz)*

* Review of all relevant factors in order to characterize the overall relationship between the parties
* Central question is whether the person engaged to perform the services is performing them as a person in business on their own account
* Principal factors include:
	+ (1) Level of control employer has over worker’s activities (central importance); (2) Whether worker provides their own equipment ; (3) Whether worker hires their own helpers; (4) Degree of financial risk taken by worker; (5) Degree of responsibility for investment & management held by worker; and (6)Worker’s opportunity for profit in performance of their tasks
* These factors are not an exhaustive list, and there is no set formula as to their application
* The relative weight of each factor will depend on the particular facts and circumstances of the case

### Intention of the Parties

* The intention of the parties may also be relevant and is generally evidenced by the form of contract
	+ Court will look to intention of parties only if contractual arrangements are not a sham (properly reflects parties’ relationship)
	+ We look for objective intention based on reality of relationship as ascertained through objective facts, not subjective intention
		- Ex. Contract may state you are an independent contractor; however, based on facts and circumstances, relationship is much closer to that of an employee. In this case, objective facts are more revealing and you will be deemed an employee, despite what contract states
* The relevant factors must be considered in light of the parties’ intention
* However, the subjective intention of the parties cannot trump the reality of the relationship as ascertained through objective facts
* In general, the intention of the parties will be of greater importance where objective facts do not lead to a clear result

### Some Examples

* *Lyon v The Queen,* 2018 TCC 89
* *Cyr v MNR,* 2017 TCC 25
* *Quinte Children’s Homes Inc. v MNR*, 2015 TCC 250
* *Robertson Human Asset Management Inc. v MNR*, 2014 TCC 23
* *1392644 Ontario Inc O/A Connor Homes v. MNR*, 2013 FCA 85
* *Royal Winnipeg Ballet v. MNR*, 2006 FCA 87
* *Wolf v Canada,* 2002 FCA 96

## Income Inclusions

* **Subsection 5(1)-** Subject to this Part, a taxpayer’s income for a taxation year from an office or employment is the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year
	+ **“Salary and wages”** – ordinary meaning
	+ **“Other remuneration”** – includes honoraria, commissions, bonuses, gifts, rewards & prizes provided as compensation
	+ **“Gratuities”** – voluntary payments made in consideration of services rendered during taxpayer’s office/ employment (i.e. tips)
* **Benefits**
	+ In computing their income, a taxpayer is required to include the amount specified under section 6(1) of the *ITA*. Of particular importance is 6(1)(a) which requires a taxpayer to include, in computing their income from an office or employment, the value of all benefits received or enjoyed by the taxpayer in respect of, in the course of or by virtue of an office or employment
	+ **Why Tax Benefits?**
		- Not taxing benefits would be a violation of the principal of neutrality
			* Employees would clearly prefer to be paid with in-kind benefits that were untaxed. The benefits would be deductible by the employer, so the employer would be neutral as between paying benefits and paying cash
			* If benefits were not taxed, employers would prefer to be paid with more benefits than salary to reduce tax
			* If benefits were not taxed, employers would be indifferent between paying cash or paying benefits because they would be able to deduct the benefits
		- Not taxing benefits would lead to an erosion of the income tax base
			* Employees preference to receive non-taxable benefits would reduce the amount of taxable salary & wages
		- Not taxing benefits would violate the principal of (horizontal and vertical) equity
			* Those with higher incomes usually have more freedom to negotiate “fringe benefits”, and a greater ability to receive non-cash, non-taxable benefits. (e.g. Cashier VS. CEO)
			* Certain employers would have more opportunity to offer benefits (e.g. airlines, hotels, restaurants)
			* If employees only taxed on cash salary & wages, income tax would not be levied on basis of ability to pay
		- Notwithstanding the equality and neutrality arguments, some benefits are excluded from taxation on the basis:
			* **Administrative Efficiency** (e.g. CRA provides an adminsitrative exemption for non-cash gifts and awards given to employees up to a maximum of $500 per year)- s**.56(1)1(n)**
				+ For exemption to apply, gift needs to be in recognition of special occasion (religious holiday, birthday) and award must be for an employment related accomplishment (I.e. outstanding service)
				+ E.g. the cost of employer provided meals, hotels rooms during work travel, hotel parties
			* **Tax expenditure arguments –** non-taxability is intended to encourage certain behaviour (e.g. employer sponsored health and dental plans, life insurance, etc…) – **subparagraph 6(1)(a)(i)**

### What is a Benefit?

* **Paragraph 6(1)(a)**
	+ In computing income from office or employment, taxpayer is required to include “the value of board, lodging and other benefits of any kind whatever received or enjoyed by taxpayer in the year in respect of, in the course of, or by virtue of an office or employment”
		- Broad and is intended to capture every possible benefit. The threshold for what is considered a benefit is very low.
	+ **Three questions to consider when applying 6(1)(a) to consider in determining whether or not something is a benefit:**
		1. Was something received or enjoyed in respect of, in the course of, or by virtue of an office or employment?
			- E.g. if your employer gives all employees’ birthday gifts, then it is received in virtue of an office or employment, and is therefore considered a taxable benefit
			- E.g. if your friend, who is also your employer, gives you a birthday gift, then it is not received in virtue of an office or employment, and it is therefore not considered a taxable benefit
		2. Was the thing received or enjoyed by the taxpayer a benefit?
			- Where something is principally for benefit of employer and not the employee, employee should not be taxed
				* E.g. Employer sends you to work conference in Hawaii where you get free time to relax. While you get your personal benefit, principal benefit is to employer. Therefore, trip is not a taxable benefit
			- Where something is principally for benefit of employee, it is a personal benefit in which you should be taxed
			- **Note:** What if you receive a bottle of alcohol, but cannot drink? Assess objective value, not subjective value.
		3. What is the value of the benefit?
	+ Examples:
		- Work uniform? No
		- Tickets to a conference in Hawaii? Yes
		- Birthday gift from friend who is also your employer? No
		- Birthday gift from employer who is not your friend? Yes
		- Gift card from lawyer to assistant? Yes
			* But lawyer is not the employer, so why is it a taxable benefit? Nothing in the provision which states that the benefit must come from employer –must be received in respect of/in the course of/by virtue of employment

### *“In respect of,* in the course of, or by virtue of an office or employment”

#### The Queen v Savage, 1983 (SCC)

**Facts:** Savage was employed by an insurance company. She voluntarily took 3 courses designed to provide a broad understanding of modern life insurance and life insurance company operations. She received $100 from her employer for each course she successfully completed. In total her employer paid her $300 which it reported as Other Income on her T4 slip.

**Issue:** Was the $300 received in respect of her employment?

**Held:** Yes, because it was only received by virtue of her employment. The company was not paying members of the public for passing the courses. However, it was also determined that the amount was “a prize for achievement in a field of endeavor ordinarily carried on by the taxpayer” within the meaning of paragraph 56(1)(n). Accordingly, it was not taxable since it did not exceed the statutory exemption of $500.

**Ratio:** This case reduced the question of whether something was in respect of, in the course of or by virtue of an office or employment to a but for test. In other words, but for your employment would you have received the benefit? The meaning of “in respect of, in the course of, or by virtue of an office or employment” is a payment given to an employee upon passing a voluntary course related to one’s job is a taxable benefit.

**Reasons:** “I do not agree with… the statement that, to be received in the capacity of employee, the payment must partake of the character of remuneration for services. Such was the conclusion in the English cases but based on narrower language. Our Act contains the stipulation, not found in the English statutes referred to, ‘benefits of any kind whatever…in respect of, in the course of, or by virtue of an office or employment’. The meaning of ‘benefit of whatever kind’ is clearly quite broad; in the present case the cash payment of $300 easy falls within the category of ‘benefit’. Further, our Act speaks of a benefit ‘in respect of’ an office or employment. In *Nowegijick v The Queen* this Court said, at p. 5045, that: “This effectively creates a rebuttable presumption to the effect that if you receive a benefit from your employer it will be taxable”

* + Test is incredibly broad and intended to capture anything that could be a benefit. Threshold of what constitutes benefit is low
* Dickson said that benefits do not have to be in the form of remuneration from the employer

### “In respect of, in the course of, or *by virtue of an office or employment”*

#### Laidler v. Perry, 1965 (HL)

**Facts:** Each employee received a 10-pound voucher at Christmas accompanied by a letter thanking them for past services. The vouchers were intended to help foster a good working spirit among employees.

**Issue:**  Was the gift of the 10-pound voucher a personal gift or taxable benefit?

**Held:**  Received “by virtue of employment” and not as personal gifts.

**Reasons:** Amounts paid were large and were given to all employees regularly. Objective of payment was to induce good employment relationships; to benefit the company. Everyone received a payment because they were an employee. Company was not handling out vouchers to the public.

**Ratio:** If a benefit is given to all employees then it is likely to be required to be included.

#### Waffle v. MNR, 69 DTC 5007 (Ex. Ct.)

**Facts:** Taxpayer was a shareholder and the secretary-treasurer of T Ltd., which was franchised as a Ford dealer. Under a sales incentive program, the president of T Ltd. and his wife became entitled to take a Caribbean cruise with the Ford Company paying all expenses. The president and his wife were unable to go so the taxpayer and his wife went instead. Minister reassessed the taxpayer to add the cost of the cruise to his income.

**Issue:** Was the cruise a taxable benefit?

**Held:**  Yes, the cruise was a taxable benefit because it was received (although not from taxpayer’s employer) by virtue of the taxpayer’s office or employment within the dealership. The fact that the person paying the cost of the benefit is not the employer of the recipient, does not mean that the benefit does not accrue to the recipient in respect of, in the course of, or by virtue of their office or employment.

**Reasons:** The cruise was paid by Ford. Taxpayer was an employee of the dealership. Although taxpayer was not an employee of Ford, he was the recipient of the cruise “by virtue of his office or employment” with the dealership. Fact that person paying the cost of the benefit is not the employer of the recipient, does not mean benefit does not accrue to the recipient in respect of, in the course of, or by virtue of his office or employment.

**Ratio:** A taxable benefit does not have to come directly from one’s employer, but rather simply by virtue of one’s employment.

### “Benefit of Any Kind Whatever”

#### Lowe v. The Queen, 1996 (FCA)

**Facts:** Taxpayer was employed as an account executive by insurance company. His responsibility was to maintain and develop relationships with independent insurance brokers. Upon achieving certain quotas, the indepenadnt brokers, together with their spouses, were eligible for a trip to New Orleans, pursuant to the terms of the company’s brokerage inventive program. At the request of the company, and at the company’s expense, the taxpayer and his wife accompanied the brokers to New Orleans for the purpose of ensuring they had a good time. Minister reassessed the taxpayer to include a portion of the value of the trip in his income as a taxable employment benefit pursuant to paragraph 6(1)(a).

**Issue:** Was the value of the trip taken by the taxpayer and his wife a taxable benefit?

**Held:** No, the value of the trip taken by the taxpayer and his wife were not a taxable benefit.

**Reasons:**  “In light of existing jurisprudence that no part of the appellant’s trip expenses should be regarded as a personal benefit unless that part represent a material acquisition for or something of value to him in an economic sense and that if the part which represents a material acquisition or something of value was a mere incident of what was primarily a business trip it should not be regarded as a taxable benefit within s. 6(1)(a).”

* A tax benefit to an employee is something that represents a material acquisition for, or something of, value to the employee in an economic sense and that is not merely incidental to something that is undertaken primarily in furtherance of the employer’s business.
* The principal purpose of the trip to New Orleans was business, having regard to the fact that the overwhelming portion of the taxpayer and his wife’s time in New Orleans was devoted to business activities
* Accordingly, any pleasure derived by the taxpayer or his wife was incidental to the business purpose for the trip
* The presence of the taxpayer and his wife in New Orleans was primarily for the benefit of the taxpayer’s employer and not the taxpayer

**Ratio:** Where something is principally for employer’s benefit, any personal benefit derived may be merely incidental, and not a taxable benefit.

#### The Queen v. Huffman, 1990 (FCA)

**Facts:** Mr. Huffman was a plain-clothes police officer. Unlike “regular: police officers, who received free uniforms, Huffman was required to purchase and wear ordinary street clothes. Under the terms of a collective agreement, Mr. Huffman was paid $500 as a clothing allowance to accommodate his police equipment (e.g. walkie-talkie, revolver, handcuffs, etc.) Mr. Huffman purchased his work clothes one size bigger than he would normally wear. The active nature of his job substantially reduced the usable life of the clothing he wore during the performance of his duties. The Minister reassess Mr. Huffman to include the $500 clothing allowance in his income as a taxable benefit pursuant to paragraph 6(1)(a).

**Issue:** Was the $500 clothing allowance a taxable benefit?

**Held:** No, the $500 clothing allowance was not a taxable benefit.

**Reasons:** Mr. Huffman was required to incur certain expenses with respect to his clothing to carry out the duties of his employment as a plainclothes officer. The reimbursement of these expenses should not be considered as conferring a benefit under paragraph 6(1)(a).

* The clothing allowance did not represent an economic advantage to Mr. Huffman since he was simply being restored to the economic situation he was in before his employer ordered him to incur the expenses.
* Clothes were not clothing he usually wore – they were a size bigger and wore easily. In essence, they were a different type of uniform.

**Question:** What would be the result have been if Huffman had been paid $500 more in salary? Would he have been permitted to deduct this?

* Yes, he would have been taxable on the amount without an offsetting deduction because there is no specific statutory deduction in s. 8 that would have applied in the taxpayer’s situation. Therefore, the way you structure a payment or transaction can affect how it is taxed
* H would simply be taxed on the $500 as part of his salary. It would not be deductible. Therefore, it is more tax efficient to structure the $500 as a clothing allowance that is not a taxable benefit.

**Ratio:** An allowance for expenses incurred for the principal purpose of work and by request of one’s employer are not taxable benefits.

#### Cyril John Ransom v MNR, 1967 (Ex. Ct.)

**Facts:** Mr. Ransom lived in Sarnia and worked for Dupont. Dupont transferred him to Montreal. At the time of the move to Montreal the housing prices in Sarnia had fallen and R incurred a loss on the sale of his house. Dupont reimbursed R for the loss. Minister reassessed R to include in his income the amount reimbursed by Dupont as a taxable benefit under paragraph 6(1)(a).

**Issue:** Was the amount reimbursed by Dupont a taxable benefit under section 6(1)(a)?

**Held:** No, the reimbursement for the loss on the sale of the employee’s house was not a taxable benefit.

**Reasons:** There is no difference between compensating an employee for the amount he or she is out of pocket on the sale of the employee’s house and compensating the employee for other travel expenses. The loss was incurred by R by “reason of his employment” and the reimbursement by Dupont did not confer an economic benefit on him.

* Do you disagree with this decision?
* Was the amount paid by Dupont a reimbursement of an employment expense or a personal expense?
* Or is the payment principally an economic benefit to the employee?
	+ The loss was not created by the employer asking its employee to relocate. The move did not cause the devaluation, it merely triggered the realization of the loss that already existed. The value of real property right now is the value that it is, regardless of what price it was bought at. Its current value has no connection to what it was bought for
	+ What if you overpaid for your house when you bought it? Why should your employer compensate you for that?
	+ Value of the house may never have risen, so if it were naturally sold later, it may never have been entitled to higher sale price.
	+ Double dipping: Imagine you buy a house $200K that is now worth $150K. Employer tells you to move 2 blocks and reimburses you for $50K loss. You buy a replacement home 2 blocks over for $150K. Essentially, you have an economic benefit of $50K.
		- The argument that needs to be made is, it is only because of the move that the house was worth $150K
			* Ex: Imagine if employer was relocating all Sarnia employees and suddenly there are 100 new houses on the market which drives market prices down. Then there is a better argument for connecting the move and the loss. Employees were forced to sell their house for less money because of the artificial effect of the employer’s choice to move all employees.
* Did the need to relocate to a new place of employment cause the value of the taxpayer’s house to decline?
* If the taxpayer stayed in Sarnia would this have prevented the loss he would have incurred on the sale of his house?

**Ratio:** Where employer asks as an employee to relocate for work and employee realizes a loss on the sale of their house, a reimbursement for such loss by the employer is not a taxable benefit.

#### The Queen v. Phillips, 1994 (FCA)

**Facts:** Phillips worked for CNR, and lived in Moncton, New Brunswick. CNR closed its New Brunswick operations and moved its personnel to Winnipeg. Housing was more expensive in Winnipeg and CNR gave P $10, 000 to help him purchase a new, more expensive home in Winnipeg. The Minister reassessed P to include the $10, 000 in his income as a taxable benefit.

**Issue:** Was the $10,000 payment to buy a replacement home in a more expensive real estate market a taxable benefit?

**Held:** Yes, the $10K payment to buy a replacement home in a more expensive real estate market was a taxable benefit.

**Reasons:** The Court distinguished the facts from *Ransom.* In *Ransom,* taxpayer had been reimbursed for an actual loss suffered. Here, P had been given an additional $10,000 to purchase a more expensive home. The $10,000 was an economic advantage conferred on P and was taxable.

* Argument: The payment was to help Phillips buy a house similar in features to his house in New Brunswick. For example, a $100K house in Winnipeg might have one less bedroom than a $100K house in New Brunswick, so the employee lost a bedroom
* Counter Argument: But from an economic standpoint, the employee now has a house that is worth an additional $10K
* Do you think the *Ransom* and *Phillips* decisions can be distinguished on the facts? - MacArthur thinks these two cases are inconsistent
* Aren’t both taxpayers in either case economically better off as a result of the payment from their employer?

**Ratio:** Where an employer asks an employee to relocate for work, an allowance from the employer to buy a replacement house similar in features in a more expensive real estate market is a taxable benefit.

#### Krull v. Canada, 1996 (FCA)

**Facts:** Petro-Canada required 5 employees to move from Calgary to Toronto. Housing was much more expensive in Toronto and employees were required to take out a larger mortgage to purchase comparable homes. Petro-Canada reimbursed employees for increased amount of interest payable on employee’s mortgages. Minister reassessed employees to include the reimbursement of the interest payments as a taxable benefit.

**Issue:** Was the reimbursement a taxable benefit?

**Held:** Majority of the FCA held that this was not a taxable benefit on the basis that the employees net worth had not been increased

**Reasons:** The homes were comparable to the homes in Calgary and there had not been any increase in the employee’s equity in their homes (due to the fact that although the homes were more valuable, the mortgage principal was also larger)

* Do you agree with the logic in *Krull?*
	+ It seems like a benefit to the employee. The employee is better off than before. They have a more expensive house which comes with a more expensive mortgage, in which part of that mortgage, the interest payments, are being paid by their employer
	+ Employee could still have done his job in a smaller house in Toronto, so what is the extra money for? For the benefit of the employee to live in a larger house
	+ The distinguishing feature being whether the employee’s net benefit has changed is a view that is too simplistic
* Do you agree that providing an interest subsidy to permit employees to purchase a more expensive house does not constitute the conferral of an economic advantage?
* How is this different than *Phillips* where the employer gave the employee $10, 000 to purchase a more expensive house?
	+ Seems like the same thing as *Phillips*, except for timing of payment
	+ Professor thinks that it just took a really good lawyer who convinced the court that the interest payments were caused by the move which the employer requested; therefore, it is basically just a moving expense

**Ratio:** Where an employer asks an employee to relocate for work, reimbursements of interest payments by the employer for the interest payments on an employee’s more expensive mortgage is not a taxable benefit as long as the employee’ net worth has not increased.

## Housing Losses

* The case law was a mess so the government created legislation on housing losses:
* **Subsections 6(19) to 6(22)**
	+ Applies to an amount paid to or on behalf of a taxpayer or a person who does not deal at arm’s length with the taxpayer
	+ The full amount paid in respect of a housing loss that is not an eligible housing loss is deemed to be a taxable benefit under paragraph 6(1)(a) – **subsection 6(19): Benefit re Housing loss**
		- A payment for a non-eligible housing loss: where replacement home is not at least 40km closer to new work location
	+ The first $15,000 paid in respect of an eligible housing loss is not taxable -**subsection 6(20) – Benefit re Eligible Housing Loss**
		- This is a policy choice by the government to encourage home ownership
	+ Fifty percent (50%) of the amount paid in respect of an eligible housing loss in excess of $15,000 is deemed to be a taxable benefit under paragraph 6(1)(a)- **subsection 6(20) – Benefit re Eligible Housing Loss**
	+ An “**eligible housing loss”** is defined, in general terms, as a loss incurred on the disposition of a house in respect of an “eligible relocation” -**subsection 6(22) – Eligible housing loss**
		- Aka when you sell your house for less than you bought when relocating for work
	+ An **“eligible relocation”** is defined, in general terms, to mean a relocation to enable the taxpayer to carry on employment or business at a new work location, where the taxpayer’s new residence is at least 40km closer to the new work location than the taxpayer’s former residence **-subsection 248(1) – Employer provided housing subsidies**
* **Subsection 6(23)- Employer provided housing subsidies**
	+ For greater certainty, an amount paid or the value of assistance provided by any person in respect of, in the course of or because of, an individual’s office or employment in respect of the cost of, the financing of, the use of or the right to use, a residence is, for the purposes of this section, a benefit received by the individual because of the office or employment
		- “For greater certainty” is used to convey the intention that such amounts are already considered to be a benefit received by the individual because of the office or employment
		- Employer provided housing subsidies provided in the course of employment are employment benefits
		- In *Ransom*, reimbursement for the loss on the sale of the house would be captured. The first $15K would be taxed and 50% of the remaining $35K would be taxed.
		- In *Phillips*, the payment to assist an employee purchase a replacement home in a more expensive real estate market is captured. The full $10K would be taxed.
		- In *Krull*, reimbursement of interest payments on more expensive mortgage captured. Full $10K would be taxed.

### What is the Value of the Benefit?

* In theory, the benefit should be the subjective value to the employee. However, a determination of subjective value to the employee would be difficult. Employees would lie and say that X is not a subjective benefit to them. Courts generally base this determination on the “fair market value” of the benefit
* **Fair Market Value**
	+ “price that would be willingly paid by a buyer who does not have to buy to a seller who doesn’t have to sell” (*Steen v The Queen*, )
* The value of the benefit is the value to the employee
* Fair market value is generally the appropriate proxy for the value of the benefit (*Giffen v The Queen)*
* The cost to the employer of providing a benefit is not an appropriate measure of value (*Giffen v The Queen)*
* The opportunity cost of providing a benefit may be the appropriate measure of value when the benefit is provided at the request of and in accordance with specifications established by the taxpayer (*Youngman v The Queen)*
* Even if employee does not make use of the benefit, it will generally still be taxable as a benefit (e.g. paid parking and gym memberships) (*Richmond v The Queen*, 98 DTC 1804 (TCC))
* Where a benefit has both a work-related purpose and an element of personal benefit, the value of the benefit is apportioned between the work-related purpose and the personal benefit (*Ferguson v MNR*, 72 DTC 1097 (TRB))

#### Giffen v. The Queen, 96 DTC 1011 (TCC)

**Facts:** Taxpayers were required to travel frequently for work and earned frequent flyer points. They redeemed the points for free airline tickets which were used by family members. Minister reassessed taxpayers to include, as a benefit of their employment, the value of the free tickets.

**Issues:** Was the use of the free airline tickets a taxable benefit?What was the value of the benefit?

* The actual cost of an economy ticket on the same flight?
* The cheapest economy ticket on the same flight?
* The incremental cost to the airline of providing the seat on the flight?
	+ Cost of carrying your luggage and weight, your complimentary beverage, etc.
* The cost to the employer?

**Held:** Yes, free tickets were a taxable benefit under 6(1)(a). Value of reward tickets should be no greater than the most heavily discounted economy ticket for the same flight (i.e. FMV).

**Reasons:** The incremental cost to the airline of filling the reward seat was not an appropriate measure of value nor was the cost to the employer since the employer had not paid for the benefit in the open market. The value of the reward tickets should be its FMV which in this case was no greater than the most heavily discounted economy ticket for the same flight.

* CRA since changed adminsitrative policy with respect to goods & services obtained with loyalty points (*Income Tax Technical News No. 40*, June 11, 2009)
* Effective for 2009, the CRA no longer requires the value of these benefits to be included in income, provided:
	+ The points are not converted to cash;
	+ The plan or arrangement is not indicative of an alternate form of remuneration; and
	+ The plan or arrangement is not for tax avoidance purposes

**Ratio:** The general rule is that FMV is the appropriate basis for valuation.

#### Youngman v The Queen, 1990 (FCA)

**Facts:** The taxpayer, his wife and children were shareholders of A Ltd. which had been incorporated for a variety of purposes, including the development of land. The taxpayer and his family moved into a luxury home built by A Ltd. at a cost of approximately $400,000 on land which Ltd. had originally acquired in 1966. The taxpayer paid A Ltd. approximately $1,100 per month for rent and utilities for the house. The taxpayer had loaned A Ltd. approximately $100,000 on an interest-free basis for the purpose of building the house. Minister reassessed the taxpayer to include in his income as a shareholder’s benefit an amount equal to the difference between what the taxpayer had paid for the use and what the company could have otherwise earned if it had invested the funds it had used to build the home (i.e. A Ltd’s opportunity cost).

**Issue:** What was the value of the benefit? Fair market value rent? A Ltd.’s opportunity cost?

**Held:** The appropriate measure of value was A Ltd.’s opportunity cost (i.e. what it could have earned if it invested its money elsewhere)

**Reasons:** In valuing the benefit, it was also necessary to take account of the interest-free loan that the taxpayer made to A Ltd. by reducing the value of the benefit by an amount equal to the interest that A Ltd should have paid

* Why didn’t the court accept fair market value rent as the appropriate measure?
	+ Because A Ltd. built the house at the request of and in accordance with the taxpayer’s specifications. Because the house was built according to the taxpayer’s specifications, it was unlike other houses in the area which made it difficult to establish a FMV rent. Also, in the area that the house was built, there were no comparable houses to determine FMV for the rent.
* So the court used the opportunity cost of what the company could have earned with the money used to build the house
	+ This case had unique circumstances. Can stand for the principle that sometimes FMV will not be used when it is not determinable

**Ratio:** Where FMV is not determinable, sometimes it will not be used. The opportunity cost to an employer of providing a benefit may be the appropriate measure of value when the benefit is provided at the request of and in accordance with specifications established by the employee.

## Allowance

* A periodic/other payment that employee receives from an employer, in addition to salary/wages, without having to account for its use
	+ *The Queen v Huffman*
	+ Employer doesn’t require receipts. You just get the allowance, regardless of what you actually spend it on.
* Normally the purpose of an allowance is to compensate the employee for expenses they are likely to incur in the course of employment
* An amount received as an allowance for personal/living expenses or for any other purpose is generally taxable – **paragraph 6(1)(b)**
	+ Some allowances are non-taxable.

## Reimbursement

* This contrasts with an allowance
* A payment from an employer to an employee to compensate for actual amount of expense incurred by employee **on behalf of employer**
	+ Requires receipts which will be specifically reimbursed
* Includes an amount advanced to an employee if the employee must account for how it is spent
* Normally not taxable unlike allowances

## Non-Taxable Allowances

* Reasonable allowances for travel expenses (including payment in respect of use of MV) received by salesperson – **subparagraph 6(1)(b)(v)**
* Reasonable allowances for travel expenses (other than allowances for the use of a motor vehicle) received by non-salesperson for travelling, in the performance of employment duties, away from the municipality and the metropolitan area where the employer’s establishment, at which the employee ordinarily worked, is located **– subparagraph 6(1)(b)(vii)**
* Reasonable MV allowances received by non-salesperson employee travelling in performance of duties of employment – **s. 6(1)(b)(vii.1)**
	+ A salesperson is an employee employed in connection with selling of property or negotiating of contracts on behalf of employer
	+ Allowance in respect of the use of a motor vehicle *must be based solely on the number of kilometers for which the vehicle is used*in connection with or in the course of the office or employment, if it is deemed not to be reasonable – **subparagraph 6(1)(b)(x)**
	+ The number of kms cannot be based on an estimate and must be based on the actual number of kms driven each month.
		- *Positano v The Queen*, 2018 TCC 160
		- See also Doc 2005-01150611E5
* If the taxpayer receives both an allowance for the use of a motor vehicle and is reimbursed in whole or in part for expenses relating to the use of the motor vehicle, the allowance is deemed not to be reasonable -  **subparagraph 6(1)(b)(xi)**
* Per km rates set out in Reg 7306 are only a guide, not determinative of what is reasonable (See Doc 2015-0565961E5)

## Deductions

* **Subsection 8(2)**
	+ Except as otherwise permitted by this section, no deductions shall be made in computing a taxpayer’s income for a taxation year from an office or employment (the only amounts that can be deducted are those specifically provided for in this section)
	+ Legal expenses – **paragraph 8(1)(b)**
		- Amounts paid as legal fees to collect or establish a right to amounts taxable as income from an office or employment under subdivision a (E.g. if you sue your employer, those legal fees will be deductible)
	+ Salesperson expenses – **paragraph 8(1)(f)** (can deduct as long as the aggregate of these expenses does not exceed their income from commissions). Essentially, where a company is treating its salesperson like they operate their own mini business and they incur costs that are not reimbursed, that individual can deduct those expenses
		- Taxpayer must be employed in connection with selling property or negotiating contracts
		- Required to pay own expenses under employment contract
		- Regularly required to carry on duties away from their place of work
		- Was remunerated in whole or part by commissions
		- Did not receive a non-taxable allowance for travel expenses
	+ Travelling expenses - **paragraph 8(1)(h)**
		- Regularly required to carry on duties away from their place of work
		- Required to pay own expenses during employment contract
		- Did not receive a non-taxable allowance for travel expenses
		- Did not deduct expenses under another provision
		- Excludes motor vehicle expenses
	+ Motor vehicle travel expense -**paragraph 8(1)(h.1)**
		- Regularly required to carry on duties away from the workplace
		- Required to pay own expenses under employment contract
		- Did not receive a non-taxable allowance for motor vehicle expenses
		- Did not deduct expenses under another provision
	+ Annual professional membership dues **– subparagraph 8(1)(i)(i)**
		- E.g. Law Society annual fee?
	+ Office rent and assistant’s salary required under employment contract – **subparagraph 8(1)(i)(ii)**
	+ Supplies required under employment contract - **subparagraph 8(1)(i)(iii)**
		- Limited to materials that are consumed directly in the performance of the duties of the employment
	+ Union dues – **subparagraph 8(1)(i)(iv)**
	+ Professional board dues- **subparagraph 8(1)(i)(vii)**
	+ CPP and EI premiums – **paragraph 8(1)(I.1)**- for renumeration paid to an assistant or substitute
		- Not CPP and EI premiums that you pay on your income (those are credits), but for renumeration paid to an assistant
	+ Registered pension plan contributions – **paragraph 8(1)(m)**
* **Home Office Expenses- Subsection 8(13)**
	+ This is a LIMIT on a deduction, not permission to deduct!
		- This provision limits the deduction of home office expenses that otherwise would be deductible
			* E.g. lawyer who has a home office. If you are permitted to deduct HO expenses, s. 8(13) will limit them
	+ Limitation does not apply to supplies like pens and pencils, but rather to the expenses connected to maintaining a home office such as utilities, rent, insurance and property tax etc.
	+ Limits an employee’s ability to claim home office expenses except in respect of a workplace:
		- Where the individual principally (more than 50% of the time) performs the duties of their office or employment; **OR**
		- That has been used **exclusively** during the period to which the expenses relate to earn income from the office or employment and, on a regular and continuous basis, for meeting customers or other persons in the ordinary course of performing the office or employment duties
			* Home office expenses are those incurred that help to physically maintain the office space (i.e. rent,. Mortgage interest, utilities, property taxes, insurance and maintenance costs or minor repairs)
			* Do not include expenses in relations to office supplies and equipment (I.e. fees for telephone and internet)
			* E.g. A room in your house when you do some extra work at night in will NOT pass this test for a home office. The application of this exception is quite restrictive to true home offices.
	+ **Subsection 8(2)** is still applicable; therefore, only those employees entitled to a deduction under p. 8(1)(f) [as a salesperson] and, to a lesser extent, 8(1)(i)[those entitled to deduct for office rent] are permitted to deduct home office expenses
		- See IT-352R2- Employee’s expenses, including workspace in home expenses
* **Subsection 8(4)- Meals**
	+ The cost of meals consumed by the taxpayer is only deductible under paragraph 8(1)(f) or 8(1)(h) if the meal is consumed during a period while the taxpayer is required to be away for a period of not less than twelve hours from the municipality and metropolitan area where the employer’s establishment to which the taxpayer ordinarily reported for work is located
		- Whereas a meal allowance does not require a minimum 12-hour period away from the city
* **Subsection 8(10) – T2200**
	+ An amount is only deductible under paragraph 8(1)(f), (h) or (h.1) or subparagraph 8(1)(i)(ii) or (iii) if a prescribed form (T2200), signed by the taxpayer’s employer and certifying that the conditions are set out in the applicable provision were met, is filed with the taxpayer’s return of income for the year
		- To actually get the deduction from income from employment, you need to have your employer sign this form
			* *Chao v The Queen*, 2018 TCC 72
			* *Richardson v The Queen*, 2018 TCC 135
* **Subsection 220(2.1) – Waiver by Minister**
	+ Minister may waive the requirement to file the prescribed form, in which case the taxpayer is required to provide the documentation or information at the Minister’s request
		- If employer refuses to sign form, there have been some cases where courts are understanding and accepts deductions

# Income from a Business

## Legislative Framework

* **Part I, Division B – Computation of Income**
	+ **Paragraph 3(a)**
		- 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 (other than a taxable capital gain from the disposition of a property) 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
* **Subdivision b – Income or Loss from a Business or Property**
	+ **Subsection 9(1)**
		- Taxpayer’s income for a taxation year from a business/property is taxpayer’s profit from that business/property
		- Profit not defined in *ITA*. Profit is defined as the difference between the receipts from the business and expenditures laid out to earn those receipts. If taxpayers expenditures exceed receipts, the taxpayer has a loss from the business.
		- Profit is a determination of law to be determined in accordance with the *ITA*
	+ **Subsection 9(2)**
		- … a taxpayer’s loss for a taxation year from a business or property is the amount of the taxpayer’s loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require
	+ **Subsection 12(1)**
		- There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
			* Amounts received on account of services not rendered or goods not delivered before end of year – **p. 12(1)(a)**
			* Amounts receivable for property sold or services rendered during business – **paragraph 12(1)(b)**
			* Interest – **paragraph 12(1)(c)**
			* Amounts deducted in a preceding year as a reserve for doubtful accounts – **paragraph 12(1)(d)**
			* Amounts deducted in the immediately preceding taxation year on account of a reserve for services not rendered or goods not delivered or in respect of reasonable warranty claims – **paragraph 12(1)(e)**
			* Partnership income – **paragraph 12(1)(l)**
	+ **Subsection 18(1)**
		- In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
			* An outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property – **paragraph 18(1)(a)**
			* An outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Par t – **paragraph 18(1)(b)**
			* An amount as, or on account of, a reserve or a contingent liability except as expressly permitted by this Part – **paragraph 18(1)(e)**
			* Personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer’s business – **paragraph 18(1)(h)**
			* Expenses of a personal services business – **paragraph 18(1)(p)**
		- Unlike employment income where a taxpayer’s deductions are limited to those permitted by s. 8, in computing income from business a taxpayer is generally allowed a deduction for any amount expended to earn the income unless expenditure is specifically prohibited by *ITA*. Main limitation of amounts expended by a taxpayer is subsection 18(1)
	+ **Subsection 20(1)**
		- Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer’s income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonable be regarded as applicable thereto:
			* Capital cost allowance – **paragraph 20(1)(a)**
			* Interest – **paragraph 20(1)(c)**
			* Reserve for services not rendered or goods not delivered in the year – **paragraph 20(1)(m)**
			* Reserve for unpaid purchase price of goods sold – **paragraph 20(1)(n)**
			* Employer contribution to a registered pension plan – **paragraph 20(1)(q)**
	+ **Section 10 – Inventory Valuation**
		- Inventory is the property acquired or produced by a taxpayer for the purpose of resale at a profit
		- Cost of inventory sold is deducted in computing taxpayer’s profit from its sale and therefore taxpayer’s income from business
	+ **Section 13- Depreciable Property**
	+ **Section 67 – Reasonableness requirement**
		- Limits the amount of an outlay or expense to an amount that is reasonable in the circumstances
	+ **Section 67.1- Limitation on expenses for food and entertainment**
	+ **Section 67.5 – Non-deductibility of illegal payments**
	+ **Section 67.6- Non-deductibility of fines and penalties**

## Income from Business

### What is a Business?

* “anything which occupies the time and attention and labour of a man for the purpose of profit is business” (*Smith v Anderson* (1880))
* **Subsection 248(1)**
	+ “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”
* Caselaw generally states that a business is “an organized activity that is carried on by a taxpayer for the purpose of profit”

#### Graham v. Green (Inspector of Taxes), 1925

**Facts:** The taxpayer was in the habit of betting on horses and did so on a large and sustained scale. Very successful and made a living out of it.

**Issue:** Was betting on horses a business that gave ride to a taxable profit?

**Held:** No, betting on horses was not a business that gave rise to taxable benefits Therefore, if he wins, it’s not taxable because it is a windfall (gambling), and if he loses, it cannot be counted as a loss.

**Reasons:** Activities of a gambler can be distinguished from those of a book-maker who rationally organizes activities in a way designed to earn profit by setting odds & placing bets with different parties in an effort to earn a spread. A bet is merely an irrational agreement. It does not involve a rational system designed to make profit. Where an activity becomes more frequent & strategic, there is a question as to whether it is a business

**Ratio:** A business will involve rational system designed to make profit. Therefore, irrational gambling not a business that gives rise to taxable profits.

**Notes:** How would this logic apply to the activities of a casino?

* + Casino owner not a gambler. There is a rational system designed to make a profit whereby a consumer will occasionally win, but for the most part, customers lose and the casino profits. Therefore, a casino is a business.
* What about professional poker players?
	+ Where a poker player is a professional, they are a trained expert and use skills to promote their winnings. They have a rational system designed to make a profit. Therefore, a professional poker player is a business.

#### Walker v MNR, 1951 (Ex. Ct.)

**Facts:**  Taxpayer regularly attended racetracks to place bets. Unlike *Graham¸* he was very active in horse racing and had an interest in 3 horses.

**Issue:** Was the betting of horses a business that gave rise to taxable profit?

**Held:** Yes, betting on horses was a business that gave rise to taxable profits.

**Reasons:** “The crucial point seems to be, was he betting as a hobby, or for pure amusement, or was he systematically carrying on with a view to making money… [W]hen it is considered that the taxpayer did have an interest in several race horses; had the benefit of inside information from jockeys and other persons on the probable outcome of races, which he admits he had due to the fact that he was running some horses which he owned or had an interest in and the further fact that for ten years or more he systematically attended all the races in sometimes four different cities and bet on most of the events, one is almost driven to the conclusion that this set of facts constitutes a business or calling within the meaning of the tax Acts, and the monies made thereby would therefore be taxable.

**Ratio:** A business will involve a level of activity and knowledge which is designed to minimize risk and maximize profit. Therefore, in some circumstances, gambling may be a business that gives rise to taxable profits.

**Note:** How do you distinguish *Graham* and *Walker*?

* *Walker* operated like a business, has a financial interest, relies on more than luck (strategy, inside info, experience, etc.)
* Level of activity and knowledge

#### MNR v Morden, 1961 (Ex. Ct.)

**Facts:**  Taxpayer was an inveterate gambler, placing bets on horse races, baseball, hockey and football games, and on a variety of card games.

**Issue:** Were the taxpayer’s gambling winnings taxable?

**Held:** No, betting on everything was not a business that gave ride to taxable profits

**Reasons:** “I can find no evidence that his operations amounted to a calling or the carrying on of a business. Gambling was in his blood and it provided him with the excitement which he craved. It was his hobby”. The taxpayer gambled because he enjoyed it, not with a view to making money.

* The court did note that had the taxpayer’s activities for the years under assessment been as extensively organized and time consuming as his activities in prior years, any net gain from them might possible have been income from a business.

**Ratio:** Gambling for fun and without a view to making money is not a business that gives rise to taxable profits.

#### Leblanc et al. v the Queen, 2007 DTC 307 (TCC)

**Facts:** After winning a substantial amount of money, 2 taxpayers began participating extensively in sports lotteries, playing 4-5 times a week and betting $200-300K a week on average. They purchased thousands of lottery tickets that covered dozens of combinations selected using a computer program which increased their potential payout and risk significantly. They negotiated volume discounts with lottery retailers and employed friends to pick up the tickets for them. Although they lost 95% of the time, they managed to win $2, 761, 544 from 1996 to 1999. Minister reassessed the taxpayers to include net winnings in their income on the basis that (1) taxpayers were in the business of wagering on government-run sports lotteries in an organized fashion; and (2) they developed a system that ensured that, if they won, the amounts would be large.

**Issue:** Were the gambling winnings taxable? Were the taxpayers carrying on a business?

**Held:** No, the sport lottery gamblers were not carrying on a business that gave rise to taxable profits

**Ratio:** There are three broad categories of gambling cases. Only the last two categories are businesses that give rise to taxable profits.

1. Those involving gamblers of whom gambling was a pleasurable pursuit and therefore not taxable **(hobby)**
2. Those where gambling gains were taxable as an incident of a business carried on by the gambler, **(e.g. a casino owner)**
3. Those where gambling gains were taxable because the gambler used his own expertise and skill to earn a livelihood in a gambling game in which skill is a significant factor **(experience and skill)** (e.g. pool share or riverboat gambler)

**Reasons:** The taxpayers’ activities did not fall into either of the taxable categories.

* “It is suggested that the appellants must have had a system because they were so successful and that that system involved buying a significant number of tickets on long shot outcomes, which, it is argued, minimized their risk, because it ensured that if they did win, they won big. For the reasons that I set out below this strikes me as a *non sequitur*.
* … If I understand it correctly it is this: since you won it proves you must have had a system and therefore business. If you had lost it would have provided you had no system and therefore no business and you could not have deducted your losses. This contention is about as classic an exposition as I have ever seen of the logical fallacy *post hoc ergo propter hoc* [“after this, therefore because of this”]. It is true, they won, but to say they won because they had a system has no basis in the evidence at all. They won in spite of having no system. If one is looking for a partner it is that they bet massively and recklessly and where they could, they bet on long shots. Certainly it meant that if they won they won big, but the converse is that if they lost they lost big and given the astronomical odds against winning, their chances of losing were far greater than their chances of winning.
* This conclusion is consistent with the case law on gambling. The appellants are not professional gamblers who assess their risks, minimize them, and rely on inside information and knowledge and skill. They are not like the racehorse-owner, who has access to the trainers, the horses, the track conditions, and other such insider information to which to base his wagers. Nor are they like seasoned card players or pool players. Who prey on unsuspecting, inexperienced opponents. Rather, they are more accurately described as compulsive gamblers, who are continually trying their luck at a game of chance.”
	+ Minister wanted it both ways. If you win, you have a system, and therefore, should be taxed. If you lose, you don’t have a system, and therefore, you cannot write off those losses.

## Income from Business

* “…Counsel for the Minister stressed that the appellant gambled with a view to profit. However, it must be observed that such an intention is one shared by all who gamble, and the presence of the intention to win or make money in gambling, which is there in all who gamble, does not lead to a conclusion that all who gamble, or even all those who gamble frequently, are carrying on a business. Counsel for the Minister stressed that the appellant took risks, and that he borrowed money in order to carry on his gambling activities. **While risk-taking is necessary in a business, it is management or minimization of risk which is the characteristic of business activity…**There is a total absence of any evidence here which indicates the presence of any organized system for the minimization or management of risk. This lack of system distinguishes the appellant, or intemperate gambler from the professional gambler.”
	+ *Balanko v. Minister of National Revenue*, 81 DTC 887 (TRB), aff’d 88 DTC 6228 (FCTD)
		- **Ratio:** It is management of risk, not risk taking itself, that is the characteristic of a business activity. Just because a gambler has an intention to win money does not mean that they are carrying on a business.
* “I have no difficulty in concluding that Appellant carried on a business of playing pool for profit. He had a system and a reasonable expectation of profit. It was his principal source of income for the years in question. He approaches his business in a professional manner:
	1. He carefully managed the risks.
	2. He was a skilled player.
	3. He played Monday through to Friday each week.
	4. He spent his afternoons playing snooker to perfect his skills.
	5. He played inebriated opponents after 11:00 p.m. to minimize his risk.
	6. He won most of the time earning, approximately $200.00 daily
	7. He drank alcoholic beverages only on weekends when not playing pool to give him a sober advantage over inebriated opponents.
	8. He was calculating and disciplined.
	9. It was his primary source of income and he relied on this steady income.”
		+ *Luprypa v The Queen*, 97 DTC 1416 (TCC)
			- **Ratio:** It is management of risk, not risk taking itself, that is the characteristic of a business activity.

### Reasonable Expectation of Profit (“REOP”)

* In general, the gambling cases turned on issue of whether it was reasonable for taxpayer to expect to make a profit
	+ Where activity relied principally on luck and not skill there could be no reasonable expectation of profit, therefore no business
	+ This approach was also applied in non-gambling cases for purpose of determining if a taxpayer had a source of income from business or property, and over time evolved into judicial test known as the **“reasonable expectation of profit” test or REOP test**
* Under the REOP test, a taxpayer had a source of income if the taxpayer’s activity or property carried a reasonable expectation of profit
* If the taxpayer did not have a reasonable expectation of profit (questioned in cases where the taxpayer realized a loss), the activity or property did not constitute a source of income and the expenses (or loss) claimed by the taxpayer were not deductible
* The REOP test gained prominence in *Moldowan v MNR*, (SCC), where Dickson stated that **“although originally disputed, it is not accepted that in order to have a ‘source of income’ the taxpayer must have a profit or a reasonable expectation of profit.”**
* Following *Moldowan*¸ the REOP Test was applied inconsistently by the Courts, and in many instances as a means of second-guessing the legitimate (*bona fide)* business or commercial decisions of taxpayers
* Eventually rejected as a stand-alone source test by the Supreme Court of Canada (*Stewart v The Queen* and *The Queen v Walls*)

#### Landry v The Queen, 94 DTC 6624 (FCA)

**Facts:** Landry was a 71-year-old lawyer who was retired for 23 years. He started a new practice, which continued for 15 years. Every year he incurred significant losses. He didn’t keep business records, had no budget, he didn’t advertise other than through a listing in the yellow pages, he didn’t always bill clients, he hadn’t taken any professional development courses to update his skills and he hadn’t done anything to change his practice in light of the huge losses. Minister reassessed Landry, disallowing his losses on the basis that he had no reasonable expectation of profit, and therefore, his legal work was not a source of income.

**Issue:** Were Landry’s losses deductible? Was his legal work a source of income? Was there a reasonable expectation of profit?

**Held:** He had no “reasonable expectation of profit” and therefore was not carrying on a business and could not deduct his losses. The evidence does not support the argument that Landry was trying to run a business. Therefore, he had no reasonable expectation of profit. Therefore, his legal work was not a source of business income and he could not claim his losses.

#### Tonn v Canada, [1996] 2 F.C. 73

**Facts:** Tonn purchased a residential property that contained 2 residential rental units, financing the purchase with a mortgage. When he acquired it, Tonn anticipated he would start earning a profit in approximately 3 years. Unfortunately, he did not receive the rental income as expected and expenses were higher than he forecasted. Tonn realized a loss in each of the 3 years, which Minister disallowed on the basis that he did not have a reasonable expectation of profit and therefore the rental units were not a source of income.

**Issue:** Were Tonn’s losses deductible? Were the rental units a source of income? Was there a reasonable expectation of profit?

**Held:** Taxpayer did have a REOP.In the absence of any non-business motive the REOP test should be applied sparingly and with a latitude favouring the taxpayer, whose business judgement may have been less than competent. As long as the evidence doesn’t show a non-business motive, we should consider that the activity/property lost money because taxpayer had bad business judgement. Not because it was simply not a business.

#### Stewart v The Queen, 2002 (SCC)

 **Facts:** Stewart owned 4 rental condo units from which he earned rental income. There was no “personal element” to the ownership of the condos. He didn’t own them for aesthetic value, or for the pure pleasure of owning them. Units were rented to “arm’s length” parties, and taxpayer never intended to occupy them himself. The purchase of the condos was almost entirely financed with borrowed money, on which a considerable amount of interest was paid. The projected revenue and expenses for the condos (taking account of the interest payments) showed an expected loss for the first 10 years. Minister reassessed Stewart, disallowing his losses on the basis that he had no reasonable expectation of profit and therefore the condos were not a source of income.

**Issue:** Were the condos a source of income? Were Stewart’s losses deductible?

**Held:** Yes, the condos were a source of property income, notwithstanding the fact they could not, by design, produce net income.

**Reasons:** SCC concluded that the condos were a source of property income during the years under appeal, even though they could not produce net income. The fact that a reasonable expectation of profit may be a sufficient requirement to conclude that a source of income exists does not mean that a reasonable expectation of profit is a necessary requirement to find a source of income exists. SCC was critical of the decision in *Landry* which had been wrongly decided because there was no “personal consumption element” to Landry’s law practice

* “We emphasize that this pursuit of profit source test will only require analysis in situations where there is some personal or hobby element to the activity in question. **With respect, in our view, courts have erred in the past in applying the REOP test to activities such as law practices and restaurants where there exists no such personal element:** see, for example, *Landry*; *Sirois*; *Engler v The Queen*. Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer’s business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further”

**Ratio:** REOP Test should not be used as a stand-alone test for determining source of income. SCC suggested a two-stage test for determining whether the taxpayer has a source of income from business or property:

1. Determine if the activity of the taxpayer is undertaken in pursuit of profit or as a personal endeavour
2. If it is found not to be a personal endeavour, determine if the source of income is business or property. This means that if there is no personal element, then it is a source of income.
	1. If there is no personal element, then by default, it is a source of income,
	2. If there is a personal element, consider the REOP test and other factors to determine whether an activity has sufficient degree of commerciality to be considered a source of income
* Only in those situations where there is some personal element to the taxpayer’s activities is it necessary to consider the REOP Test for the purpose of determining whether an activity has a sufficient degree of commerciality to be considered a source of income
* Furthermore, in such circumstances the REOP test is only one factor that need to be considered. Other factors may include: (*Moldowan*)
	+ The profit and loss experience in past years
	+ The taxpayer’s training
	+ The taxpayer’s intended course of action
	+ The capability of the venture to show a profit
* The list of factors is non-exhaustive and will differ with the nature and extent of the undertaking
* Overall, the assessment to be made is whether the taxpayer is carrying on the activity in a sufficiently commercial manner
* The assessment should not be used to second-guess the business judgement of the taxpayer. It is the commercial nature of the taxpayer’s activity which must be evaluated, not his or her business acumen.
	+ Bad business acumen does not disqualify a taxpayer’s activity from being a source of income
* “It should also be noted that the source of income assessment is not a purely subjective inquiry. Although in order for an activity to be classified as commercial in nature, the taxpayer must have the subject intention to a profit…this determination should be made by looking at a variety of objective factors. Thus, in expanded form, the first stage of the above test can be restated as follows: “Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention?” **This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.”**

#### Cohen v The Queen, 2011 TCC 262

**Facts:** Taxpayer was an associate lawyer. He decided to leave the practice of law and play poker full time. Taxpayer claimed losses from his poker activities on the basis that he was engaged in the full-time business of poker playing as a professional poker player. Minister denied his claim on the basis that he was a hobby gambler and was not in the business of gambling.

**Issue:** Was the taxpayer in the business of poker playing such that he had a source of income from business?

**Held:** No, the taxpayer’s poker activities were not a source of income and his losses were not deductible.

**Reasons:** “I cannot find that the [taxpayer] demonstrated that he conducted his venture in such a manner as to constitute a profession, calling, trade, undertaking, or adventure or concern in the nature of trade so as to fall within the definition of a business.”

* Gambling activities normally include a personal element. As such, the application of the first stage of the test in *Stewart* is necessary
* Following *Stewart*, each case must be decided on its own facts and one must look to the “commerciality of the activity in question”, meaning the taxpayer’s activity specifically
* Although the ability of a taxpayer to minimize risk is still an important factor, it is only one of the factors to be considered in determining the commerciality of gambling activities following *Stewart*
* In reaching this conclusion, the court found that the taxpayer:
	+ Had no history of profit or losses;
	+ Lacked any real skill or training above that of a novice;
	+ Did not have a well-developed plan and what plan he did have he did not follow;
	+ Lost consistently and provided no evidence that his activities had the capacity to show a profit;
	+ Failed to manage his risk; and
	+ Lacked credibility
* All this supported the finding that the taxpayer had not conducted his poker playing activities in such a manner as to constitute a business

**Note:** this case seems like it has more to do with the carrying out a business test rather than the source of income test. How do they relate to each other? Are they different tests? Or is carrying out a business part of the source of income test under step 1 or step 2?

* Step 1 – pursuit of profit – is the taxpayer carrying out a business?
* Step 2- if there is no personal element, is the taxpayer carrying out a business or is this income from property?
* Step 2- if there is a personal element, is there a sufficient degree of commerciality/ aka is the taxpayer carrying out a business?

# Income from Property

## Business or Property Income?

* The first stage of the test in *Stewart* is determining if you have a commercial activity and therefore a source of income
	+ 1. Determine if the activity of the taxpayer is undertaken in pursuit of profit or as a personal endeavor
	+ 2A. If there is no personal element, then by default, it is a source of income.
	+ 2B. If there is a personal element, consider the REOP test and other factors to determine whether an activity has a sufficient degree of commerciality to be considered a source of income
* Once it is determined that there is a source of income, the second stage is to determine if the source of the income is business or property
	+ The principal factor in distinguishing between business or property income is the level of activity involved:
		- **Question:** Is this where we use the case law for determining what a business is?
		- “If income from property has any meaning at all, it can only mean the production of revenue from the use of such property which produces income without the active and extensive business-like intervention of its owner or someone on his behalf.” (*Lois Hollinger v MNR*, 73 DTC 5003 (FCTD))
* The determination of whether an activity produces income from business or property is particularly difficult in the context of real property transactions and, to a lesser extent, financial or investment activity

### Real Property Transactions

* Renting a single condominium unit
	+ Likely would be income from property since renting a single condominium unit requires very little activity on behalf of the owner
* Renting a condominium building
	+ Requires more activity. However, if only activity is collecting monthly rent and other services are not provided to any significant degree, still likely income from property. If there are also ancillary services provided, then it might be income from business.
* Renting and managing a group of condominium buildings
	+ This requires significantly more activity. You would need to take into consideration the additional services provided in addition to simply collecting rent but here the level of activity is more extensive and therefore, it is more likely, but not certain, that the income earned from this activity is income from a business
* Operating a hotel
	+ This involves extensive activity and includes the provision of many other services, beyond the mere collection of a charge or the use of a hotel room. The income earned from operating a hotel is therefore income from a business
* Real estate development activities
	+ Involves extensive activity. Furthermore, a real estate developer earns income from building, improving and selling real estate. If the earned income is derived from the sale of property, this is clearly income from a business given that, in this context, the owner of the property is engaged in the activity of realizing profits from buying and selling real property

### Financial or Investing Activities

* + Personal investment portfolio
		- This type of investment activity is, with few exceptions, considered income from property
	+ Trading securities
		- Person actively engaged in trading/dealing securities in professional capacity is clearly earning income from a business.
	+ Making a single loan
		- The interest earned on this single loan is generally income from property.
	+ Regularly making loans
		- More likely, but still far from certain, that the income earned from this activity is income from a business
	+ Operating a Bank
		- They are carrying on a business and earning income from a business

## Why distinguish Between Income from Business and Income from Property?

* The application of some of the provisions of the *ITA* depend upon whether the income is income from a business or income from property
* Active business income earned by Canadian controlled private corporations is taxed at preferential rates
* Rules that integrate taxation of private corporations and SHs operate differently when corporation earns business vs property income
* **The attribution rules in sections 74.1, 74.2, 74.3 and 75 apply to income from property, but NOT income from a business**
* Deductibility of certain amounts may be limited where income earned on real property is income from property, but not where it is income from a business
* Non-residents carrying on business in Canada pay tax on business income under Part 1 and tax on income from property under Part XIII
* Tax Treaty provisions may fully exempt non-residents from tax on Canadian business income (i.e. where it is not attributed to a permanent establishment in Canada) but may not exempt them from tax on Canadian source property income
* Certain rules in *ITA* apply differently to foreign business income and foreign property income earned by residents of Canada
* For individuals, income from business is generally taxable in the Province where it is earned; income from property is taxed in the Province where the individual resided on the last day of the calendar year. One exception is where an individual carries on business through a permanent establishment in another province, business income is attribute to that province
* The treatment of foreign tax credits for taxes paid on foreign business income and foreign non-business income is different

## Legislative Framework

* **Part I, Division B- Computation of Income**
	+ **Paragraph 3(a)**
		- 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 (other than a taxable capital gain from the disposition of a property) 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**
* **Subsection 2481(1)**
	+ **“property”** means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes…
		- (a) a right of any kind whatever, a share, or a chose in action
		- (b) unless a contrary intention is evident, money,
		- (c) a timber resource property, and
		- (d) the work in progress of a business that is a profession;
* **Subdivision B- Income or Loss from a Business or Property**
	+ **Subsection 9(1)**
		- Subject to this Part, a taxpayer’s income for a taxation year from a business or property is the taxpayer’s profit from that business or property for the year.
	+ **Subsection 9(2)**
		- … a taxpayer’s loss for a taxation year from a business or property is the amount of the taxpayer’s loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require
		- Profit is not defined in the *Income Tax Act*. Generally, a taxpayer’s profit from a property is the difference between the receipts from the property and the expenditures laid out to earn those receipts. If taxpayer’s expenditures exceed the receipts, the taxpayer has a loss. Profit is a determination of law to be determined in accordance with *ITA*
	+ **Subsection 9(3)**
		- In this Act, “income from property” does not include any capital gain from the disposition of that property and “loss from a property” does not include any capital loss from the disposition of that property
		- This is consistent with the scheme of the *ITA* which distinguishes between income from a source and capital gains
	+ **Subsection 12(1)**
		- There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such the following amounts as are applicable:
			* Interest – **paragraph 12(1)(c) –**
				+ Cash – paid the interest you are owed
				+ Accrued- amount receivable – does this need to have taxes paid on it? No, not until it is received.
			* An amount dependent on the use of or production from property – **paragraph 12(1)(g)**
			* Dividends- **paragraphs 12(1)(j) and (k)**
			* Partnership income – **paragraph 12(1)(l)**
			* Income from trusts – **paragraph 12(1)(m)**
	+ **Subsection 18(1)**
		- In computing the income of a taxpayer from a business or property, no deduction shall be made in respect of (taxpayers are generally allowed a deduction for any amount expended to earn the income unless it is prohibited by the Act)
			* An outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property – **paragraph 18(1)(a)**
			* An outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence, or depletion except as expressly permitted by this Part – **paragraph 18(1)(b)**
			* An amount as, or on account of, a reserve a contingent liability or amount or a sinking fund except as expressly permitted by this Part – **paragraph 18(1)(e)**
			* Personal or living expenses of the taxpayer - **paragraph 18(1)(h)**
	+ **Subsection 20(1)**
		- Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer’s income from a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to the source or such part of the following amounts as may reasonably be regarded as applicable thereto:
			* Capital cost allowance - **paragraph 20(1)(a)**
			* Interest – **paragraph 20(1)(c)**
	+ Depreciable Property – **Section 13**

## Income from Property

### Interest Income

* **Paragraph 12(1)(c)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
		- (c) … any amount received or receivable by the taxpayer in the year (depending on the method regularly followed by the taxpayer in computing the taxpayer’s income) as, on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer’s income for a preceding taxation year;
			* Although interest is normally included in computing the taxpayer’s income from property, there are some circumstances where interest received by a taxpayer (i.e. a Bank) is characterized as income from a business. **However, for the purposes of this course, interest will always be treated as income from property.**

### Interest Income – Cash or Accrual?

* Interest is included in income when received or receivable by taxpayer, depending on the method regularly followed – **paragraph 12(1)(c)**
	+ Receivable means the taxpayer has a right to the amount but has not received it yet
	+ Whether an amount is included when it is received or when it is receivable depends on whether the taxpayer accounts for income on a cash basis or an accrual basis. In most cases, an individual will accrue income on interest on a cash basis or when it is received. **For this course, we will assume that all individuals accrue interest on a cash basis.**
* Corporations, partnerships, unit (i.e. commercial) trusts or any other trust of which a corporation or a partnership is a beneficiary, are **required** to include interest in computing income on an accrual basis or when it is receivable – **subsection 12(3)**
* The fact that an individual accounts for interest on a cash basis when it is received creates the opportunity to convert an amount that would otherwise be received as interest on a debt obligation into a capital gain by selling debt obligation immediately before the interest is paid. This is because when a debt obligation (bond) is bought or sold, the price paid for the bond will normally increase with the amount of interest accrued on the bond. If this is done, individual includes only half the amount in their income as a taxable capital gain. In contrast, if individual had continued to hold debt obligation, and received amount as interest, full amount would have been included.

### Sample Problem

* Assume that Jack holds a bond with a par value of $100, which pays simple interest of 10% per year
	+ The par value of the bond is the amount that would be paid to the holder of the bond when the bond matures
* Jack originally purchased the bond for $100
* Assume bond matures at end of the year and Jack receives interest of $10 and repayment of $100. What are Jack’s tax consequences?
	+ Interest income: **$10 –** Jack will be required to include this $10 of interest in computing his income. -**12(1)(c)**
	+ The return of the $100 is considered PoD. As such, he does not realize a gain or loss on the disposition of the bond because Jack’s ACB is $100, what he originally paid to purchase the bond. Jack therefore has $10 of income
		- Capital gain: PoD ($100)- ACB ($100)= $0
* Now assume Jack sells this bond to Jill for $110, immediately before the $10 of interest is paid. What are the tax consequences to Jack?
	+ Bond held by Jack is an investment property and therefore, a gain realized on its disposition will likely be a capital gain. As such, if Jack sells bond to Jill for $110, Jack will realize a capital gain of $10. Half of this, $5, will be included in his income as a taxable capital gain. Jack only has $5 of income which is $5 less than when he held the bond to maturity and received the $10 as interest.
	+ Interest income: $0
	+ Capital gain: PoD ($110) – ACB ($100) = $10
	+ Taxable capital gain: $10 X ½= **$5**
* Tax consequences to Jill:
	+ Interest income: **$10**
	+ Capital loss: ACB ($110)- PoD ($100) = $10
		- Jill acquired bond with an ACB of $110. When bond matures, Jill will receive $10 of interest and $100 par value.
	+ Allowable capital loss = $10 X ½ = **$5**
	+ Jill is required to report $10 of income even though she has only received back the $110 she paid Jack for the bond. The return of the $100 par value is considered PoD. As such, Jill will realize a capital loss of $10 because her PoD are only $100 and her ACB is $110. Half of this capital loss, or $5, is an allowable capital loss which can only be used if Jill has taxable capital gains. The overall result for Jill is that she is taxed on $10 of income and realizes a $5 allowable capital loss which she cannot use to offset the interest income. The tax result is particularly bad for Jill because she received $110 when the bond matured which is exactly what she paid Jack to purchase the bond. Why should Jill be required to pay tax on any of the $110 when it is simply return of what she paid for the bond? Does this result seem appropriate?
		- It is because of this problem that subsection 20(14) was enacted

### Sale of Obligations with Accrued Interest

* **Subsection 20(14)**
	+ Where, by virtue of an assignment or other transfer of a debt obligation … **the transferee has become entitled to an amount of interest that accrued on the debt obligation** for a period commencing before the time of transfer and ending at the time that is not payable until after that time, that amount
		- (a) shall be **included as interest in computing the transferor’s income** for the transferor’s taxation year in which the transfer occurred, except to the extent that it was otherwise included in computing the transferor’s income for the year or a preceding taxation year; and
		- (b) **may be deducted in computing the transferee’s income** for a taxation year to the extent that the amount was included as interest in computing the transferee’s income for the year
			* If Jack has a bond that is going to receive $10 in interest the next day, he will sell it today for $110. The gain of $10 is now a capital gain rather than income from property which would have been taxed on receipt. That means Jack has an incentive to sell the bond before receiving the interest in order to treat it as a capital gain and get taxed on only 50% of it instead of all of it. S. 20(14) closes this loophole. It causes that $10 gain to be treated as interest and the $100 to be treated as the PoD, thereby removing any capital gain.

### Sample Problem 1 – Continued:

* Assume that Jack holds a bond with a par value of $100, which pays simple interest of 10% per year.
* Jack originally purchased the bond for $100.
* What are the tax consequences if Jack sells the bond to Jill for $110, immediately before the $10 of interest is paid?
	+ Tax consequences to Jack?
		- Interest income: $10 – **paragraph 20(14)(a)**
			* Jack will have to include this $10 of interest in computing his income. The $10 included as interest will not be treated as PoD so Jack’s PoD will be $100.
		- Capital gain: PoD ($100) – ACB ($100)= $0
			* Jack does not realize a gain or loss on the disposition of the bond because hid PoD is equal to his ACB. Therefore, Jack has $10 of income.
	+ Tax consequences to Jill?
		- Interest income: $10 – **paragraph 12(1)(c)**
			* Jill is required to include $10 of interest received in computing income but is permitted deduction of $10
		- Deduction: $10 – **paragraph 20(14)(b)**
		- Net income inclusion: $10 - $10 = $0
* What about Jill’s gain or loss on disposition of the bond?
	+ Capital loss: ACB (what she paid for the bond) ($110)- PoD (par value of the bond) ($100)= $10
	+ Allowable capital loss = $10 X ½ = $5
* Does this make any sense?
* Why does she get a capital loss if she was not taxed on interest income because of the deduction she was permitted under 20(14)(b)?
	+ **Answer:** Jill does not realize a capital loss because of paragraph 53(2)(l)

### Sale of Obligations with Accrued Interest

* **Paragraph 53(2)(l)**
	+ “(2) In computing the adjusted cost base to a taxpayer of property (a debt obligation) at any time, there shall be deducted such of the following amounts in respect of the property as are applicable: …
		- (l) where the property is a debt obligation, any amount that was deductible by virtue of s. 20(14) in computing the taxpayer’s income for any taxation year commencing before that time in respect of interest on that debt obligation;”
			* If Jill buys a bond for $105, then her cost base will be $105. When she sells the bond for $100, her PoD will be $100, resulting in a $5 capital loss, which she could then get a tax benefit from. Section 53(2)(l) closes this loophole. It reduces the ACB by an amount equivalent to the accrued interest collected by Jack.
			* Section 53(2)(l) deals with the ACB of the bond to Jill. Jill can deduct the amount of interest accrued to Jack to offset that amount of income. When the bond pays the $10 of interest to Jill, she can deduct the $5 that was included in Jack’s income.

### Sample Problem #1-Continued:

* Under 20(14)(b), when computing her income, Jill is required to deduct $10 from her ACB of the bond in accordance with 53(2)(l)
* Jill’s adjusted gain or loss on disposition:
	+ ACB = $110- $10 = $100 – **paragraph 53(2)(l)**
	+ Capital gain/loss: PoD ($100) – ACB ($100) = $0

### Sample Problem #2:

* Assume that Jack holds a bond with a par value of $100, which pays simple interest of 10% on December 31st of each year.
* Jack originally purchased the bond for $100.
* What are the tax consequences if Jack sells this bond to Jill on June 30th for a cash purchase price of $110?
	+ It is important to note that Jack is selling the bond to Jill on June 30th which is halfway through the year. As such, there is only $5 of accrued interest on the bond because if the bond pays $10 of interest at the end of the year, there will only be $5 of interest accrued on the bond on June 30th. The face value of the bond is $100. On June 30, 10% \* 6/12 =5% interest has accrued.
* What are the tax consequences to Jack?
	+ Interest income: $5 – **paragraph 20(14)(a)**
		- Since there is only $5 of accrued interest at the time Jack sells the bond, Jack is only required to include, in computing his income, $5 as interest pursuant to paragraph 20(14)(a). The $5 included as interest will not be treated as PoD.
	+ Capital gain: PoD ($105) – ACB ($100) = $5
		- Jack’s PoD will be $110 - $5 = $105. The $5 capital gain here is the amount by which his PoD exceeds his ACB on $100
	+ Taxable capital gain: $5 X ½ = $2.50
* What are the tax consequences to Jill?
	+ Interest income: $10 – **paragraph 12(1)(c)**
		- If Jill receives the $10 of interest on December 31st, she is required to include the $10 in computing her income.
	+ Deduction: $5 – **paragraph 20(14)(b)**
		- However, she is also entitled to deduct the $5 of interest that had accrued on the bond
	+ ACB = $110 - $5 = $105 – **paragraph 53(2)(l)**
		- Jill includes a net amount of $5 in computing her income which is equal to the amount of interest that accrued on the bond for the 6 months that Jill has owned it. Since Jill deducted $5 under 20(14)(b), she is required to deduct $5 in computing her ACB of the bond in accordance with 53(2)(l).

### Sample Problem #3:

* Assume that Jack holds a bond with a par value of $100, which pays simple interest of 10% on December 31st of each year.
* Jack originally purchased the bond for $100
* What are the tax consequences if Jack sells this bond to Jill on June 30th for a cash purchase price of $100?
* What are the tax consequences to Jack?
	+ Interest income: $5 – **paragraph 20(14)(a)**
		- Since Jack sold the bond to Jill on June 30th, there is $5 of accrued interest on the bond when Jack sells the bond to Jill. Jack is therefore required to include $5 in computing his income
	+ Capital loss: ACB ($100) – PoD ($95) = $5
		- The $5 included as interest will not be treated as PoD so Jack’s PoD will be $100 - $5 or $95.
		- As such, Jack will realize a capital loss of $5 which is the amount by which his ACB exceeds his PoD
	+ Allowable capital loss: $5 X ½= $2.50
* What are the tax consequences to Jill?
	+ Interest income: $10 – **paragraph 12(1)(c)**
		- Since Jill receives the $10 of interest on December 31st, she is required to include the $10 in computing her income
	+ Deduction: $5 – **paragraph 20(14)(b)**
		- However, Jill is also entitled to deduct the $5 of accrued interest
		- As such, Jill includes a net amount of $5 in computing her income which is equal to the amount of interest that accrued on the bond for the 6 months Jill has owned it.
		- 20(14)(b) still applied even though the value of the bond was equal to its par value of $10 because the application of s. 20(14) does not depend on the value of the debt obligation, nor the price paid for it. The application of 20(14) depends on the sole question of whether the transferee becomes entitled to interest that accrued on the debt obligation before it was transferred
	+ ACB = $100 - $5 = $95 – **paragraph 53(2)(l)**
		- Since Jill deducted $5 under 20(14)(b), she is required to deduct $5 in computing her ACB of the bond

### Rents and Royalties

* **Paragraph 12(1)(g)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
		- (g) any amount received by the taxpayer in the year that was dependent on the use of production from property…;
* **Meaning of “Rent” or “Royalty”**
	+ P. 12(1)(g) does not use the term “rent” or “royalty”, however, these are the types of payments to which it generally applies
	+ The basic difference between a rent and a royalty is that rent is normally a fixed amount paid for the use of property and a royalty is normally a variable payment that is dependent on the degree of use or production from property
	+ **Rent**
		- In general terms is a fixed payment for the use of real or personal property over a specified period of time
		- Although not necessary, rent payments are normally made on a periodic basis
	+ **Royalty**
		- A payment that is computed by reference to the production or use of property
		- Common royalties include payments based on the production or use of a resource property (timber, minerals, oils and gas) and the use of intellectual property (e.g. copyright, trademarks and patents)

### Canadian Source Dividends

* **Paragraph 12(1)(j)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:…
		- (j) any amount required by subdivision (h) to be included in computing the taxpayer’s income for the year in respect of a dividend paid by a corporation resident in Canada on a share of its capital stock;
			* Subdivision (h) includes special rules that are applicable to computation of income in respect of corporations resident in Canada and their shareholders.
* The term dividend is not defined in the *Income Tax Act*, other than defining it as including a stock dividend – **subsection 248(1)**
* Under common law a dividend is generally defined to include any *pro rata* distribution from a corporation to its shareholders, unless the distribution is made on the liquidation of the corporation or as a reduction and return of share capital
* For Canadian income tax purposes, the characterization of a payment as a dividend generally follow its legal form. For example, if it is a dividend for corporate law purposes, then it is a dividend to *ITA* purposes
* If a dividend is properly declared in accordance with the provisions of the governing corporate statute then it will generally be a dividend for tax purposes, unless a provision of the *Income Tax Act* deems otherwise:
	+ For example, certain inter-corporate dividends are deemed to be capital gains when paid in connection with a divisive (“butterfly”) reorganization **- subsection 55(2)**
* If a distribution is properly constituted as a reduction and return of capital, then it will generally not be a dividend for tax purposes.
* For the purposes of this course, where “dividend” is used to describe a payment, it should be assumed to be a dividend for tax purposes

**Basic Tax Treatment**

* The *ITA* contains special rules relating to the taxation of dividends from Canadian corporations for individual and corporate taxpayers
* Rules based on the presumption that dividend is a distribution of profits that has already been subject to tax levied on corporation
* Accordingly, the rules are designed to effectively avoid the double taxation of corporate profits (i.e. tax on the profits both when they are earned by the corporation and again when they are distributed to the shareholder as a dividend)
* For Canadian resident individuals, the rules attempt to integrate the shareholders and corporate levels of tax through the use of a dividend “gross-up and credit mechanism” – **subsection 82(1) and section 121**
* For Canadian resident corporations the elimination of double tax is achieved by permitting corporate shareholder a deduction (referred to as *“inter corporate dividend deduction”* equal to the amount of dividends received from other Canadian corporations – **s. 112(1)**

**Gross-Up and Credit**

* In dealing with the taxation of dividends received by Canadian resident individuals, the first step is to “gross up” the amount of the dividend by the assumed amount of tax paid by the corporation
* In theory, the objective of the gross up and credit mechanism is to make a taxpayer pay the same amount of tax on income received through a corporation as he would have paid if the income was earned directly
* **The “Gross-Up”**
	+ In calculating income, an individual is required to include 2 amounts in respect of a dividend on shares of a Canadian corporation:
		- The actual amount of the dividend – **paragraph 82(1)(a)**
		- A “gross-up” which is computed as a specified percentage of the actual amount of the dividend – **paragraph 82(1)(b)**
	+ For the purpose of the course, we will assume the specified percentage is 25%
	+ Net result is that individual is required to include in income an amount greater than what they actually received as a dividend
	+ On the assumption that the corporation is distributing the dividend from after tax profits, purpose of the “gross-up” is to notionally add back amount of tax paid by the corporation and treat it as if it was paid to the individual shareholder as a dividend
	+ In general, provincial tax statutes compute income by reference to *ITA* so “gross-up” is also applied for provincial tax purposes
* **The “Credit”**
	+ In computing the amount of tax payable, an individual is permitted a deduction (a dividend tax credit) equal to a specified proportion of the “gross-up” computed under paragraph 82(1)(b) – **section 121**
	+ The amount of the credit assumes that the provincial tax statutes will provide an equivalent credit in computing provincial tax
		- For example, if credit is equal to 2/3 of “gross-up”, this assumes that the provincial credit will be 1/3 of the “gross-up”
	+ For the purposes of this course, the dividend tax credit (“DTC”) is assumed to be equal to the full amount of the gross-up
* In theory, the objective of the “gross-up and credit” mechanism is to make an individual pay the same amount of tax on income received through a corporation as he or she would have paid if the income was earned by the individual directly

### Sample Problem

* Sam earns $100 of business income and is taxed at a rate of 40% (combined federal and provincial rate). Sam pays $40 of tax on his income and is left with $60 after paying the tax.
* Dean owns all of the shares of a Canadian corporation, which pays tax on its income at a rate of 20%. The corporation earns $100 of business income and pays $20 of tax. The remaining $80 is paid to Dean as a dividend.
* If Dean is also taxed at a rate of 40% how much tax does Dean pay and how much does Dean have left after paying the tax?
* Assume a gross-up of 25% and a DTC equal to the gross-up
	+ **Without the Gross-Up and Credit**
		- Dividend received - $80
		- Amount included in Dean’s income - $80
			* This is the amount of the dividend he received
		- Tax payable by Dean: - $32 ($80 X 40%)
		- Dean’s After Tax Income: $48 ($80- $32)
			* Dean would be left with $48 after paying the tax which is $12 less than Sam
		- Tax Paid by the Corporation: $20
		- Aggregate Tax Paid (on the original $100 of business income owned by the corporation): $52 ($32 + $20)
		- Effective Combined Tax Rate: 52% ([$52 / $100] X 100)
			* As such, earning $100 of income through a corporation resulted in an additional $12 of tax. This is the double taxation of corporations that the dividend “gross-up and credit mechanism” was designed to eliminate
	+ **With Gross-Up and Credit**
		- Dividend received: $80
		- Gross-up Amount – **paragraph 82(1)(b):** $20 ($80 X 25%)
			* 25% is the default gross-up we always use
		- Amount included in Dean’s income: $100 ($80 + $20)
			* Actual dividend received + gross-up amount
		- Tax payable by Dean (before credit): $40 ($100 X 40%)
		- Dividend Tax Credit – section 121: $20
			* The dividend tax credit is equal to the amount of the gross-up, or $20
		- Net Tax Payable: $20 ($40-$20)
			* Initial tax ($40) - $20 dividend tax credit
		- Tax Paid by the Corporation: $20
		- Aggregated Tax Paid: $40 ($20 +$20)
			* This is the total amount of tax paid on the original $100 of income of the corporation
		- Dean’s After-Tax Income: $60 ($80- $20)
			* This is the same amount as Sam
		- Effective Combined Tax Rate: 40% ([$40 / $100] X 100)
			* This is same rate of tax that would have been paid by Dean if he had earned $100 of business income directly. As such, double tax has been eliminated and tax paid by Dean and his corporation have been integrated.

### Capital Dividend

* Dividends that are paid out of certain “tax-exempt” income earned by a corporation
* Capital dividends can be distributed to Canadian resident shareholders tax free (UNIQUE)
* A capital dividend is a dividend for corporate law purposes but is not a taxable dividend for purpose of the *ITA* if the payor of the dividend elects to treat it as a capital dividend – **subsection 83(2)**
* Where a capital dividend is paid to a non-resident shareholder, withholding taxes still apply – **paragraph 212(2)(b)**
* **\*for exam purposes, we will be told if something is a capital dividend. All we need to know is that it is tax free\***

### Foreign Source Dividends

* In general terms, the amount of a dividend (including any amount withheld as foreign tax) paid on a share of a foreign corporation is included in computing an individual’s income – **paragraph 12(1)(k) and subsection 90(1)**
* The dividend “gross-up” and “credit” mechanism does not apply to foreign source dividends
* The amount of the dividend included in income includes not only the portion of the dividend received by the individual but also, any amount of the dividend that was withheld by the payor as foreign withholding tax
* Where foreign tax has been withheld from the amount of the dividend, the individual may be entitled to a foreign tax credit or a deduction in computing income – **subsections 20(11), 20(12) and 126(1)**
* The rules dealing with foreign source dividends received by Canadian corporations are exceedingly complex and will not be discussed

## Foreign Tax Credits

* There are separate rules for foreign tax credits with respect to business income and non-business income
* **Non-Business Income-** where the amount paid is income from property such as interest, rents, royalties and dividends
	+ **Subsection 126(1)**
		- Where foreign tax has been withheld on an amount paid as income to a Canadian resident by a non-resident payor, the Canadian resident is generally permitted to deduct, in computing their tax payable, an amount equal to the lesser of the foreign tax withheld and the amount of Canadian tax otherwise payable on the amount paid
			* For this course, always assume the foreign withholding tax is always less than the tax otherwise payable
		- Provides a deduction in computing tax basically equal to the lesser of the foreign tax paid on non-business income and the amount of Canadian tax otherwise payable on such income
		- Non-business income includes employment income and property income
		- The maximum foreign tax credit for income from property is generally limited to 15% of the gross foreign property income – **definition of “non-business income tax” in subsection 126(7)**
		- What is left over after the 15% maximum foreign tax credit is non-creditable foreign tax on property income and it is deductible under **subsection 20(11)**
		- No carry-forward is available for the unused foreign tax
			* If it is not usable in the year, it cannot be carried forward and used in a future taxation year
* **Business Income**
	+ **Subsection 126(2)**
		- Provides a deduction in computing tax basically equal to the lesser of the foreign tax paid on business income and the amount of Canadian tax otherwise payable on such income.
		- Unused foreign tax credits of business income can be carried forward 10 years or back 3 years.

### Sample Problem

* Samantha holds shares of a foreign public corporation. The corporation declares a dividend of $10, 000 payable on the shares held by Samantha. Pursuant to the foreign tax laws, the corporation withholds $1, 000 of tax from the dividend payment and remits it to the foreign tax authority. The remaining $9,000 is paid to Samantha. Assume that Samantha pays Canadian tax at a rate of 50% on the dividend. How much Canadian tax does Samantha pay? What is Samantha’s effective tax rate on her foreign source income?
	+ Samantha includes $10,000 in her income – **paragraph 12(1)(k) and subsection 90(1)**
		- This is full amount of the dividend and includes the $9,00 received by Samantha and $1,000 withheld as foreign tax
	+ **Maximum Foreign Tax Credit (“Max FTC”)**
		- = gross foreign property income ($10,000) X 15%
		- = $1, 500
			* Since income from property, maximum foreign tax credit is limited to 15% of gross foreign property income
			* The gross foreign property income is $10,000
	+ **Foreign Tax Credit (“FTC”)**
		- = lesser of foreign tax withheld ($1,000) and Max FTC ($1, 500)
		- = $1, 000 – **subsection 126(1)**
			* Samantha can claim the full $1,000 as a foreign tax credit
	+ **Initial Canadian Tax Payable**
		- = Income ($10,000) X tax rate (50%)
		- = $5,000
	+ **Actual Canadian Tax Payable**
		- = Initial Canadian Tax Payable ($5,000) – FTC ($1, 000)
		- = $4,000
	+ **Effective Tax Rate**
		- Total tax ($1,000 + $4,000) / foreign source income ($10,000) X 100
		- = 50%
			* This is equal to her Canadian tax rate. The reason the amounts are equal is because her Canadian rate was reduced by the full amount of the foreign tax. As such, she paid the same amount of tax in aggregate as she would have paid if no foreign tax had been withheld from the dividend payment. The foreign tax credit has therefore eliminated any double taxation on the foreign source income, but this is not always the case.

### Sample Problem #2:

* Samantha holds bonds issued by a foreign public corporation. The bonds have a par value of $100,000 and pay interest of 10% each year. Samantha receives interest payment of $10,000. Pursuant to foreign tax laws, corporation withholds $4,000 of tax from the interest payment and remits it to the foreign tax authority. The remaining $6,000 is paid to Samantha. Assume that Samantha pays Canadian tax at a rate of 50%. How much Canadian tax does Samantha pay? What is Samantha’s effective tax rate on her foreign source income?
	+ Samantha includes $10,000 in her income – **paragraph 12(1)(c)**
		- This includes the $6,000 she actually received and the $4,000 that was withheld as foreign tax
	+ **Maximum Foreign Tax Credit (“Max FTC”)**
		- = gross foreign property income ($10,000) X 15%
		- = $1, 500
			* Since income from property, maximum foreign tax credit is limited to 15% of gross foreign property income
	+ **Foreign Tax Credit (“FTC”)**
		- = lesser of foreign tax withheld ($4,000) and Max FTC ($1, 500)
		- = $1, 500- **subsection 126(1)**
		- Since the $4,000 paid is more than the maximum credit Samantha can only claim $1,500 as a foreign tax credit
	+ **Non-creditable Foreign Tax**
		- = foreign tax withheld ($4,000) – Max FTC ($1,500)
		- = $2, 500
	+ Deduction for non-creditable foreign tax – **subsection 20(11)**
		- The $2,500 of non-creditable foreign tax is deductible in computing Samantha’s income.
	+ **Income**
		- = foreign interest ($10,000) – non-creditable foreign tax ($2,500)
		- = $7,500
	+ **Initial Canadian Tax Payable**
		- = Income ($7,500) X tax rate (50%)
		- = $3, 750
	+ **Actual Canadian Tax Payable**
		- = Initial Canadian Tax Payable ($3, 750) – FTC ($1, 500)
		- = $2, 250
	+ **Effective Tax Rate**
		- Total tax ($4,000 + $2, 250) / foreign source income ($10,000) X 100
		- = 62.5%
	+ Why is Samantha’s effective tax rate on her foreign source income greater than her Canadian tax rate?
		- This is because Samantha did not receive a full credit for the foreign tax she paid. Although she was permitted to deduct the non-creditable foreign tax in computing her income, a deduction in computing income is not as valuable as a foreign tax credit which reduces, dollar for dollar, the amount of Canadian tax payable. As such, Samantha paid $1,250 more tax than she would have paid if no foreign tax had been withheld.

# Deductions in Computing Income from Business or Property

## Legislative Framework

* **Subdivision b – Income or Loss from a Business or Property**
	+ **Subsection 9(1)**
		- Subject to this Part, a taxpayer’s income for a taxation year from a business or property is the taxpayer’s **profit** from that business or property for the year.
		- “profit” is not defined in the *ITA*. In general terms, a taxpayer’s profit is the difference between a taxpayer’s receipts from a business or property and the expenditures laid out to earn those receipts. If the taxpayer’s expenditures exceed their receipts, the taxpayer has a loss from the business or property
	+ **Subsection 9(2)**
		- … a taxpayer’s loss for a taxation year from a business or property is the amount of the taxpayer’s **loss**, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require
	+ **Subsection 18(1)**
		- In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
			* An outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property – **paragraph 18(1)(a)**
			* An outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of a depreciation, obsolescence, or depletion except as expressly permitted by this Part – **paragraph 18(1)(b)**
			* An amount as, or on account of, a reserve, a contingent liability or amount or a sinking fund except as expressly permitted by this Part – **paragraph 18(1)(e)**
			* Personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer’s business – **paragraph 18(1)(h)**
	+ **Subsection 20(1)**
		- Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer’s income for a taxation year from a business or property, there may be deduced such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:
			* **Some Examples:**
				+ Capital cost allowance – **paragraph 20(1)(a)**
				+ Interest – **paragraph 20(1)(c)**
				+ Reserve for services not rendered or goods not delivered in the year – **paragraph 20(1)(m)**
				+ Reserve for unpaid purchase price of goods sold- **paragraph 20(1)(n)**
	+ Depreciable Property – **Section 13**
	+ **Section 67 -** Reasonableness requirement
		- Limits the deduction of an outlay or an expense to an amount that is reasonable in the circumstances
	+ **Section 67.1** – limitation on expenses for food and entertainment
	+ **section 67.5 -** non-deductibility of certain illegal payments
	+ **section 67.6-** non-deductibility of fines and penalties
	+ **subsection 18(12)-** Limitation on Home Office Expenses

## Deductions

### What is Profit?

* The term “profit” is not defined in the *Income Tax Act*
* In a series of decisions, Thorson P. of the Exchequer Court of Canada developed an approach to the determination of profit
	+ *Daley v M.N.R.* [1950] 4 DTC 877 (Exch. Ct.)
	+ *Imperial Oil Limited v M.N.R,* [1947] 3 TC 1090 (Exch. Ct.)
	+ *The Royal Trust Co. v M.N.R.* [1957] 57 DTC 1055 (Exch. Ct.)
* According to this approach, an amount is generally deductible in computing profit if the amount is properly deductible according to the ordinary principles of commercial trading and well-established principles of business and accounting practice
* The deductibility of an amount, however, remains subject to, and may be altered by, the provisions of the *Income Tax Act*
* As such, the provisions of the *Income Tax Act* may apply to prohibit the deduction of an amount that is otherwise deductible or permit the deduction of amount that is not otherwise deductible
* The approach developed by Thorson P. has more recently been affirmed by the Supreme Court of Canada in *Candarel Ltd v The Queen,* 98 DTC 6100 (SCC), which is commonly cited as a leading authority on the computing of profit for tax purposes:
	+ That the profit from a business or property is the difference between the receipts from the business or property and the expenditures laid out to earn those receipts.
	+ **Profit is a determination of law,** to be determined in accordance with provisions of *ITA*  [most notably p. 18(1)(a), (b) and (h)] and the established rules of law resulting from judicial interpretations of those provisions. **Profit is not a factual determination.**
	+ In the determination of profit regard may be had to interpretive aids such as “well-accepted principles of business (or accounting) practice” or “ordinary commercial principles” or “well-accepted principles of commercial trading”, a formal codification of which is found in the generally accepted accounting principles (GAAP) developed by the accounting profession for use in financial statement preparation
		- **Note:** The current required financial reporting standard in Canada (“Canadian GAAP”) is the International Financial Reporting Standards (IFRS) and the accounting standards for private enterprises (ASPE)
		- Well-accepted principles of business (or accounting) practice are not determinative of the issue and are subject to modification in accordance with the provisions of the *Income Tax Act* or other established rules of law
	+ The principle goal in the determination of profit is to achieve an accurate picture of income
		- It is not necessary to show a causal connection between an expenditure and a receipt. An expenditure may be properly deductible even if it produces no income (i.e. creates a loss)
	+ Where there is more than one approach to the calculation of profit, the taxpayer is free to choose any approach is not inconsistent with the law and yields an accurate picture of income
		- Canada Revenue Agency is free to indicate its disapproval with the method of computing profit adopted by the taxpayer; however, CRA is not entitled to insist that the taxpayer necessarily use one method over another
	+ Where the approach taken by the taxpayer is consistent with well-accepted principles of business (or accounting) practice, is not inconsistent with the *ITA* or other established rules of law and presents an accurate picture of income, the burden of proof is on the Minister to show that a different method would yield a more accurate picture of income
		- This is a departure from the normal rule that generally requires the taxpayer to show that his or her approach should be preferred to the approach advocated by the CRA
* The *Income Tax Act* expressly provides that an expense is only deductible to the extent that it is incurred for the purpose of earning income from a business or property – **paragraph 18(1)(a)**
* Given current approach to determining profit, it is likely that limitations set out in p. 18(1)(a) and (h) and s. 67 (reasonableness requirement) are not necessary, however most challenges to deductibility of expenses continue to be based in an application of these
* The reason why paragraph 18(1)(a) continues to be the basis for challenging the deductibility of expenses may be rooted in its historical development. The predecessor provisions to paragraph 18(1)(a) [paragraph 6(a) of the *Income War Tax Act]* required the expense be “wholly, exclusively and necessarily laid out… for the purpose of earning the income”, which arguably established a more restrictive test

### Business or Personal Expense?

* Personal or living expenses are not deductible except where expressly permitted by the *ITA* (e.g. moving expenses and childcare expenses)
* In addition to the general limitations in subsection 9(1) and paragraph 18(1)(a), the deduction of personal or living expenses (other than travel expenses incurred by taxpayer while away from home in the course of carrying on the taxpayer’s business) are expressly prohibited by paragraph 18(1)(h)
* **Subsection 248(1)**
	+ “personal or living expenses” **includes**
		- (a) the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or common-law partnership or adopted, and not maintained in connection with a business carried on for profit or with a reasonably expectation of profit,
		- (b) the expenses, premiums or other costs of a policy of insurance, annuity contract or other like contract if the proceeds of the policy or contract are payable to or for the benefit of the taxpayer or a person connected with the taxpayer by blood relationship, marriage or common-law partnership or adoption, and
		- (c) expenses of properties maintained by an estate or trust for the benefit of the taxpayer as one of the beneficiaries;
	+ The definition in subsection 248(1) is inclusive, not exhaustive, and is quite narrow. Accordingly, Canadian courts consider various factors when distinguishing between business and personal expenses:
		- Whether the expense is one that would ordinarily be allowed as a business expense by accountants;
		- Whether the expense is normally incurred by others in the same business;
		- Whether the expenses would have been incurred if taxpayer was not carrying on business (i.e. is it an expense of the trader or the trade?); and
		- Whether the taxpayer could have avoided the expense without an impact on gross income

### Housekeeping Expense

#### Thomas Harry Benton v MNR (1952)

**Facts:** A farmer claimed a deduction in wages paid to a person he hired to help with certain farm work and housekeeping chores. The Minister reassessed the taxpayer to deny the deduction of the portion of the wages paid in respect of housekeeping chores on the basis that such position was a personal or living expense of the taxpayer.

**Held:** The portion of the wages paid for housekeeping were non-deductible personal expenses. The portion of the wages that were paid in respect of farm work was deductible.

**Note:** This is a slippery slope argument because then anything that makes you available for work would be a work expense (i.e. shelter, food, transportation, etc.) Had the taxpayer spent more of his time on housekeeping and hired another person to perform more of the farm work the salary paid to that person would have been deductible in computing the taxpayer’s farming income. This serves as a reminder that the way in which a taxpayer chooses to structure their activities will often affect how those activities are taxed.

### Legal Fees

#### Leduc v The Queen, 2005 (TCC)

**Facts:** A taxpayer, a lawyer, incurred legal expenses to defend against criminal charges. Taxpayer claimed legal expenses were deductible in computing business income on the basis that if the taxpayer was convicted, Law Society had the power to investigate and possibly revoke his license. Minister denied the deductions on the basis that the legal expenses were not incurred for the purpose of earning income from his business.

**Held:** The legal expenses were personal expenses and therefore not deductible. The criminal charges did not relate to the taxpayer’s business. The taxpayer would have incurred the legal expense even if he had not been carrying on a business.

### Child Care Expenses

#### Symes v The Queen, 1994 (SCC)

**Facts:**  Symes was a lawyer who had a husband (who was employed full time) and 2 small children. Symes and her husband made a “family decision” that she would bear the child-care expense if she returned to the practice of law. In 1985, she hired a nanny for $13, 000 per year, and claimed the full amount as an expense of doing business, notwithstanding that s. 63 of the *ITA* provided authority to deduct child care expenses up to a certain limit. Minister limited her deduction in accordance with s. 63. S. 63 allows any taxpayer to deduct childcare expenses up to a certain limit per child. S. 63 creates a level playing field for all taxpayers: employees and business owners. Otherwise a business owner would be able to expense as much childcare expenses as they want.

**Held:** The majority (7-2) of the Supreme Court of Canada upheld the Minister’s assessment.

**Reasons:** Although it was clear that Symes would not have incurred the expenses but for her business, it was equally clear that the need to care for her children existed regardless of her business activity. As such, the childcare expenses were incurred to make Symes available to practice her profession not for any other purpose associated with the business itself. There is no evidence to suggest that childcare expenses are treated as business expenses by accountants when determining profit. Although there are policy arguments for and against the deductibility of childcare expenses as a business expense, the presence of s. 63 of the *ITA* makes the need to reconceptualize childcare expenses as business expenses unnecessary. The fact that Parliament decided to resolve this question by enacting s. 63 should not be lightly disregarded.

**Ratio:** Expenses that make you available for work are not “income earning expenses”. They are not part of the “income earning process”. It would be unequal treatment between those taxpayers who were/were not paying childcare expenses.

### Food and Beverage

* The *ITA* makes an exception for business meals because you are not buying the food for the purpose of substance and consumption, it is a marketing technique to get the clients business. Therefore, we have **subsection 67.1** which says you can only deduct half which then accounts for the fact that half of that food expense is for you

#### Scott v MNR, 1998 (FCA)

**Facts:** Scott was a food and public transit courier who walked and rode the subway over 150km per day. He ate an extra meal during the day, which he claimed was required as a result of all the travel.

**Issue:** Did the cost of extra food and beverage was deductible as a business expense?

**Held:** The cost of the extra food and beverage consumed by the taxpayer above and beyond an average person’s intake was deductible. The consumption of extra food and beverage was analogous to putting fuel in an automobile, the cost of which would be deductible by a courier who used an automobile.

**Question:** Do you think this decision is right? Do you think it provides a narrow exception?

* Where things fall apart in this decision is when you think about it in the broader income tax area of who this will apply to and how do we draw the line between the amount of food and consumption that is personal and the amount that is for business purposes?
* Should we limit the amount of food and consumption that is deductible is that which is not pleasurable. For example, if the cost of eating sludge (purely for nutritional value but no taste) is $3 but a gourmet burger is $25, should we only allow the deduction of $3?
* This is not a narrow exception – this can apply in many situations – MacArthur doesn’t like the case for this reason

### Commuting Expenses

* The costs associated with commuting to work are generally personal expenses
* The cost of work-related travel from your place of work to other locations is generally characterized as a business exception

#### Cumming v MNR, 1967 (Exch. Ct.)

**Facts:** The taxpayer was a doctor who had no office in the hospital where he worked. He had an office at home which was where he kept his business records, texts, periodicals and other office equipment and was where he performed adminsitrative tasks (e.g. record keeping and sending out accounts) and undertook professional study and writing. He was required to travel back and forth between the hospital and his home and therefore deducted in computing his income the expenses associated with these trips (e.g. the cost of operating his automobile). Minister disallowed the taxpayer’s deduction on the basis that the expenses were not incurred to earn income and were personal expenses.

**Issue:** Were the expenses incurred to travel between his home and the hospital deductible in computing his business income?

**Held:** Expenses were deductible. Taxpayer had no base in the hospital and therefore, the commuting expenses were deductible. The operating expenses of his automobile were apportioned on the basis of relative mileage. The capital cost allowance was apportioned on a basis of usage.

**Reasons:** “While I think it might be said in a particular sense that the appellant exercise his profession at the hospital, as I see it, he had no base of his practice there. His services were not performed in any one place in the hospital but in the numerous areas in which anesthetics were administered… The appellant had no space there but a locker that he could call his own… [He did not have] an office or even a desk there to which he could repair to do the adminsitrative work of his practice when he was not immediately engaged with a patient…”

* “In my opinion the base of the appellant’s practice, if there was any one place that could be called its base, was his home. This was the place from which he was called when required and whence he set fort to serve patients, whether by scheduled appointments or in emergencies. It was the place where the records of his practice were kept, where he worked on them and where his studying for particular cases and for the purpose of keeping up with developments in his specialty was done. It was the place to which he returned during the day whenever the time available was long enough to enable him to make the trip and do some work of the kind which he did there. Indeed, though in fact he went nearly every day, he had no occasion to go to the hospital at all in connection with his practice except when there was some service to be rendered to a patient there. And when he had no work to do there he had no place of his own or base of his practice to repaid to but his home where the adminsitrative side of his practice was carried out.”
* “It seems to me that is the appellant had not found it convenient to carry out at his home that part of the work of his practice in face done there and had maintained an office for the purpose, whether near to or at some distance from the hospital, there could have been little doubt that such office was the base of his practice and that both the reasonable expense of maintaining it and the expense of travelling between it and the hospital would have been expense of his business. The result is, I think, the same were the office, such as it was, was at his home and the work was done there. In the present case it seems to me to be the only single place which could be regarded as the base from which his professional operation was carried on…”

### Home Office Expenses

* **Subsection 18(12)** does not permit the deduction, but rather it limits the deduction of home office expenses. If a taxpayer does not comply with section 18(12), they cannot make home expense deductions.
* **Subsection 18(12)**
	+ Notwithstanding any other provision of this Act, in computing an individual’s income from a business for a taxation year,
		- (a) **no amount shall be deducted** in respect of an otherwise deductible amount for any part (in this subsection referred to as the “work space”) of a self-contained domestic establishment in which the individual resides, **except to the extent** that the work space is either
			* (i) the individual’s principle place of business, or
			* (ii) used exclusively for the purpose of earning income from business and used on a regular and continuous basis for meeting clients, customers or patients of the individual in respect of the business;
		- (b) where the conditions set out in subparagraph (a)(i) or (ii) are met, **the amount for the work space that is deductible** in computing the individual’s income for the year from the business **shall not exceed the individual’s income for the year from the business** …; and
		- (c) any amount not deductible by reason only of paragraph (b) in computing the individual’s income from the business for the immediately preceding taxation year shall be deemed to be an amount otherwise deductible that, subject to paragraphs (a) and (b), may be deducted for the year for the work space In respect of the business.
* The expression “**self-contained domestic establishment”** is defined in subsection 248(1) as “a dwelling-house, apartment or other similar place of residence in which place a person as a general rule sleeps and eats”
* The limitation in subsection 18(12) applies only to amounts expended to physically maintain the workplace. The limitation does not apply to other general office expenses such as office supplies and equipment and fees for internet and telephone.
* Home office expenses are those incurred to physically maintained the workspace, for example
	+ Rent;
	+ Capital cost allowance;
	+ Mortgage interest;
	+ Utilities (e.g. heat and electricity);
	+ Property taxes;
	+ Insurance; and
	+ Maintenance costs or minor repairs
* Where an individual converts a portion of a principal residence to an office or other workspace, this may result in a partial change in use of the principal resident in accordance with **subsection 45(1)**
* However, as an administrative practice, the Canada Revenue Agency will generally not apply the partial change in use rules where:
	+ The income-producing use is ancillary to the main use of the property as a residence;
	+ There is no structural changes to the property; and
	+ **No capital cost allowance is claimed on the property.**
* For this reason, capital cost allowance should normally not be claimed as a home office expense
* Home office expenses must be apportioned between business and non-business use on a reasonable basis
* Apportionment based on the proportion of the home used as a workspace is normally considered to be reasonable, although other allocation methods may be considered reasonably depending on the circumstances
	+ For example, if your house was 2,000 square feet and 1,000 square feet was used as your home office, it would be reasonable to deduct 50% of your mortgage interest, utilities, property taxes and insurance you paid in respect of your house
* Income Tax Folio S4-F2-C2, Business Use of Home Expenses
* Sample Problem
	+ Monica is a self-employed lawyer. She owns a house and uses the basement the house as her law office. During Year 1, Monica earned $15, 000 in revenue and incurred the following expenses in connection with her law practice:
		- (a) $20,000, which is a reasonable portion of the total mortgage interest, property tax, property insurance and utility cost for the whole house,
		- (b) $1, 000 for stationary,
		- (c) $5, 000 in salary paid to her part-time assistant,
		- (d) $2,000 paid for telephone, fax and internet access (Monica has a separate dedicated line for her office)
	+ For Year 1, what amount can Monica claim as a deduction for home office expenses in computing her income from her law practice? If the amount of expenses remains the same for Year 2, while the revenue is increased to $100,000, what would her income be for Year 2?
		- * Is Monica eligible to claim home office expenses in Year 1?
				+ Yes
				+ Monica uses the basement of her home as her office for her law practice
				+ Nothing suggests that Monica maintains an office in a separate location, so we can reasonably assume that this is Monica’s only place of business
				+ As such, Monica satisfies the condition in subparagraph 18(12)(a)(i) because her home office is her principal place of business
			* Monica’s Business Income in Year 1 (before home office expenses):
				+ Revenue= **$15, 000**
				+ Expenses= $1,000 (stationary) + $5,000 (employee salary) + 2,000 (telephone, fax and internet)

**= $8, 000**

**Note:** the addition $20,000 would be considered home office expenses

* + - * + Business Income (before home office expenses) = $15, 000 - $8,000

**= $7, 000**

* + - * Monica’s deduction of home office expenses is limited to her business income - **$7, 000 – s. 18(12)(b)**
			* Monica’s Business Income in Year 1 (after home office expenses):
				+ = $15,000 (Revenue) - $8,000 (Other Expenses) - $7, 000 (home office expenses) = **$0**
			* Monica’s Non-Deductible Home Office Expenses
				+ = $20,000 - $7, 000 = **$13, 000**

This can be deducted from Monica’s business income in Year 2 provided the conditions in subsection 18(12) are satisfied in Year 2 – **s. 18(12)(c)**

* + - * Year 2
				+ Monica’s home office is still her principal place of business in Year 2 so the condition in subparagraph 18(12)(a)(i) is satisfied for Year 2
				+ Monica’s Business Income in Year 2 (before home office expenses):

Revenue = **$100,000**

Expenses = $1,000(stationary)+$5,000(employee salary)+$2,000(telephone, fax, internet)

= **$8,000**

Business Income (before home office expenses): = $100,000 - $8, 000

= **$92, 000**

Monica’s home office expenses in Year 2:

= $20,000 (Year 2 expenses) + $13, 000 (non-deductible Year 1 expenses)

= **$33, 000**

**Note:** Her business income (before home office expenses) exceeds $33, 000 which means she can claim the full amount

Monica’s Business Income in Year 2 (after home office expenses):

= $92,000 (business Income before HO expenses) - $33, 000 (HO expenses)

= **$59,000**

### Entertainment Expenses and Business Meals

* **Subsection 67.1(1)**
	+ For the purposes of this Act, other than sections 62 [moving expenses], 63 [ child care]… an amount paid or payable in respect of the human construction of food or beverages or the enjoyment of entertainment is deemed to be 50 per cent the lesser of
		- (a) the amount actually paid or payable in respect thereof, and
		- (b) an amount in respect thereof that would be reasonable in the circumstances
* Limitation in s. 67.1(1) does not apply to certain amounts including an amount paid in respect of moving expense or childcare expenses
* **Subsection 67.1(2) - Exceptions**
	+ The limitation in subsection 67.1(1) does not apply to certain amounts. For example, where:
		- The amount is paid or payable in the ordinary course of a business of providing the food, beverage or entertainment for compensation – **paragraph 67.1(2)(a)**
		- The amount is included in employee’s income in accordance with s. 6 – **paragraph 67.1(2)(d)** (aka employee benefit)
		- The amount is paid in respect of one of 6 or less special events held for all employees in year – **paragraph 67.1(2)(f)**
			* E.g. for Christmas parties
	+ Interpretation Bulletin IT-518R: Food, Beverage and Entertainment Expenses

### Education Expenses

* Educational expenses are generally characterized as personal expenses
* Traditionally, the CRA has treated university education as a personal expense. Particularly when you are taking a course that leads to a degree. Education may make you better at your job, but there is great personal benefit that comes with it (degree, personal brand, networking, etc.). However, there is nothing in *ITA* that says this. Therefore, you can bring arguments against such.
	+ **Section 118.5** – credit for tuition fees
		- Where expenses are not deductible, students may be entitled to a tuition tax credit
	+ **Section 118**.**62-** tax credit for interest on student loans under federal or provincial student – loan programs
* In contrast, professional development courses or refresher courses taken by professionals are generally deductible as business expenses

### Deductibility of Damages

* In general, damages & similar payments are deductible if they were incurred for purpose of generating income from business or property
* Principle question is whether the damages arose “as part of the operations, transactions or services by which the taxpayer earned income”
* A payment in settlement of a claim for damages resulting from the negligence of an employee was found to be deductible, since it was a normal and ordinary risk of carrying on the taxpayer’s business – ***Imperial Oil v MNR* [1947], 3 DTC 1090 (Exch. Ct.)**
* The payment of damages by an accountant as a result of his breach of a non-compete agreement entered into in connection with the sale of his accounting practice was also found to be deductible – ***McNeil v The Queen*, 2000 DTC 6211 (FCA)**
	+ As long as activities that led to damages payment has some relation to the activities of your business, then it will be deductible.

### Deductibility of Expenses from an Illegal Business

* It has been argued that the deduction of expenses incurred to carry on illegal activities should be disallowed on public policy grounds
* However, in general. Canadian courts have held that the illegality of an expense does not preclude its deductibility, provided that
	+ The expense was made or incurred for the purpose of producing income, and
	+ The deduction of the expense was not expressly disallowed by the provisions of the *Income Tax Act*
* *Canadian Imperial Bank of Commerce v The queen*, 2013 FCA 122
	+ “”[2] Indeed, it has long been accepted in Canada that a taxpayer who conducts an illegal business, or a business conducted unlawfully, is taxable on the profits of that business on the same principles as any other business, except to the extent that a different result is required by a specific provision of the *ITA*. Similarly, the Courts have consistently rejected the notion that the *ITA* should be interpreted or applied more generously for a taxpayer whose conduct meets a sufficiently high moral standard.”
	+ “[78] In my view, subsection 9(1) does not harbour an implicit morality test that could deny the deduction of a claimed business expense that is deductible under well accepted business principles and passes all of the specific statutory tests for deductibility. If it is finally determined in this case that the deduction of the settlement payments accords well with accepted business principles, that CIBC made the settlement payments for the purpose of earning income from a business, that the settlement payments were not outlays on account of capital, that the settlement payments were not contingent liabilities when made, and that the amount of the settlement payments were reasonable in the circumstances, then nothing implicit in subsection 9(1) could possibly justify the disallowance of the deduction the settlement payments on the basis of the Crown’s assertion that CIBC’s conduct was egregious or repulsive.”
* Notwithstanding that expenses incurred to carry on illegal activities are (as a legal matter) generally deductible, evidentiary issues related to proving such expenses were actually incurred create a *de facto* prohibition on deduction in many situations
	+ *MNR v Eldridge*, 64 DTC 5338 (Exch. Ct.)
		- **Facts:** The taxpayer operated a call girl operation and paid protection fees to law enforcement authorities in exchange for information on which hotels to avoid because they were under police surveillance. Taxpayer claimed payment of these protection fees were deductible since she would not have been able to carry on her activities without them.
		- **Held:** Payments were not deductible.
		- **Ratio:** In order to deduct an expense, you need proof. However, often when people are carrying on illegal activities, they don’t provide proof of purchase or receipts.
		- “The fourth item… is the amount claimed for protection fees, being $9,000 in 1959 and $7,000 in 1960. The respondent maintained that she could not conduct her business without the payment of protection to the law enforcement authorities… In exchange for such payment the respondent was advised of certain hotels to be avoided by her girls when these hotels were under police surveillance and like information. She also attributed the fact that her business was operated without molestation until November 10, 1960 due to these protection payments being made. While the respondent hinted that she knew the recipients of these payments, she refused to identify such persons because, as she stated, she feared for the safety of the lives of her children and her own life if she made such disclosures. I must assume that the law enforcement officers are conscientious in the exercise of their duties and are incorruptible and such assumption can only be rebutted by convincing evidence to the contrary. The evidence which I received was not of this nature and accordingly I have not been satisfied that payments for protections were made.”
			* Since the taxpayer was unwilling to give the identity of the law enforcement officers, the court denied the taxpayer’s deductions on the basis that they were not satisfied that payments for protection had been made
* **Section 67.5**
	+ In computing income, no deduction shall be made in respect of an outlay made or expense incurred for the purpose of doing anything that is an offence under section 3 of the *Corruption of Foreign Public Officials Act* or under any of sections 119 to 121, 123 to 125, 292 and 426 of the *Criminal Code*, or an offence under section 465 of the *Criminal Code* as it related to an offences described in any of those sections
	+ **The above offences include:**
		- Bribes to foreign public officials
		- Bribes to judges, public officials and law enforcement officers
		- Payments made for the purpose of influencing municipal officers
		- Payments made to buy an official appointment
		- Kickbacks and frauds on the government
		- Conspiracy

### Fines and Penalties

* The decision of the SCC in *65302 BC Ltd. v The Queen*, 99 DTC 5799 (the ”BC Egg Case”) held that the fines or penalties incurred for the purpose of earning income are normally deductible, unless expressly prohibited by a provision of the *Income Tax Act*
* In 2004, section 67.6 was introduced to override the decision the Supreme Court of Canada
* **Section 67.6**
	+ In computing income, no deduction shall be made in respect of an amount that is a fine or penalty (other than a prescribed fine or penalty) imposed under a law of a country or of a political subdivision of a country (including a state, province or territory) by any person or public body that has authority to impose the fine or penalty

### Interest Expense

* **Paragraph 20(1)(c)**
	+ Notwithstanding paragraphs 18(1)(a), (b) and (h),in computing a taxpayer’s income for a taxation year from a business or property there may be deducted such of the following amounts as are wholly applicable that source or such part of the following amount as may reasonably be regarded as applicable thereto….an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer’s income), pursuant to a legal obligation to pay interest on
		- (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt to acquire a life insurance policy),
		- (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),
	+ …. Or a reasonable amount in respect thereof, whichever is the lesser;
		- Whether the amount is deducted when it is paid or payable depends on the taxpayer’s income on a cash basis or an accrual basis. A taxpayer that is an individual normally accounts for income from property, i.e. interest and dividends, on a cash basis and income from a business on an accrual basis.
* **Four Conditions to Application of Paragraph 20(1)(c)**
	+ The amount must be paid in the year or payable in respect of the year
	+ The amount must be paid pursuant to a legal obligation to pay interest
	+ The amount must be paid on
		- Borrowed money that is used for the purpose of earning non-exempt income from a business or property, or
		- The unpaid purchase price of property acquired for the purpose of gaining or producing non-exempt income from the property or from a business, and
	+ The amount must be reasonable
* Interest is generally considered a payment on account of capital, the deduction of which would be denied under paragraph 18(1)(b) if not for paragraph 20(1)(c)
	+ Therefore, it is a stand-alone test for determining the deductibility of interest. This is important because interest is generally considered a payment on account of capital
* Strict compliance with paragraph 20(1)(c) is therefore a necessary pre-condition for deductibility of interest
* Under paragraph 20(1)(c) the deduction of interest is dependent on the existence of a source of business or property income
* It is the current use of the funds that is relevant. Therefore, where source of income that was originally acquired with borrowed money disappears, deductibility of the interest on the borrowed money that is still outstanding may be disallowed – ***Tennant v The Queen* (SCC)**
	+ Section 20.1 provides an explicit statutory deduction where there is a loss of the source
* Interest on borrowed money is deductible if it was used to repay another borrowing the interest on which was deductible – **s. 20(3)**
	+ The original problem that this section solved was because in such a case, the money was not borrowed for the purpose of earning income from business or property, it was borrowed to repay the existing loan
* Compound interest is only deductible when paid (not when payable) – **paragraph 20(1)(d)**
	+ Imagine a debt with compound interest that was payable in 100 years. Imagine you never intended to pay back this debt and interest, the fact that it is “payable” would give you the advantage of a huge deduction.
	+ Why do we need this limitation?
		- As a matter of practice, the CRA often does not apply this rule. It would only be applied in extreme situations.
		- Compound interest could potentially last for the life of a loan and if you are allowing people to deduct interest expenses prior to 10 years prior to when they actually have the cash expense, the time value of money would give the taxpayer a significant benefit there. The concern is that you are allowing this huge deduction for the taxpayer every year without them having any cash output.
* Because it is the current use of the funds that is relevant, it is necessary to trace the use of the borrowed money when determining if interest paid on that borrowed money is deductible.
* In tracing the use of borrowed money, the Canadian courts have normally adopted an approach that emphasizes the legal form and substance of transactions and not their economic substance
* This approach is highlighted by the decisions of the Supreme Court of Canada in *The Queen v Bronfman Trust* and *Singleton v The Queen*

#### The Queen v Bronfman Trust, 87 DTC 5059 (SCC)

**Facts:** Trustees of a trust borrowed money to make a capital distribution to beneficiaries. Although trust had sufficient investments to make the distributions, trustees considered it advantageous to leave trust assets invested and temporarily fund distribution to beneficiaries with borrowed money. The deduction of the interest on the borrowed money was disallowed on the basis that it was not borrowed for purpose of earning income.

**Held:** The interest was not deductible.

**Reasons:** It is the direct use of the money that is relevant. The fact that borrowing the money allows the trust to retain income producing assets did not permit the deduction of the interest because the text of the *Income Tax Act* requires “tracing” the use of the borrowed funds to a specific income earning (‘eligible”) use. Making a distribution to beneficiaries of the trust was not an income earning use.

#### Singleton v The Queen, 2002 DTC 5533 (SCC)

**Facts:** The taxpayer, a partner in a law firm, withdrew $300,000 from his partnership capital account to purchase a house. He immediately borrowed $300,000 to replace it. He tried to deduct the interests on this loan as a business expense. The deduction of the interest on the borrowed money was disallowed on the basis that the money was borrowed to purchase the house and not for the purpose of earning income.

**Held:** The interest was deductible.

**Reasons:** You do not look to the overall purpose of the borrowing, but to the taxpayer’s purpose in using the borrowed money. In this case, the taxpayer had borrowed the money to contribute capital to his partnership which was an income earning purpose. The economic realities of a situation cannot be used to recharacterize a taxpayer’s bona fide relationships. Absent a sham, effect must be given to the taxpayer’s legal relationships.

* “The Tax Court Judge found that the purpose in using the money was to purchase a house and that this purpose could not be altered by the “shuffle of cheques” that occurred on October 27, 1988. I respectfully disagree. It is this “shuffle of cheques” that defines the legal relationship which must be given effect"

### Reasonableness

* Applies to the deductibility of ALL expenses
* **Section 67**
	+ In computing income, no deduction shall be made in respect of an outlay or expense… except to the extent that the outlay or expense was reasonable in the circumstances
* *Gabco Limited v Minister of National Revenue*, 68 DTC 5210 (Exch. Ct.) at 5216
	+ “It is not a question of the Minister or [t]his Court substituting its judgement for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.”
		- The question to ask is “is there something more than the interest of the business that went into the decision?”. Not “did this businessperson make a reasonable decision?” because maybe he just has had bad business acumen
* *Anderson v The Queen*, 2016 TCC 106
	+ “[35] If the Minister concludes that they are unreasonable in the sense that “no reasonable business man would have contracted to pay that amount” (*Gabco*, supra), then, notwithstanding the business acumen of the business owner, the expenditures may be denied in whole or in part relying on section 67.”
	+ “[36] The case law also illustrates that it is not the role of the Minister (or of te Court), which the benefit of hindsight, to second-guess the business acumen of a taxpayer who incurs expenses in the context of a business venture, particularly where it is not as successful as was initially anticipated.”

### Determining the Deductibility of Expenses

* *Stewart v The Queen*, 2002 DTC 6969
	+ “[57] It is clear from these provisions that the deductibility of expenses presupposes the existence of a source of income, and thus should not be confused with the preliminary source inquiry. If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, but the relationship between that expense and the source to which it is purported to relate. The fact that an expense is found to be a personal or living expense does not affect the characterization of the source of income to which the taxpayer attempts to allocate the expense, it simply means that the expense cannot be attributed to the source of income in question. As well, if, in the circumstances, the expense is unreasonable in relation to the source of income, then s. 67 of the Act provides a mechanism to reduce or eliminate the amount of the expense. Again, however, excessive or unreasonable expenses have no bearing on the characterization of a particular activity as a source of income.”
	+ Ask whether the deduction is connected to the source of income?
* **Step 1:** In determining whether an expense or outlay is deductible, it is first necessary to determine if a source of income exists (*Stewart)*
	+ If there is no source of income, then no deduction can be made. You’re done
	+ If there is a source of income, move on by relating the deduction to the source of income.
* **Step 2:** Determine if there is a reasonable connection between the particular expense claimed and the source of income
	+ Section 9, paragraph 18(1)(a), paragraph 18(1)(h) of the *Income Tax Act*
	+ Was the expense incurred for the purpose of earning income?
	+ Was it a personal or business expense?
* **Step 3:** Determine if the expense was reasonable in the circumstances
	+ This is a quantitative analysis. Not a qualitative analysis.
		- At this stage, the quality of the expense, in other words whether it is deductible in computing income from a source, has already been determined. What remains to be determined is what amounts of the expense is deductible
	+ Is the amount of the expense excessive? This is an issue of magnitude or quantum (not whether you should have made the expense to begin with)
	+ If it is determined that “no reasonable businessperson would have contracted to pay that amount”, the deduction of the expense may be denied in whole or in part under section 67

# Computation of Profit and Timing Principles

## Income Tax Reporting Period

* Taxpayers are required to report income and pay taxes on an annual basis
* For purposes of the *Income Tax Act*, the reporting period is a “taxation year” which is defined in subsection 249(1)
* The taxation year for an individual is a calendar year
* Corporations, partnerships and certain trusts are permitted to have an off-calendar year end which is normally a period of 1 year but does not necessarily have a December 31st year end
* In computing income, it is therefore necessary to determine not only if the taxpayer has earned revenue or incurred an expense, but also the taxation year in which such revenue or expense is recognized for tax purposes

## Methods of Accounting

* Profit is not defined in the *ITA* and as such, the general approach for the determination of profits for income tax purposes has been developed by the courts. According to this judicial approach, a taxpayer’s profit is the difference between the taxpayer’s receipts from a business or property and the expenditures laid out to earn those receipts. Courts have also held that the computation of profit is a determination of law and not a factual determination. As such, profit is determined in accordance with the provisions of the *ITA* and the established rules of law resulting from judicial interpretations of those provisions.
* In determining profit, regard may also be had to interpretative aids such as well accepted principles of business or accounting practice. However, such business or accounting practices are not determinative and remain subject to modification in accordance with the provisions of the *ITA* or other establishes rules of law
* Accordingly, in determining profit, the method of accounting adopted by the taxpayer may be relevant when determining the taxation year in which a taxpayer’s revenues or expenses are recognized for tax purposes
* The two basic methods of accounting are cash accounting and accrual accounting
* Cash
	+ Income is accounted for on a received basis
		- Taxpayer is required to account for revenue or income when it is received
	+ Expenses are accounted for on a paid basis
	+ For example, when calculating income from employment, an individual accounts for salary and wages when they are received and employment expenses when they are paid and individuals account for income from property earned by an individual on a cash basis in most circumstances
	+ Farming business may use cash basis (section 28)
* Accrual
	+ Income is recognized in the year in which it is receivable or earned, regardless of when payment is received
	+ Expenses are deductible in the year they are payable or incurred, regardless of when they are paid
	+ Corporations normally account for income from all sources on an accrual basis
	+ Individuals normally account for income from business on an accrual basis

## Significance of Timing

* Because taxpayers are required to report income and pay tax on an annual basis, the year in which the taxpayer is required to report income is of fundamental importance because taxpayers normally prefer to pay taxes later than sooner so that they can retain the use of their money for a longer period of time
* The cost of paying tax today exceeds the cost of paying the same amount of tax tomorrow

### Sample Problem 1

* Michael and Sara each receive a payment of $100,000 on January 1, 2018 in respect of income they earned throughout 2017. Michael accounts for income on a cash basis and Sara accounts for income on an accrual basis.
* **Assumption 1:** Michael and Sara are taxed at a rate of 40%
* **Assumption 2:** Any tax owing in resect of a particular taxation year is payable on April 30th of the following taxation year
* **Assumption 3:** Michael and Sara can earn a 12% **tax-free** rate of return on money they invest
* Who is better off?
	+ Michael
		- **$100,000** is treated as income in Michael’s 2018 taxation year
		- Michael invests the **$100,000** from January 1, 2018 to April 30, 2018, earning tax free investment income of **$4, 000**
			* This is because the annual rate of return is assumed to be 12%, so during the 4 month’s the money is invested, Michael earns 4% on the $100,000 or $4,000
		- Michael invests the **$104,000** from May 1, 2018 to April 30, 2019, earning tax free investment income of **$12, 480**
			* This is because the annual rate of return is assumed to be 12% so during the 12 month’s the money is invested, Michael earns 12% on $104,000 or $12, 480
		- On April 30, 2019 Michael pays tax of **$40,000** ($100,000 x 40%)
			* Because income earned from investing the money is assumed to be tax free, no additional tax is payable
		- Michaels after-tax amount as of April 30, 2019 is **$76,480** ($100,000 + $4,000 + $12,480 - $40,000)
	+ Sara
		- **$100,000** is treated as income in Sara’s 2017 taxation year
		- Sara invests the **$100,000** from January 1, 2018 to April 30, 2018, earning tax free investment income of **$4,000**
			* This is because the annual rate of return is assumed to be 12% so during the 4 month’s the money is invested, Sara earns 4% on $100,000 or $4,000
		- On April 30, 2018, Sara pays tax of **$40,000** ($100,000 X 40%), leaving her with an after-tax amount of **$64,000** ($100,000 + $4,000 - $40,000)
		- Sara invests the **$64,000** from May 1, 2018 to April 30, 2019, earning **$7,680**
			* This is because the annual rate of return is assumed to be 12% so during the 12 month’s the money is invested, Sara earns 12% of $64,000 or $7, 680
			* Because the investment income Sara earned from investing her money is assumed to be tax free, no additional tax is payable
		- Sara’s after-tax amount as of April 30, 2019 is **$71,680** ($100,000 + $4,000 + $7,680 - $40,000)
* So, who is better off?
	+ Michael has **$76,480** after tax
	+ Sara has **$71,680** after tax
	+ As such, Michael is better off since he has **$4,800** ($76,480 - $71, 680) more after tax on April 30, 2019
		- The reason Michael has more than Sara is because Sara had to pay her tax in 2018 and Michael did not have to pay his tax until 2019. Michael, therefore, had $40,000 more to invest during the 12 month period from May 1, 2018 to April 30, 2019. During this period, Michael earned an extra $4,800 of tax free investment income which is 12% of $40,000
	+ The difference of **$4,800** results from the fact that Michael did not have to pay $40,000 in tax on April 30, 2018
	+ Instead, Michael was able to keep the $40,000 invested and earn a 12% tax free rate of return from May 1, 2018 to April 30, 2019 when his taxes were payable
		- $40,000 x 12% = **$4, 800**

### Sample Problem 2

* Although it is generally preferable to defer the payment of taxes until a later year, this is not always the case. Individuals are taxed at progressive rates meaning the rate of tax increases as their income increases. As such, reporting income in an earlier taxation year may be beneficial where the marginal tax rate in the earlier taxation year is lower than the marginal tax rate in the later taxation year
* Meredith and Derek each received a payment of $100,000 on April 30, 2018 in respect of $50,000 of income each of them earned in 2017 and $50,000 of income each of them earned in 2018. Derek accounts for income on an accrual basis and Meredith accounts for income on a cash basis
* **Assumption 1:** Meredith and Derek’s tax rate is 20% on the first $50,000 of income and 40% on income in excess of $50,000
* **Assumption 2:** Any tax owing in respect of a particular taxation year is payable on April 30 of the following taxation year
* **Assumption 3:** Meredith and Derek can earn a 10% tax-fee rate of return on money they invest
* Who is better off?
	+ Meredith
		- **$100,000** is treated as income in Meredith’s 2018 taxation year
		- Meredith invests the $100,000 from May 1, 2018 to April 30, 2019, earningtax free investment income of **$10,000**
			* This is because the annual rate of return is presumed to be 10% so during the 12 months the money is invested, Meredith earns 10% on $100,000 or $10,000
		- On April 30, 2019 Meredith pays tax of $30,000 ($50,000 x 20% (or$10,000) + $50,000 x 40% (or $20,000)
			* Because the investment income Meredith earned from investing her money is assumed to eb tax free, no additional tax is payable
		- Meredith’s after-tax amount as of April 30, 2019 is **$80,000** ($100,000 + $10,000 - $30,000)
	+ Derek
		- **$50,000** is treated as income in Derek’s 2017 taxation year
		- **$50,000** is treated as income in Derek’s 2018 taxation year
		- On April 30, 2018, Derek pays tax of **$10,000** ($50,000 X 20%), leaving him with an after-tax amount of **$90,000** ($100,000 - $10,000)
		- Derek invests the **$90,000** from May 1, 2018 to April 30, 2019, earning tax free investment income of **$9,000**
			* This is because the annual rate of return is assumed to e 10% so during the 12 months the money is invested Derek earns 10% on $90,000 or $9,000
		- On April 30, 2019 Derek pays tax of **$10,000** ($50,000 x 20%)
		- Derek’s after-tax amount as of April 30, 2019 is **$89,000** ($100,000 + $9,000 - $20,000)
* Who is better off?
	+ Meredith has **$80,000** after tax
	+ Derek has **$89,000** after tax
	+ As such, Derek is better off since he has **$9,000** ($89,000 - $80,000) more after tax on April 30, 2019
	+ The difference of **$9,000** is the result of two things:
		- The fact that Derek paid **$10,000** less tax than Meredith; and
		- The fact that Derek earned **$1,000** less investment income than Meredith
			* This is because Derek was required to pay $10,000 of tax on April 30, 2018 and therefore had $10,000 less than Meredith invested at the 10% tax-free rate of return from May 1, 2018 to April 30, 2019. During this period, Meredith earned an extra $1,000 of tax-free investment income which is 10% of $10,000. However, because Derek reported $50,000 of income in each of 2017 and 2018, Derek paid tax of 20% on each of the $50,000 of income earned in 2017 and the $50,000 he earned in 2018. In total, Derek paid only $20,000 in tax. On the other hand, Meredith reported all of her income in 2018 and therefore paid tax of 20% on the first $50,000 and tax of 40% on the remaining $50,000 which means that Meredith paid $30,000 of tax in total. Derek therefore paid $10, 000 less tax than Meredith, but received $1, 000 less investment income which accounts for the difference of $9,000.
			* As such, even though Derek was required to report part of his income in an earlier year, he is still better off than Meredith because Meredith’s tax rate on the extra $50,000 of income he reported in 2018 was higher than her tax rate would have been if she had reported the income in 2017
			* $10,000 x 10% = **$1,000**
		- $10,000 - $1,000 = **$9, 000**

## Revenue Recognition

### The Realization Principle

* **Subsection 9(1)**
	+ A taxpayer’s income for a taxation year from a business / property is taxpayer’s profit from that business / property for the year.
* In general terms, a taxpayer’s profit is the difference between the taxpayer’s receipts from a business or property and the expenditures laid out to earn those receipts
* As such, in computing a taxpayer’s profit for the year, it is necessary to determine what receipts/amounts need to be included in computing profit for that year
* In computing a taxpayer’s profit for the year, it is necessary to determine which items of income (Revenue) need to be included in computing profit
* Generally an amount must be included in computing profit when it is realized (the “realization principle”) and an amount is realized once it has the “quality of income” – this is the **realization principle**
* An amount has the “quality of income” when the taxpayer’s right to it is absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment:
	+ “Is his right to it absolute and under no restriction, contractual or otherwise as to its disposition, use or enjoyment? To put it in another way, can an amount in a taxpayer’s hands be regarded as an item of profit or gain from his business, as long as he holds it subject to specific and unfulfilled conditions and his right to retain it and apply it to his own use has not yet accrued, and may never accrue?”
		- *Kenneth B.S. Robertson Limited v. Minister of National Revenue,* (1944) 2 DTC 655 (Ex. Ct.)
* An amount may also have the “quality of income” even where the taxpayer has not actually received the amount but has only “realized” it in accordance with accrual accounting methods:
	+ “[A]n amount may have the quality of income even though it is not actually received by the taxpayer, but only “realized” in accordance with the accrual method of accounting. The ultimate effect of [the Realization Principle] is clear: amounts received or realized by a taxpayer, free of conditions or restrictions upon their use, are taxable in the year realized, subject to any contrary provision of the Act or other rule of law”
		- *Ikea Limited v. The Queen,* 98 D.T.C. 6092 (SCC)
	+ Not about possession
		- What if I provide services and you have not paid me yet – is that income? – Yes
		- What if you haven’t invoiced your customer yet – is that income? - Yes
* The Realization Principle is modified by sections 12 to 17 of the *Income Tax Act*

### Amounts Receivable for Goods and Services – Unearned Amounts

* Under the accrual method of accounting, a taxpayer is normally required to include in computing income, an amount that is receivable in the year even if the amount has not been received. For the purpose of computing income from a business, the requirement to account for income on an accrual basis is codified in **p. 12(1)(b)**
* **Paragraph 12(1) (a) +(b)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
		- (a) Any amount received by the taxpayer in the year in the course of a business
			* (i) That is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been carried in the year or a previous year, or
			* (ii) Under an arrangement or understanding that it is repayable in whole or in part on the return or resale to the taxpayer of articles in or by means of which goods were delivered to a customer
		- (b) any amount receivable by the taxpayer **in respect of property sold or services rendered in the course of a business** in the year, notwithstanding that the amount or any part thereof is not due until a subsequent year… and for the purposes of this paragraph, an amount shall be deemed to have become receivable in resect of services rendered in the course of a business on the day that is the earlier of
			* (i) the day on which the account in respect of the services was rendered, and
			* (ii) the day on which the account in respect of those services would have been rendered had there been no undue delay in rendering the account in respect of the services
* The *ITA* does not defined “receivable” but its meaning has been considered by the courts and common law

#### MNR v J. Colford Contracting Co., 1960 (Exch. Ct.)

**Facts:** The taxpayer was a sub-contractor engaged in the business of installing HVAC units. Under the terms of the installation contract, the taxpayer was not entitled to receive certain amounts (“holdbacks”) until the entire project was completed and a certificate of completion had been issued by the architect or engineer. Under the relevant law in Ontario the contractor (and by extension the taxpayer as a sub-contractor) had no legal right to enforce payment of the holdback until an architect or engineer’s certificate had been issued. The job was completed by the taxpayer before the end of the taxation year, but payment was not received until the following year. A certificate had also been issued before the end of the taxation year, but the taxpayer was not aware of this. (This last point ultimately changed the result. If the certificate was granted, then the taxpayer is entitled to the payment, whether or not he knows about it and whether or not he is actually paid the holdback right then. Him not having knowledge did not change the legal result).

**Issue:** Was the holdback receivable and therefore includable in income for the taxation year in which the certificate had been issued?

**Held:** Yes, the amount was includible in the taxpayer’s income

**Reasons:** The fact that the taxpayer was not legally entitled to payment of the holdback until a certificate was issued was a valid condition precedent that until satisfied meant the holdback was not “receivable”. However, the condition precedent was satisfied on the date the certificate was issued, not the day that the taxpayer obtained knowledge of that fact.

* What mattered was the timing that the certificate was granted. At that moment, he became entitled to the holdback, regardless of knowledge or time of actual payment.

**Ratio:** Provided a taxpayer is legally entitled to an amount, the fact that payment is not due until a subsequent taxation year does not mean the amount is not receivable in the year. “It is not enough that the so-called recipient have a precarious right to receive the amount in question, but **he must have a clearly legal, though not necessarily immediate, right to receive it.”**

#### MNR v Benaby Realities Ltd., 1967 (SCC)

**Facts:** In the 1954 taxation year the Crown expropriated two parcels of land belonging to the taxpayer. An agreement was reached fixing the amount of compensation in the 1955 taxation year, and the compensation was paid in that same year (1955). The taxpayer took the position that its profit from the expropriation was taxable in the year in which the expropriation took place, 1954, since from the moment of expropriation, it no longer had its land but had instead the right to receive compensation in that year. The Minister contended that the amount was taxable in the 1955 taxation year being the year the compensation was paid.

**Issue:** Was the amount receivable in 1954 or 1955? Was an amount of compensation received by a taxpayer receivable in a taxation year even though the amount in question could not be determined until the following taxation year?

**Held:** The amount was not receivable until 1955.

**Reasons:** The *ITA* requires that profits be taken into account and assessed in the year in which the amount of profit is obtained. Although the taxpayer acquired a right to receive compensation at the moment of expropriation in 1954, in the absence of a binding agreement between the parties or of a judgement fixing the compensation, the taxpayer had no more than a right to claim compensation. There was nothing which could be taken into account as an amount receivable until the amount was fixed by agreement in 1955. Even if he were to file it in 1954, what amount would he declare? He would have no idea how much to declare.

#### West Kootenay Power and Light Company, Limited v The Queen, 1992 (FCA)

* What if the exact amount owing to a taxpayer is not known but it is possible to reasonably estimate the amount? Is the taxpayer required to include an estimate of the amount in computing income on the basis that the amount is receivable?

**Facts:** The taxpayer distributed electricity to consumers who were billed on a bi-monthly basis. In previous taxation years, the taxpayer had used the accrual basis for accounting and tax purposes and would include in computing its income an estimate of the delivered but unbilled electricity at the end of each taxation year. The taxpayer changed to an “as billed” basis for tax purposes and did not include in computing its income for tax purposes an estimate of the amount payable by its customers in respect of electricity that had been delivered but not billed. The Minister reassessed the taxpayer to include the unbilled estimates in the taxpayer’s income.

**Issue:** Was the amount receivable notwithstanding that the taxpayer could not compute the exact amount owing at the end of its taxation year?

**Held:** The taxpayer was entitled to payment for the electricity it delivered and had a legal right to payment. The amounts were sufficiently ascertainable to be receivable and therefore had to be included income. The customers had already used the goods and services, its just that the exact amount had not yet been calculated.

* 12(1)(b) did not provide an exemption since method adopted by taxpayer (cash basis) was not accepted for purposes of Part I of the *ITA*
	+ Essentially, they were trying to account on a cash basis, which they are not allowed to do.
	+ But also, 12(1)(b) says that something is receivable when billed, but it does not say that it is not receivable if not billed either

#### Maritime Telegraph and Telephone Company, Limited v The Queen, 1992 (FCA)

**Facts:** The taxpayer provided telephone and other telecommunication services to consumers who were billed on a monthly basis. In previous taxation years the taxpayer had used the accrual basis for accounting and tax purposes and would include in computing its income an estimate of the unbilled services at the end of each taxation year. The taxpayer changed to an “as billed” basis for tax purposes and did not include in computing his income for tax purposes an estimate of the amount payable by its customers in respect of unbilled services.

**Issue:** Were the unbilled amounts receivable?

**Taxpayer’s Argument:** The taxpayer’s argument was based on the wording of paragraph 12(1)(b), which provided that, for the purposes of that paragraph, “an amount shall be deemed to have become receivable in respect of services rendered in the source of a business” on the earlier of the day the account for such services was rendered or should have been rendered. Since paragraph 12(1)(b) established a deeming rule for when amounts in respect of services were to be considered receivable, the taxpayer argued that this provision also applied to deem an amount in respect of services not to be receivable until the conditions were met (i.e. until the account was billed or should have been billed)

**Held:** FCA rejected the taxpayer’s argument and held that the unbilled services were receivable.

**Reasons:** 12(1)(b) was enacted to expand the ambit of inclusion under s. 9(1) and could not support the interpretation given to it by the taxpayer.

* **Subsection 12(2)** – Paragraphs [12(1)(a)] and [12(1)(b)] are enacted for greater certainty and shall not be construed as implying that any amount not referred to in those paragraphs is not to be included in computing income from a business for a taxation year whether it is received or receivable in the year or not.
	+ This expresses the purpose of enacting 12(1)(b)

### Unearned Income

* The accrual method of accounting in 12(1)(b) requires a taxpayer to include, in computing income, an amount that is receivable in the year even if the amount has not been received in the year. But what if a taxpayer receives an amount in a taxation year that is paid in respect of goods or services to be delivered or provided in a future taxation year? Is the amount included in computing the taxpayer’s income for the year in which it is received? Remember that an amount is included in income when it is receivable and an amount is receivable when it has the “quality of income”. Also remember that an amount has the “quality of income” when the taxpayer’s right to be is absolute, and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment.
* Where a taxpayer has received an amount as a payment for future goods or services (normally considered unearned revenue) and excluded from income for accounting purposes. However, 12(1)(a) overrides the accounting treatment of unearned revenue and requires the taxpayer to include, in computing income, any amount received in the year in the course of a business that is on account of services not rendered or goods not delivered before the end of the year
* **Paragraph 12(1)(a)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amount as are applicable:
		- (a) any amount received by the taxpayer in the year in the course of a business
			* (i) this is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been earned in the year or a previous year, or …

### Reserves

* **Paragraph 18(1)(e)**
	+ In computing the income of a taxpayer from a business or property no deduction shall be made in respect of…
		- (e) an amount as, or on account of, a reserve, a contingent liability or amount or a sinking fund except as expressly permitted by this Part
* The *ITA* specifically permits a deduction in respect of certain reserves
* Two examples:
	+ Unearned Revenue – **p. 20(1)(m)**
	+ Deferred Payments – **p. 20(1)(n)**
		- The partner provision to section 12(1)?
* **Paragraph 20(1)(m) – Unearned Revenue**
	+ Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer’s income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonable be regarded as applicable thereto:
		- (m) … where amounts described in paragraph 12(1)(a) have been included in computing the taxpayer’s income from a business for the year or a previous year, a reasonable amount as a rese in respect of
			* (i) goods that it is reasonably anticipated will have to be delivered after the end of the year,
			* (ii) services that it reasonable anticipated will have to be rendered after the end of the year….
	+ Purpose of this section is to provide the taxpayer with flexibility
	+ The combined effect of 12(1)(a) and 12(1)(m) is to codify the accounting treatment of unearned revenue. The principle difference is that whereas under accounting rules a person is not permitted to recognize unearned revenue for financial accounting purposes, under the rules in the *ITA*, a taxpayer has the option to recognize or defer the unearned revenue for income tax purposes
* **Paragraph 12(1)(e)**
	+ There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
		- (e) any amount
			* (i) deducted under paragraph 20(1)(m)…, or
			* (ii) deducted under paragraph 20(1)(n),

In computing the taxpayer’s income from a business for the immediately preceding (next) year;

### Sample Problem

* Marie operates a website design business. Marie billed her clients a total of $48,000 in 2019. Of this amount, she received $30,000 during 2019 and the remaining $18,000 in early 2020. In October of 2019 Marie also received $25, 000 as an advance on a large website design project. Marie completed 20% of the project in 2019 and the remainder of the project in 2020. In what year is Marie required to include these amounts in computing her income for income tax purposes?
	+ Pursuant to 9(1), Marie’s income from a business for a year is her profit for the year. In computing her profit for the year, Marie is required to include any amount that is realized in the year. An amount is realized when it has the “quality of income” which means that Marie’s right to the amount is absolute and under no restriction, contractual or otherwise, as its disposition, use or enjoyment
	+ The $30,00 received by Marie is included in her income in 2019 because the services in respect of this amount have already been provided to her clients and therefore, her right to the amount is absolute
	+ The $18,000 which has been billed but is not payable until 2020 is also included in Marie’s income for 2019 because:
		- Marie’s right to the amount is absolute and the amount is considered to be receivable even though it is not payable until 2020;
		- This result is consistent with accounting practice and is also required by 12(1)(b) which provides that a taxpayer must include in computing income an amount that is receivable notwithstanding it is not due until a subsequent year; and
		- Paragraph 12(1)(b) deems the amount to be receivable on the day Marie billed her clients for the services
	+ The $25, 000 that Marie received in October of 2019 is included in computing her income for 2019 pursuant to paragraph 12(1)(a)
	+ Marie is entitled to claim a deduction under paragraph 20(1)(m) as a reserve in respect of services that it is reasonably anticipated will have to be rendered after the end of the year
		- Since we know that 80% of the project was not completed until 2020, Marie can deduct 80% of the $25,000 or $20,000 as a reasonable reserve
	+ Marie is therefore required to include $5, 000 in computing her income for 2019
	+ The $20,000 claimed by Marie as a reserve in 2019 is included in computing her income from business in 2020 pursuant to 12(1)(e)

### Deferred Payments

* When a taxpayer sells property in the course of their business, the taxpayer may be able to defer the recognition of profit realized on the sale of the property to the extent that a portion of the sale proceeds are not payable to the taxpayer in the year of sale
* **Paragraph 20(1)(n)**
	+ Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer’s income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonable be regarded as applicable thereto:
		- (n) where an amount included in computing the taxpayer’s income from the business for the year or for a preceding taxation year in resect of property sold in the course of the business is payable to the taxpayer after the end of the year and … all or part of the amount was, at the time of the sale, not due until at least 2 years after that time, a reasonable amount as a reserve in respect of such part of the amount as can reasonably be regarded as a portion of the profit from the sale….
* A reserve cannot be claimed in a taxation year if the sale occurred more than 36 months before the end of that taxation year. This effectively limits the reserve to 3 years – **para 20(8)(b)**
* The amount deducted under paragraph 20(1)(n) is included in computing the taxpayer’s income in the next taxation year – **p. 12(1)(e)**

### Sample Problem

* Simon purchases a widget for $2, 000 and sells it to a customer for $5, 000 in 2017. The customer agrees to pay Simon $3, 000 in 2017, $1, 000 in 2018, $500 in 2019 and the remaining $500 in 2020
* How much does Simon include in computing income for each taxation year?
	+ 2017 taxation year
		- Simon’s profit from the sale of the widget: amount by which the sale proceeds exceed the amount Simon paid to acquire the widget
			* **$5, 000 - $2, 000 = $3,000 –** include this $3, 000 profit in computing his income for 2017 but is also entitled to a deduction under 20(1)(n) because a portion of the sale proceeds are not until 2019 which is at least 2 taxation years after the date the property was sold
			* Pursuant to 20(1)(n) Simons deduction is equal to the amount that can reasonably be regarded as a portion of the profit from the sale that is not payable until after the end of the taxation year.
		- The reasonable reserve for 2017 is Profit X [amount due after year/total sale proceeds] – **subsection 20(1)(n):**
			* **$3, 000 x [$2, 000/$5,000] = $1, 200**
		- Simons income from business in 2017 is therefore:
			* **$3, 000 - $1,200 = $1, 800**
	+ 2018 taxation year
		- Simon includes the reserve claimed in 2017 (**$1, 200)** in computing his income for 2018 – **paragraph 12(1)(e)**
			* However, a portion of the proceeds of sale are not due until after 2018 so Simon is entitled to a deduction under 20(1)(n) when computing his income for his 2018 taxation year
		- The reasonable reserve for 2018 is Profit X [Amount due after year/ total sale proceeds] **– subsection 20(1)(n)**
			* **$3, 000 X [$1, 000/$5, 000] = $600**
		- Simon’s income from business in 2018 is therefore:
			* **$1, 200 - $600 = $600**
	+ 2019 taxation year
		- Simon includes the reserve claimed in 2018 (**$600**) in computing his income for 2019 – **paragraph 12(1)(e)**
			* However, a portion of the proceeds of sale are not due until after 2019 so Simon is entitled to a deduction under 20(1)(n) when computing his income for his 2019 taxation year
		- The reasonable reserve for 2019 is Profit X [Amount due after year/ total sale proceeds] **– subsection 20(1)(n)**
			* **$3, 000 X [$500/$5, 000] = $300**
		- Simon’s income from business in 2019 is therefore:
			* **$600 - $300 = $300**
	+ 2020 taxation year
		- Simon includes the reserve claimed in 2019 **($300)** in computing his income for 2020 – **paragraph 12(1)(e)**
		- Since the remaining $500 was paid in 2020 and no sale proceeds are due after 2020, Simon is not entitled to a reserve in 2020
		- Furthermore, since the sale occurred in 2017, which is more than 36 months before the end of 2020, Simon would not be permitted to claim a reserve in 2020 even if a portion of the sale proceeds were due after that year – **s. 20(8)(b)**
		- Simon’s income from business in 2020 is therefore **$300**
* In aggregate, how much profit has Simon recognized on this sale?
	+ 2017 = **$1, 800** [$3,000 - $1, 200]
	+ 2018 = **$600** [$1, 200-$600]
	+ 2019= **$300** [$600 - $300]
	+ 2020 = **$300**
* Total recognized in all three years: **$3, 000** (i.e. Simon’s total profit)

## The Recognition of Expenses

* Analogous timing rules apply in relation to the deductibility of expenses
* Under accrual accounting rules, an expense is normally deductible when it is incurred or payable. An amount is incurred or payable when all events have occurred that are necessary to establish the taxpayer’s liability to make the payment and the amount of the expense can be determined with reasonable accuracy.
* The question of whether a taxpayer has incurred an expense for tax purposes was considered in the below case.

#### J.L. Guay Ltee v MNR, 1971 (FCTD)

**Facts:** The taxpayer, a general contractor, was entitled to holdback 10% from the amount it was required to pay to subcontractors (a “holdback”) until an architect or engineer’s certificate was issued. The taxpayer deducted an amount in respect of these holdbacks in computing its income.

**Issue:** Were the holdbacks were incurred by the taxpayer for the purpose of earning income and therefore deductible in the year?

**Held:** No. This is the opposite result than we saw in *MNR v J. Colford Contracting Co.*

**Reasons:** The liabilities were contingent and therefore not deductible until the contingency is satisfied.

## Recognition of Expenses

* An expense is normally deductible in the accounting period in which the revenues related to that expense were earned. If an expense is not directly tied to revenues, the expense is normally reported in the accounting period in which the expense expires or is used up. This is commonly referred to as the ***matching principle***
* In determining whether an expense is deductible in computing profit in a particular taxation year, a taxpayer must have regard to the matching principle as modified by provisions of the *ITA* or other established rules of law
* Based on this approach, we can allocate expenses to one of three broad categories:
	+ Current Expenses
		- Value of or benefit from which relates to current year
		- Generally relate to a particular item of revenue
		- ***Accounting:*** deductible in the current year
		- ***Tax:*** deductible in the year incurred
	+ Capital Expenses
		- Value of or benefit from which endures for more than one year
		- ***Accounting:*** Amortized/Depreciated over its useful life
			* Matching revenues with capital expense over time
		- ***Tax:*** Deduction denied unless specifically permitted under the *ITA* – **paragraph 18(1)(b) and section 20**
			* **20(1)(a)-** permits the deduction of capital cost allowance
			* Capital cost allowance rules
			* *ITA* does not allow you to use accounting rules for computing income for tax purposes
	+ Pre-paid Expenses
		- Expense in respect of a service or good to be received in a future year (e.g. pre-paid rent)
		- ***Accounting:*** Amortized over the period to which it relates
		- ***Tax:*** Deduction for pre-payment of services, interest, taxes, rent and royalties is delayed until the year to which it relates – **paragraph 18(9)(a) and (b)**
		- Although the treatment of all pre-paid expenses is not expressly provided for in the *ITA*, CRA generally requires the same treatment for all pre-paid expenses on the basis that it is generally consistent with accounting practice

# Capital Expenditures

* “When a payment is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, there is very good reasons for treating such an expenditure as capital” (*British Insulated and Helsby Cables Limited v IRC*, 1926 HL)
	+ E.g. I buy a truck to deliver my goods, I buy a machine to produce my goods
* In determining the proper tax treatment of an expenditure, it is first necessary to determine if the expenditure is a current expense or a capital expense
	+ If it is a current expense, it is fully deductible in the year it is incurred.
	+ If however, if it a capital expense, its deduction is limited by paragraph 18(1)(b)
* **Paragraph 18(1)(b)**
	+ In computing the income of a taxpayer from a business or property no deduction shall be made in respect of …
		- (b) any outlay or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as generally permitted by this Part
* As such, a capital expense is not deductible for tax purposes unless it’s deduction is expressly permitted
	+ A common exception to the limitation in 18(1)(b) is capital cost allowance
* The deduction of capital cost allowance is expressly permitted – **paragraph 20(1)(a)**

## What is a Capital Expenditure?

* Unlike current expenses which only relate to the year in which they are incurred, a capital expenditure is incurred with a view to bringing into existence an asset or an advantage for the enduring benefit of trade
* “When a payment is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade… there is very good reason… for treating such an expenditure… as capital.”
	+ *British Insulated and Helsby Cables, Limited v. IRC*, 1926, HL
* **Capital Expense**
	+ An amount paid to purchase a capital property (e.g. machinery)
		- i.e. an amount paid to purchase machinery for use in the manufacturing of products is capital expenditure because the amount is paid to acquire a tangible property that will provide a benefit, not only in the taxation year it is purchased, but for a number of future taxation years as well
		- As such, the amount paid to purchase the machine is not fully deductible in the taxation year it is purchased and must be deducted over time in accordance with the capital cost allowance rules (this type of property is often referred to as a “capital asset” or “capital property”)
		- This type of property is normally treated as depreciable property as well
	+ An amount paid to upgrade or improve a capital property
		- Once a taxpayer owns a capital property the taxpayer may expend further amounts to repaid, maintain or improve it
		- The deductibility of these amounts will also depend on whether they are characterized as a current expense or a capital expense
			* Where a taxpayer pays an amount for the repair or maintenance of a capital property, this is normally treated as a current expense that is deductible in the year
			* Where an amount is expended to upgrade or improve the capital property, the amount is generally treated as a capital expenditure and is added to the cost of the property. As such, an amount paid to improve a capital property is not fully deductible in the current year, but will normally be deductible over time in accordance with the capital cost allowance rules
	+ The treatment of an outlay or expense as a capital expenditure is not limited to amounts paid to purchase or improve tangible capital property. There are many other payments that are treated as capital amounts as well. For example, amounts paid to acquire intellectual property, amounts paid in respect of good will on the purchase of a business and amounts paid by a corporation to facilitate the issuance of shares of its capital stock
		- For the purpose of this course, we will limit our discussion to outlays and expenses in relation to the purchase, repair, maintenance and improvement of tangible capital property
* **Current Expense**
	+ An amount paid to repair or maintain a capital property

## Capital vs. Current Expenses

* Where a taxpayer has paid an amount in relation to a tangible capital property, it is not always clear if that amount was paid to repair the property or to improve it. This distinction is significant since an amount paid to repair a capital property is normally deductible as a current expense and an amount paid to improve or update a capital property is generally only deductible over time as a capital expense
* **Repair of Tangible Assets**
	+ In determining if an amount is currently deductible as a repair it is important to answer the following questions:
		- Does the expense provide lasting long-term benefits? (capital)
		- Does the expense maintain or improve the property? (Maintain = repair; improve = capital (*Shabro)*)
		- Does the expense purchase a new asset of is it an integral part of an existing asset? (new asset = capital) (integral part of the asset = a repair)
		- What is the value of the expense in relation to the value of the asset? (high = capital)

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

**Facts:** The taxpayer owned ships that it used in a shipping business. The taxpayer incurred expenses to (i) replace the floors and walls of cargo holds in certain of these ships; and (ii) replace the boiler in one of the ships. The taxpayer treated these amounts as repairs and deducted them as current expenses. The Minister reassessed the taxpayer and characterized the amounts as capital expenses.

**Held:** The work performed to replace the floors and walls of cargo holds was a current expense but the replacement of the boiler was a capital expenditure.

**Reasons:** The replacement plates for the floors and walls were an integral part of the asset and the work had been made necessary by the wear and tear caused by the taxpayer’s use of the ship. As such, the work performed was a repair and deductible as a current expense. The fact that the repairs were extensive and the cost of completing them was substantial did not change their character. If the parts had been replaced with something so different in kind that it constituted a change in the character of the ship, this could result in an upgrade and not just a repair. In finding that the cost to replace the boiler was a capital expenditure, the Court stated that it felt bound by prior cases that characterized the boilers as a separate capital property the acquisition of which was a capital expenditure and not an integral part of the ship. But for this desire to maintain consistency, the court would of likely found that the cost of replacing the boiler was a current expense on the basis that the boiler was an integral part of the ship and the replacement of the boiler was a repair

#### The Queen v Shabro Investments Ltd., 1979, (FCA)

**Facts:** The taxpayer owned a building that had been constructed on a garbage land-fill site. Although the walls of the building were supported by piles sunk through the garbage fill to solid earth, the bottom floor consisted of concrete slabs reinforced by “wire mesh” laid on the fill and dependent on the fill for support. Over time, the fill compacted causing the floor to subside and break, with the result that the lower floor of part of the building became unusable as rental space. It was determined that the damaged floor could not simply be replaced with a new floor of similar construction but that it would be necessary to replace it with a floor consisting of a concrete slab reinforced by steel so that it could be supported by steel piles in a way similar to the construction of the walls. The taxpayer replaced the floor according to these recommendations and deducted the cost as a current expense. The Minister disallowed the deduction.

**Held:** The court held that the cost of replacing the floor was a capital expenditure.

**Reasons:** In general, replacements of worn or damaged parts, even though substantial, are repairs and are to be contrasted with changes designed to create an enduring addition or improvement to the structure. Furthermore, “repairs” do not become disqualified as “repairs” merely because they are carried out in the light of technology unknown when the original structure was built or because they take into account conditions not taken into account when the original structure was built. As such, the real question is whether the replacement of the floor was merely the remedying of damage to the building of whether it was an integral component of the work designed to improve the building by replacing a substantial part thereof by something essentially different in kind. In the view of the Court, the removal of the old floor, the installing of steel piles and a concrete slab floor reinforced by steel was a single operation whereby an improvement was made to the building that was essentially different in kind from a repair to the building as originally constructed. Accordingly, the replacement of the floor was a capital expense.

* This was an improvement, not just a repair. When you improve something, it should be included in the capital of the asset
* They improved the building, they made it better than before, and arguably it is something that should have happened originally. It increased the value of the building, so it should be a capital, not just an expense

#### Gold Bar Developments Ltd. v. The Queen, 1987, (FCTD)

**Facts:** The taxpayer owned an apartment building the exterior of which was constructed of brick veneer. Bricks began to fall from the building and based on the advice of professional engineers, the taxpayer had the building repaired using metal cladding instead of brick veneer. The taxpayer deducted the cost of the metal cladding as a current expense and the Minister reassessed the taxpayer to characterize it as a capital expense.

**Held:** The expense was a repair and therefore deductible as a current expense.

**Reasons:** The Court looked to the purpose of the outlay. Here, the outlay was not a voluntary expenditure made with a view to bringing into existence a new capital asset or creating an improved building. The taxpayer was faced with an unexpected deterioration in the walls of the building which put the viability of the property at risk. The decision to spend the money was a decision to repair to meet that crisis. The fact that the taxpayer replaced the brick veneer with metal cladding also did not change its characterization as a repair. Once the decision to repair is forced upon the taxpayer, the taxpayer should not be expected to ignore advancements in building techniques in carrying out the work. In choosing to install the metal cladding the taxpayer simply adopted an extremely popular modern construction technique. Nothing in the repair project attempted to change the structure of the building. What was done was neither more nor less than what was required to replace the deteriorating and dangerous brick condition. The value of the alteration was also less than 3% of the value of the building itself and the alteration did not substantially increase the value of the building. This was an update in materials

* Repairs = a deductible expense
* Improvements = a capital expense

## Capital Cost Allowance

* Where a taxpayer pays an amount to acquire a capital asset (i.e. machinery) which is to be use for the purpose of gaining or producing income, the amount paid t
* purchase the capital asset is normally deductible in accordance with 20(1)(a)
* **Paragraph 18(1)(a)**
	+ In computing the income of a taxpayer from a business or property, no deduction shall be made in respect of
		- (b) an outlay, loss or replacement of capital, a payment of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part
			* 18(1)(a) says you cannot deduct
			* 18(1)(b) says you can deduct as permitted
* **Paragraphs 20(1)(a)**
	+ Notwithstanding paragraph 18(1)(a), (b) and (h), in computing a taxpayer’s income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source of such part of the following amounts as may reasonably be regarded as applicable thereto:
		- (a) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;
* The deduction permitted by 20(1)(a) is usually referred to as capital cost allowance
* Capital cost allowance is the income tax equivalent of accounting depreciation
* Permits a write-off of the cost of a capital asset over time
* The basic purpose of the CCA is to allocate the cost of the capital asset over its useful life
* Since different types of assets depreciate at different rates, assets are divided into various classes each of which has a specified capital cost allowance rate
* The CCA rates are set out in Schedule II and Regulation 1100
* Property on which CCA can be claimed is referred to as “depreciable property” – **subsection 13(21)**
	+ Depreciable property is a sub-set of “capital property” (section 54)
		- “capital property” specifically includes “depreciable property” in its definition, so “depreciable property” is “capital property” by definition
* The classes of property described in Schedule II are deemed not to include property that is inventory or that was not acquired for the purpose of gaining or producing income – **Regulation 1102(1)(b) and (c)**
	+ Capital property that does not depreciate such as land and financial investments are also not included in the classes of property described in schedule II and Regulation 1100
* In some circumstances the CCA rules provide for an accelerated write-off of assets, normally motivated by some social, economic or political reason
	+ E.g. accelerated write-off for the purchase of manufacturing goods to encourage companies to purchase now, not later or not at all
* CCA is a permitted deduction, meaning that a taxpayer can write-off any amount up to the maximum
	+ Claiming CCA is not mandatory, it is optional
* **Regulation 1100(1) -**sets out the rate of CCA that may be claimed on various classes of assets for the purpose of s. 20(1)(a)
	+ For the purposes of paragraphs … 20(1)(a) of the Act, the following deductions are allowed in computing a taxpayer’s income for each taxation year:
		- (a) subject to subsection (2) such amount as he may claim in respect of property of each of the following classes in Schedule II not exceeding in respect of property..
			* (viii) of Class 8, 20 per cent…

Of the **undepreciated capital cost to the taxpayer… of property of the class;**

* For the purpose of this course we will not have to determine the class to which a depreciable property belongs, nor will we be required to determine the rate of CCA for that class. Where such information is relevant for the purpose of evaluation, it will be provided to us
* The starting point for determining CCA is the undepreciated capital cost to the taxpayer of depreciable property of a prescribed class. “Undepreciated capital cost” is defined in subsection 13(21)
* **Subsection 13(21)**
	+ “**undepreciated capital cost”** to the taxpayer of depreciable property of a prescribed class… means the amount determined by the following formula:
		- (A+B+C+D+d.1) – (E+E.1+F+G+H+I+J+K) 🡪 (A+B) – (E+F)
		- Where
			* **A** is the total of all amounts each of which is the capital cost to the taxpayer of a depreciable property of the class,
				+ How much did you pay for the asset?
				+ A running total. Any amount that you have ever bought of that class. Anything you have ever spent in the class
				+ This amount can only increase over time, never decrease
			* **B** is the total of all amounts included in the taxpayer’s income under this [subsection 13(1)]
				+ In some circumstances, you may have to recapture. B is the amount where you do that
			* **E** is the total depreciation allowed to the taxpayer for property of the class
				+ All your capital cost allowance. Anything you have ever deducted from this class
				+ A – E = undepreciated capital cost
			* **F** is the total of all amounts … in respect of a disposition… and is the lesser of
				+ (a) the proceeds of disposition of the property, and
				+ (b) the capital cost to the taxpayer of the property

For the purpose of this course, capital cost of depreciable property is what the taxpayer paid to acquire the property

If you sell the property, you must take out its amount of capital cost allowance

Total of disposed property. Either the PoD or the capital cost to the taxpayer

E.g.: If I buy for $100, but sell it for $50, then $50 is an expense, and you remove $50

E.g.: If I buy for $100 and sell for $150, then you only remove $100 and $50 is a capital gain

* **Subsection 13(1)- Recapture**
	+ Where, at the end of a taxation year, the total of the amounts determined for [E and F] in the definition “undepreciated capital cost” in subsection (21) in respect of a taxpayer’s depreciable property of a particular prescribed class exceeds the total of the amounts determined for [A and B] in that definition in resect thereof, the excess shall be included in computing the taxpayer’s income for the year…
		- As such, where a taxpayer sells a depreciable property for an amount greater than the remaining undepreciated capital cost of the class to which the property belongs, the excess amount is normally included in the taxpayer’s income
		- E.g.: If I buy an asset for $100, I deduct $50 for CCA, which means my undepreciated CC is $50. If I turn around and sell that asset for $100, I have no expenditure (I am not out of pocket, I broke even), so why should I get the $50 deduction. I shouldn’t and that’s where recapture comes in
		- Where E+F > A+B, include that difference in your income
			* This amount goes into B, which makes the equation back to $0
		- For example, assume a taxpayer purchases a class 8 depreciable property for $1, 000 and that this is the taxpayer’s only depreciable property in class 8. The taxpayer claims $500 of capital cost allowance on this property before selling it for $750.
			* **E=** $500 (the capital cost allowance previously claimed by the taxpayer)
			* **F=** $750 (the lesser of proceeds of disposition and the original cost of the depreciable property)
				+ **E+F**= $1, 250
			* **A=** $1,000 (the amount paid to purchase the depreciable property)
			* **B=** $0
				+ **A+B=** $1,000
			* **(E+F) – (A+B) =** $1,250 - $1,000 = **$250**
				+ The $250 is included in the taxpayer’s income pursuant to subsection 13(1)
* **Subsection 20(16) – Terminal Loss**
	+ In contrast to recapture which occurs when a property is sold for an amount greater than the remaining undepreciable cost of its class, a taxpayer may be permitted to deduct a terminal loss where the undepreciated capital cost of a class is still positive following the disposition of all property that was included in the class
	+ Notwithstanding paragraphs 18(1)(a), (b) and (h), where at the end of a taxation year,
		- (a) the total of all amounts used to determined [A and B] in the definition “undepreciated capital cost” in subsection 13(21) in respect of a taxpayer’s depreciable property of a particular class exceeds the total of all amounts used to determined [E and F] in that definition in respect of that property, and
		- (b) the taxpayer no longer owns any property of that class,

In computing the taxpayer’s income for the year

* + - (c) there shall be deducted the amount of the excess determined under paragraph (a), and
		- (d) no amount shall be deducted for the year under paragraph 1(a) in respect of property of that class
	+ When you thought the useful life would be longer, but you end up disposing of an asset for $0 before the end of its useful life, so there is still an amount of undepreciated capital cost. That’s when you have a terminal loss.
	+ Where a taxpayer has deducted a terminal loss in a tax year in respect of a class of depreciable property, the taxpayer is not permitted to also deduct a capital cost allowance for that class in the same taxation year
	+ E.g.: I buy an asset for $100, deduct $50, and then throw it away for $0 before deducting that other $50
		- Keep deducting that other $50 over time as part of the pool
		- But what is this is the only asset in my class pool? Then the *ITA* says you can write it off
	+ For example, assume a taxpayer purchases a class 8 depreciable property for $1, 000 and that this is the taxpayer’s only depreciable property in class 8. The taxpayer claims $500 of capital cost allowance on this property before selling it for $200.
		- **E=** $500 (the capital cost allowance claimed by the taxpayer)
		- **F=** $200 (the lesser of proceeds of disposition and the original cost of the depreciable property)
			* **E=F=** $700
		- **A=** $1,000 (the amount paid to purchase the depreciable property)
		- **B=** $0
			* **A+B=** $1,000
		- **(A+B) – (E+F) =** $1,000 - $700 = **$300**
			* The $300 is deductible in computing the taxpayer’ income pursuant to 20(16)
* **Regulation 1100(2) – “The Half-Year Rule”**
	+ Where, in a taxation year, there is a net increase in the undepreciated capital cost of a class of depreciable property, the taxpayer is generally only entitled to deduct 50% of the CCA that would have otherwise been deductible in the taxation year in respect of a new increase
	+ In general terms, a taxpayer is only entitled to 50% of the CCA they would have otherwise been entitled to in a particular taxation year in respect of a net increase in the UCC of a particular class of depreciable property in that year.
	+ In applying the half year rule, it is necessary to determine the taxpayer’s notional undepreciated capital cost (UCC) for the purpose of calculating capital cost allowance
	+ CCA is calculated on a Notional UCC, computing as follows:
	+ Notional UCC =
		- Year-End UCC (otherwise determined) – ½ (acquisitions – dispositions)
			* The taxpayers notional UCC is equal to the undepreciated capital cost of the class at the end of the year - ½ of the net acquisitions for that class. The net acquisitions is computed as the amount by which acquisitions in the taxation year of new depreciable property of the class (including capital expenditures incurred to improve or upgrade an existing depreciable property) exceed the dispositions in the taxation year of depreciable property that as included in the class.
			* What is the reason for limiting the taxpayer’s capital cost allowance in these circumstances?
				+ It only applies in the year of acquisition so it makes it so that it is not so much of a focus for tax purposes at what point you start depreciating the property by assuming that it is just in the middle of the year
				+ Recognizes that you should only be able to depreciate a property for the period of time you owned it in the year but this causes a bunch of adminsitrative problems
				+ This is a compromise in saying that you should not eb able to claim the full depreciation when you bought it close to the end of the year but at the same time we don’t want you to have to prorate your CCA for the portion of the year you had it. You are better off if you get the asset in the second half of the year
* Where there is a NET ACQUISITION (more added than disposed of), apply the half year rule and cut in half the net acquisition for that year in the Notional UCC Calculation
* Alternative methods:
	+ Whenever you buy assets, you have to pro-rate to the number of days within the year to the number of the days you have held it
	+ You either buy something in the first half of the year and claim 100% or the second half of the year and claim 50%
		- This is the method that the *ITA* uses
* Depreciable property is a sub-set of “capital property”
	+ **Section 54**
		- “capital property” of a taxpayer means
			* (a) any **depreciable property** of the taxpayer, and
			* (b)…;
* As such, where a taxpayer disposes of depreciable property the taxpayer will realize a capital gain to the extent their proceeds of disposition exceed their adjusted cost base – **paragraph 40(1)(a) and 39(1)(a)**
* Half of this capital gain is the taxpayer’s taxable capital gain – **paragraph 38(a)**
* The **“adjusted cost base”** of depreciable property is the taxpayer’s capital cost of the depreciable property – **section 54**
* For the purpose of this course, the taxpayer’s capital cost of depreciable property is what the taxpayer paid to acquire the property
* In contrast, where the taxpayers proceeds of disposition are less than the cost of the depreciable property the taxpayer does not realize a capital loss
	+ This is because a loss on the disposition of depreciable property is excluded from the meaning of capital loss – **s. 39(1)(b)(i)**
* The sale of a depreciable property may give rise to a terminal loss – **subsection 20(16)**

### Sample Problem #1

* In Year 1 Taxpayer (T) purchases 4 Widget Making Machines for $1, 000 each. Widget Making Machines are class 43 assets (which gives them a CCA rate of 30%). What is the maximum capital cost allowance that T can claim in Year 1?
	+ **Year 1**
		- Actual UCC = (A+B)-(E+F): - the first step is to calculate the undepreciated capital cost of the machines at the end of year 1. The undepreciated capital cost is determined by this formula
			* A = Cost of Assets = $4, 000 – the total of all amounts each of which is the capital cost to the taxpayer of a depreciable property of the class
				+ $4,000 is the aggregate purchase price of the 4 machines
			* B = Recapture for prior year = $0 – the total of all amounts included in the taxpayer’s income under subsection 13(1) in respect of the class
			* E = Depreciation, prior years + $0 – the total capital cost allowance previously claimed by the taxpayer in respect of the class
			* F = Lesser of PoD and CC of sold assets = $0- the total of all amounts that is the lesser of the proceeds of disposition and the capital cost in respect of each disposition of depreciable property that was part of the class
		- Actual UCC = ($4,000 +$0) – ($0+$0) = $4,000
		- Notional UCC (Reg. 1100(2)) = $4, 000 – 50% x ($4, 000 - $0) = $2, 000
			* T’s Notional UCC is his actual UCC less 50% of T’s net acquisitions in Year 1. In year 1, T purchased the 4 machines for $4, 000 and did not dispose of any machines. As such, T’s net acquisitions are $4, 000.
		- CCA = 30% x Notional UCC ($2, 000) = **$600**
	+ In Year 2, T purchases another Widget Making Machine for $1,000 and sells one of the original Widget Making Machines for $800. What is the maximum capital cost allowance T can claim in Year 2?
	+ **Year 2**
		- Actual UCC = (A+B)-(E+F): -
			* A = Cost of Assets = $4, 000 + $1, 000 = $5, 000 – this is the aggregate purchase price of the 5 machines
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $600 – this is the capital cost allowance claimed in year 1
			* F = Lesser of PoD and CC of sold assets = $800 – this is the lesser of the $800 PoD and the $1, 000 capital cost of the machine that T sold in Year 2
		- Actual UCC = ($5,000 +$0) – ($600+$800) = $3, 600
		- Notional UCC (Reg. 1100(2)) = $3, 600 – 50% x ($1, 000 - $800) = $3, 500
			* In year 2, T purchased 1 machine for $1, 000 and disposed of 1 machine for $800. As such, T’s net acquisitions are $1,000 - $800 or $200. 50% of this amount is $100
		- CCA = 30% x Notional UCC ($3, 500) = **$1,050**
	+ In Year 3, there are no new acquisitions or dispositions. What is the maximum capital cost allowance that T can claim in Year 3?
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $4, 000 + $1, 000 = $5, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $600 + $1, 050 = $1, 650 -this is the aggregate capital cost allowance in Year 1 and Year 2
			* F = Lesser of PoD and CC of sold assets = $800
		- Actual UCC = ($5,000 +$0) – ($1, 650 + $800) = $2, 550
		- CCA = 30% x Actual UCC ($2, 550) = **$765**
		- **Note:** since there are no net acquisitions in Year 3 it is not necessary to compute the Notional UCC

### Sample Problem #2 – Recapture

* In Year 1 Taxpayer (T) purchases 3 Widget Making Machines for $1, 000 each. Widget Making Machines are class 43 assets (CCA rate of 30%). What is the maximum capital cost allowance that T can claim in Year 1?
	+ **Year 1**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $3, 000 – the aggregate purchase price of the 3 machines
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $0
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($3,000 +$0) – ($0+$0) = $3,000
		- Notional UCC (Reg. 1100(2)) = $3, 000 – 50% x ($3, 000 - $0) = $1,500
			* In year 1 T purchased the 3 machines for $3, 000 and did not dispose of any machines. As such, T’s net acquisitions are $3, 000.
		- CCA = 30% x Notional UCC ($1, 500) = **$450**
	+ In year 2, there are no new acquisitions or dispositions. What is the maximum capital cost allowance T can claim in year 2?
	+ **Year 2**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $3, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $450 – this is the capital cost allowance claimed in Year 1
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($3,000 +$0) – ($450+$0) = $2, 550
		- CCA = 30% x Actual UCC ($2, 550) = **$765**
		- **Note:** Since there are no net acquisitions in Year 2 it is not necessary to compute the Notional UCC
	+ In year 3, T sells Widget Making Machines for $1, 000 each. What is the maximum capital cost allowance tat T can claim in Year 3?
	+ **Year 3**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $3, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $450 + $765 = $1, 215 – this is the aggregate capital cost allowance claims in year 1 and year 2
			* F = Lesser of PoD and CC of sold assets = $2,000 – this is the aggregate of the amount that is the lesser of the proceeds of disposition and the capital cost in respect of each of the 2 machines sold in Year 3
		- Actual UCC = ($3,000 +$0) – ($1, 215 + $2, 000) = - $215
			* If we compute the actual UCC, the amount would be negative since the aggregate of E+F exceeds the aggregate of A+B by $215
		- Recapture = (E+F) – (A+B) = ($1,215 + $2,000) – ($3, 000 + $0) = **$215**
		- **Note:** T is not entitled to claim CCA in Year 3 and is required to include $215 as recapture in computing income pursuant to s. 13(1)
	+ In year 4, T purchases on Widget Making Machine for $1, 000. What is the maximum capital cost allowance that T can claim in Year 4?
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $3,000 + $1, 000 = $4, 000 – this is the aggregate purchase price of the 4 machines
			* B = Recapture for prior year = $215 – this is the recapture included in computing T’s income in Year 3
			* E = Depreciation, prior years + $450 + $765 = $1, 215 – this is the aggregate capital cost allowance in the first 3 years
			* F = Lesser of PoD and CC of sold assets = $2, 000
		- Actual UCC = ($4,000 + $215) – ($1, 215 + $2, 000) = $1,000
		- Notional UCC (Reg. 1100(2)) = $1, 000 – 50% x ($1, 000 - $0) = $500
			* In year 4, T purchased 1 machine for $1, 000 and did not dispose of any machines. As such, T’s net acquisitions are $1, 000.
		- CCA = 30% x Notional UCC ($500) = **$150**

### Sample Problem #3 – Terminal Loss

* In Year 1 Taxpayer (T) purchases 2 Widget Making Machines for $1, 000 each. Widget Making Machines are class 43 assets (CCA rate of 30%). What is the maximum capital cost allowance that T can claim in Year 1?
	+ **Year 1**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $2, 000 – the aggregate purchase price of the 2 machines
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $0
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($2,000 +$0) – ($0+$0) = $2,000
		- Notional UCC (Reg. 1100(2)) = $2, 000 – 50% x ($2, 000 - $0) = $1, 000
			* In year 1 T purchased the 2 machines for $2, 000 and did not dispose of any machines. As such, T’s net acquisitions are $2, 000.
		- CCA = 30% x Notional UCC ($1, 000) = **$300**
	+ In year 2, there are no new acquisitions or dispositions. What is the maximum capital cost allowance T can claim in Year 2?
	+ **Year 2**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $2, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $300 – this is the capital cost allowance claimed in Year 1
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($2,000 +$0) – ($300 +$0) = $1, 700
		- CCA = 30% x Actual UCC ($1, 700) = **$510**
		- **Note:** Since there are no net acquisitions in Year 2 it is not necessary to compute the Notional UCC
	+ In year 3, T discontinues the production of widgets and sells the two Widget Making Machines for $500 each. What is the maximum capital cost allowance tat T can claim in Year 3?
	+ **Year 3**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $2, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $4300 + $510 = $810 – this is the aggregate capital cost allowance claimed in year 1 and year 2
			* F = Lesser of PoD and CC of sold assets = $1,000 – this is the aggregate of the amount that is the lesser of the proceeds of disposition and the capital cost in respect of each of the 2 machines sold in Year 3
		- Actual UCC = ($2,000 +$0) – ($810 + $1, 000) = - $190
		- Terminal Loss = **$190**
		- **Note:** Since T no longer owns any depreciable property in the class, T is not entitled to claim CCA in Year 3 and is permitted to deduct $190 in computing income pursuant to subsection 20(16)

### Sample Problem #4 – Sale Above Cost

* In Year 1, Taxpayer (T) purchases 5 Widget Making Machines for $1, 000 each. Widget Making Machines are class 43 assets (CCA rate of 30%) What is the maximum capital cost allowance that T can claim in Year 1?
	+ **Year 1**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $5, 000 – the aggregate purchase price of the 5 machines
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $0
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($5,000 +$0) – ($0+$0) = $5,000
		- Notional UCC (Reg. 1100(2)) = $5, 000 – 50% x ($5, 000 - $0) = $2, 500
			* In year 1 T purchased the 5 machines for $5, 000 and did not dispose of any machines. As such, T’s net acquisitions are $5, 000.
		- CCA = 30% x Notional UCC ($2, 500) = **$750**
	+ In year 2, there are no new acquisitions or dispositions. What is the maximum capital cost allowance T can claim in Year 2?
	+ **Year 2**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $5, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $750 – this is the capital cost allowance claimed in Year 1
			* F = Lesser of PoD and CC of sold assets = $0
		- Actual UCC = ($5,000 +$0) – ($750 +$0) = $4, 250
		- CCA = 30% x Actual UCC ($4, 250) = **$1, 275**
		- **Note:** Since there are no net acquisitions in Year 2 it is not necessary to compute the Notional UCC
	+ In year 3, T scales back production and sells one Widget Making Machine for $1, 200. What is the maximum capital cost allowance tat T can claim in Year 3?
	+ **Year 3**
		- Actual UCC = (A+B)-(E+F):
			* A = Cost of Assets = $5, 000
			* B = Recapture for prior year = $0
			* E = Depreciation, prior years + $750 + $1, 275 = $2, 025 – this is the aggregate capital cost allowance claimed in year 1 and year 2
			* F = Lesser of PoD and CC of sold assets = $1,000 – this is the lesser of the $1, 200 proceeds of disposition and the $1,000 capital cost of the machine that T sold in Year 3
		- Actual UCC = ($5,000 +$0) – ($2, 025 + $1, 000) = - $1, 975
		- CCA= 30% x Actual UCC ($1, 975) = **$592.50**
		- **Note:** Since there are no net acquisitions in Year 3, it is not necessary to compute the Notional UCC
	+ **Year 3 – Capital Gain**
		- Since T sold the Widget Making Machine for an amount greater than its capital cost, T realizes a gain
		- Capital Gain = Proceeds of Disposition – ACB – **paragraphs 40(1)(a) and 39(1)(a)**
			* Proceeds of Dispositions = $1, 200
			* ACB = Capital Cost = $1, 000 (What T paid to purchase the machine)
		- Capital Gain = $1, 200 - $1, 000 = $200
		- Taxable Capital Fain = $200 X ½ = $100 – **paragraph 38(a)**

## Capital Cost Allowance Contd.

### Repair, Destruction or Loss of Depreciable Property

* **Repair of Depreciable Property – Paragraph 12(1)(f)**
	+ **12(1) –** There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
		- **(f)** such part of any amount payable to the taxpayer as compensation for damages to, or under a policy of insurance in respect of damage to, property that is **depreciable property** of the taxpayer as has been expended by the taxpayer
			* (i) within the year, and
			* (ii) within a reasonable time after the damage,

On repairing the damage;

* + **Note:** Under general principles, the taxpayer is permitted to deduct the cost of the repair in computing income. This will offset the amount included in the taxpayer’s income under paragraph 12(1)(f). As such, there should be no net inclusion in income
	+ Paragraph 12(1)1(f) does not apply unless the taxpayer uses the compensation or insurance proceeds to repair the damage to the depreciable property within reasonable time after the damage has occurred.
		- If you use the insurance proceeds that year and within a reasonable time after then damage then …. Zero sum game… don’t need to include it in income?
	+ If the insurance proceeds/compensation is not used to repair the depreciable property within a reasonable time after the damage has occurred, it is treated as proceeds of disposition
	+ **13(21)- “proceeds of disposition”**
		- **“Proceeds of disposition”** of property includes...,
			* **(a)** the sale price of property that has been sold
			* **(c)** compensation for property destroyed and any amount payable under a policy of insurance in respect of loss or destruction of property
			* **(f)** compensation for property damages and any amount payable under a policy of insurance in respect of damage to property, **except to the extent that the compensation or amount as the case may be, has within a reasonable time after the damage been expended on repairing the damage.**
	+ **Note:** The definition of “disposition” in section 248(1) includes any event or transaction giving rise to PoD

### Destruction or Loss of Depreciable Property

* **Paragraph 12(1)(f)**
	+ If the depreciable property is lost or destroyed, any compensation or insurance proceeds are treated as proceeds of disposition
* **13(21) – “proceeds of disposition”**
	+ **“proceeds of disposition”** of property includes
		- (c) compensation for property destroyed and any amount payable under a policy of insurance in respect of loss or destruction of property,
* The definition of “disposition” in subsection 248(1) include any event or transaction giving rise to proceeds of disposition
* As such, where a taxpayer has received proceeds of disposition as a result of damage to or the loss/destruction of depreciable property, this is treated as a disposition of the depreciable property for the purpose of computing the “undepreciated capital cost” as defined in subsection 13(21)

### Replacement Property Rules

* **Section 44**
	+ The replacement property rule under section 44 (discussed in the lesson on capital gains) will apply to defer, in whole or in part, a capital gain realized on the disposition of depreciable property
	+ The disposition of a depreciable property will result in a capital gain where the PoD of the depreciable property exceeds its capital cost
* **Subsection 13(4)**
	+ Subsection 13(4) provides a parallel election to defer, in whole or in part, recapture under subsection 13(1) realized as a result of the disposition of depreciable property
	+ Provides a deferral of recapture realized on the disposition of:
		- A depreciable property as a result of the property being involuntarily taken or destroyed, or
		- A “former business property”
			* Defined in subsection 248(1) to mean capital property that is real property (other than rental property) used by the taxpayer or a related person for the purpose of gaining or producing income from a business
			* In the case of a “former business property”, the replacement property must be purchased before the end of the first taxation year following the year of disposition (section 14(4)(c)(ii)(B)).
			* In the case of any other property. The replacement property must be purchased before the end of the second taxation year following the year of disposition (section 13(4)(c)(ii)(A)).
	+ In circumstances where a replacement property is purchased
	+ **Note:** The rules in relation to the disposition of a former business property are not discussed
	+ Where you sell the depreciable property at a gain, both rules can apply
* **Clause 14(4)(c)(ii)A)**
	+ In the case of depreciable property that has been involuntarily taken or destroyed, subsection 13(4) only applies if the replacement property is purchased before the end of the second taxation year following the year of disposition
* **Subsection 44(2)**
	+ Pursuant to subsection 44(2) the date of disposition is generally delayed until the earlier of:
		- The day on which the taxpayer agrees to the amount of compensation payable for the loss of property; and
		- The day on which the taxpayer’s compensation is finally decided by a tribunal or court
		- If no claim or suit has been filed by the taxpayer within 2 years of the date of loss, the actual day of the loss.
* **Paragraph 13(4)(c)**
	+ Where a replacement property is acquired, the amount otherwise determined for variable “F” in the definition “undepreciated capital cost” in subsection 13(21) in respect of the disposition of the depreciable property is reduced by the lesser of:
		- (i) The amount, if any, by which the amount otherwise determined for “F” exceeds the “undepreciated capital cost” of the class [i.e. the amount recapture under subsection 13(1)] – **subparagraph 13(4)(c)(i)**
		- (ii) The amount paid to acquire a replacement property – **subparagraph 1(4)(c)(ii)**
	+ We will refer the amount determined under paragraph 13(4)(c) as the **“deferred recapture”**
* **Paragraph 13(4)(d)**
	+ The amount of the reduction determined under paragraph (c) is deemed to be the PoD of a depreciable property of the taxpayer that had a capital cost equal to that amount and that was property of the same class as the replacement property, from a disposition made on the alter of
		- (i) The time the replacement property was acquired by the taxpayer, and
		- (ii) The time the former property was disposed of by the taxpayer
	+ When the replacement property is acquired, the taxpayer is deemed to have disposed of a depreciable property of the same class as the replacement property
	+ The proceeds of disposition and capital cost of that depreciable property is deemed to be an amount equal to the deferred recapture determined under paragraph 13(4)(c)
	+ As such, when calculating the undepreciated capital cost of the class to which the replacement property belongs the amount determined for variable F is increased by the amount of the deferred recapture
		- The effect of this is to reduce undepreciated capital cost of the class to which the replacement property belongs by the amount of the deferred recapture.

### Sample Problem

* Assume that Marci owns a depreciable property which she purchased for $20,000. The property is the only property in its class and Marci has claimed $17,000 as capital cost allowance in previous years. The property is destroyed by fire on November 15, 2019. On December 15, 2019, Marci agrees to compensation of $15, 000 for the property, She uses $10,000 of this amount to purchase a replacement property on January 3, 2020. What are the tax consequences?
	+ **2019 – Without Replacement Property Rule**
		- Undepreciated capital cost (“UCC”) = (A+B) – (E+F):
			* A = Cost of Assets = $20,000 – what Marci paid to acquire the property
			* B = Recapture for prior year = $0
			* E= Depreciation, prior years= $17,000 – the aggregate of the CCA claimed in previous years
			* F = Lesser of PoD and CC f sold assets = $15,000 – the lesser of the $15, 000 proceeds of disposition and the $20,000 capital cost of the property
		- UCC = ($20,000 + $0) – ($17,000 + $15,000) = - $12, 000
			* The aggregate amount of E+F exceed the aggregate amount of A+B by $12, 000. As such, if the replacement rule does not apply, she would eb required to include $12,000 as recapture as income pursuant to subsection 13(1)
		- Recapture = (E+F) – (A+B) = ($17,000 + $15, 000) – ($20,000 + $0) = **$12, 000**
	+ However, since she bought the replacement property within 2 years of the destruction of the property, the replacement rules apply
	+ Therefore, the amount otherwise determined for variable “F” is reduced by the **lesser of:**
		- The amount of recapture that would have been realized by for the application of the replacement property rules – **subparagraph 13(4)(c)(i)**
			* $12, 000 – the amount of recapture that would of been realized but for the application of the replacement property rule
		- The amount used to acquire a replacement property – **subparagraph 13(4)(c)(ii):**
			* **$10,000 -**Variable F is therefore reduced by $10,000
	+ **2019 – With Replacement Property Rule**
		- Undepreciated capital cost (“UCC”) = (A+B) – (E+F):
			* A = Cost of Assets = $20,000 – what Marci paid to acquire the property
			* B = Recapture for prior year = $0
			* E= Depreciation, prior years= $17,000 – the aggregate of the CCA claimed in previous years
			* F = Lesser of PoD and CC of sold assets = $15,000 - $10, 000 = $5, 000
				+ This is the original amount of $15,000 less the$10,00 of deferred recapture determined under 13(4)(c)
		- UCC = ($20,000 + $0) – ($17,000 + $5,000) = - $2, 000
			* The aggregate amount of E+F still exceed the aggregate amount of A+B but by only $2, 000. Marci is therefore required to include $2, 000 as recapture in computing her income pursuant to subsection 13(1)
		- Recapture = (E+F) – (A+B) = ($17,000 + $5, 000) – ($20,000 + $0) = **$2, 000**
	+ **2019 – After Purchase of Replacement Property**
		- Undepreciated capital cost (“UCC”) = (A+B) – (E+F):
			* A = Cost of Assets = $20,000 + $10, 000 = $30,000 – this is the aggregate of the $20,000 paid to acquire the original property and the $10,000 paid to acquire the replacement property
			* B = Recapture for prior year = $2 000 – the recapture realized in 2019
			* E= Depreciation, prior years= $17,000 – the aggregate of the CCA claimed in previous years
			* F = Lesser of PoD and CC of sold assets = $5, 000 + $10, 000 = $15, 000
				+ This is the aggregate of the $5,000 determined in 2019 plus the $10,000 of deferred recapture
		- UCC = ($30,000 + $2, 000) – ($17,000 + $15,000) = - **$0**

### Replacement Property Rules

* **Other Considerations:**
	+ Where the replacement property belongs to the same class as the former property and is acquired in the year of disposition the election in subsection 13(4) is not necessary
	+ If the acquisition of the replacement property occurs after the year of disposition it will be necessary to report the disposition under the general rues and then file an amended return for that year once the replacement property has been acquired
	+ Where an election is made under either subsection 13(4) or subsection 44(!), the taxpayer is deemed to have made the other election in respect of the property – **subsection 44(4)**

# Deductions and Credits

## Deductions vs. Credits

### Deduction

* An amount that is deductible in computing income or taxable income
* In a progressive rate system, a deduction operates to refund tax at the highest marginal rate
* Because a deduction reduces the amount of income that is subject to tax, the value of a deduction increases as the tax rate increases
	+ For example, if the tax rate is 10% a $1, 000 deduction is worth $100 because the deduction reduces income by $1, 000 which means the taxpayer pays $100 less tax ($1, 000 X 10%). If the tax rate is 50% the deduction is worth $500 ($1,000 X 50%)
* Therefore, in a progressive rate system, a taxpayer in a high tax bracket receives a grater benefit from a deduction than a taxpayer in a low tax bracket

### Credit

* An amount that is deducted in computing tax payable
* Dividend tax credit and the foreign tax credit
* Many credits are calculated by multiplying a specified amount by a specified rate of tax (normally the lowest statutory tax rate)
* For example, the credit in paragraph 118(1)(c) for an unmarried individual is determined by the formula AXB where:
	+ A is the “appropriate percentage” for the year, and
	+ B is $10, 320 [**Note:** this amount is indexed for inflation each year under subsection 117.1(!)]
* **Subsection 248(1)**
	+ “**appropriate percentage**”, for a taxation year, means the lowest percentage referred to in s. 117(2) for the taxation year…
		- Subsection 117(2) set out the tax brackets and the rates of tax for individuals. The lowest rate in this subsection is 15%.
* Credits are calculated by applying a credit amount to a specified rate of tax (normally the lowest marginal tax rate)
* The value of a credit does not increase as the tax rate increases
* Therefore, a credit provides the same benefit to high income and low income taxpayers
	+ Ex: Assuming the lowest marginal rate was 15%, a $5, 000 credit would result in a reduction in tax payable of $750 ($5, 000 X 15%)
* Most credits are **non-refundable**, meaning they only reduce tax otherwise payable
	+ E.g. if a taxpayer was entitled to claim a $1,000 credit but only had $600 of tax payable, the credit would reduce the tax payable to $0. In most circumstances, the remaining $400 of credit would never be useable and is lost.
	+ In some circumstances, the useable portion of a non-refundable credit can be carried forward or back and sued tor educe taxes in other taxation years. Examples of these credits include the foreign tax credit for business income (126(2)), the charitable gifts credit (118.1) and the tuition credit in 118.5
* A limited number of credits are **refundable**, meaning the amount of the credit that exceeds the amount of tax otherwise payable is refunded to the taxpayer
	+ For example, if a taxpayer was entitled to claim a $1,000 refundable credit but only owed $600 in tax the credit would reduce the tax owing to $0 and the government would refund or pay the remaining $400 of the credit to the individual
	+ As such, the individual benefits from the full amount of the credit regardless of the amount of tax owing.
* **For example,**
	+ Assume that income tax is levied at a rate of 20% on the first $50,000 of income and 40% on income above $50,000 and that each taxpayer is entitled to deduct in computing his or her taxable income a personal exemption of $10,000. If Joy earns $100,000 er year what is the benefit of the $10,000 personal exemption to her?
		- $4,000 ($10,000 X 40%)
			* Since Joy earns $1,000 per year, her marginal tax rate is 40%. The value of the deduction to her is therefore 40% of $10,000 or $4, 000
	+ If Earl earns $30,000 per year what is the benefit of the $10,000 personal exemption to him?
		- $2, 000 ($10, 000 X 20%)
		- Since Earl earns $30, 000 per year, his marginal tax rate is 20%. The value of the deduction to him is therefore 20% of $10,000 or $2, 000
		- As such, the deduction is worth $4, 000 to Joy but only $2, 000 to Earl. If the goal was to exempt the first $10,000 of income earned by an individual, structuring the exemption as a deduction has not achieved this goal since the effect of the deduction is to exempt the last $10,00 of income from tax
	+ Instead, assume that Joy and Earl are permitted to claim a personal credit determined by the formula A X B where:
		- A is the lowest tax rate (i.e. 20%)
		- And B is $10,000
	+ Personal credit = $10, 000 X 20% = $2, 000
	+ Joy and Earl can both claim a personal credit of $2, 000
		- Since the amount of the credit is determined by the lowest tax rate, this effectively exempts from case the first $10,000 of income earned by each Joy and Earl. The fact that a deduction results in a greater tax subsidy for higher income tax payors was the reason for why the *ITA* was amended in 1988 to convert into tax credits many of the deductions originally included in subdivide (e)

## Deductions

* Unlike a general outlay or expense that is deducted from income from a specific source, the deductions in subdivision (e) are deductible pursuant to paragraph 3(c) in computing the taxpayer’s overall income
* **Paragraph 3(c)**
	+ 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:
		- (c) determine the amount, if any, by which the total determined under paragraph (a) plus the amount determined under paragraph (b) **exceeds the total of the deductions permitted by Subdivision E** in computing the taxpayer’s income for the year (except to the extent that those deductions, if any, have been taken into account in determining the total referred to in paragraph (a)…
* There are numerous deductions contained in (e). Four of the most common that are available to individuals are the deductions for moving expenses, childcare expenses, spousal support, and contributions to a Registered Retirement Savings Plan.

### Moving Expenses – Section 62

* Permits the deduction of moving expenses incurred in respect of an “eligible relocation”
* **“Eligible relocation”** is defined in subsection 248(1):
	+ The relocation enables the taxpayer to carry on business or be employed in Canada or to attend post-secondary education
	+ New home and old home must be in Canada [exception for students, subsection 62(2)]
	+ New home must be at least 40 km closer to new work location than the old home
* **“Moving expense”** is defined in subsection 62(3) to include, among other things, travel costs (including a reasonable amount for meals and lodging), the cost for transporting or storing household effects in connection to the move, selling costs related to the sale of the old residence (i.e. legal fees and real estate commissions), legal fees paid in relation to the purchase of the new residence, and land transfer tax paid on the purchase of the new residence
* Limited to the taxpayer’s income from employment at the new location or amounts received by students at scholarships, fellowships, or bursaries, etc.….
	+ Given that most scholarships, fellowships and bursaries are tax exempt, most students are unable to claim a deduction for moving expenses
	+ Where the individual is an employee, they are not permitted to deduct an amount that ahs been reimbursed by their employer unless the amount of the reimbursement is taxable.
* Can be carried forward if the full amount is not deductible in the year of the move

### Child Care Expenses – Section 63

* Permits a deduction in respect of child-care expenses incurred to enable the taxpayer who resided with the child to carry on business or be employed in Canada or to attend post-secondary education
* Is deductible in respect of each child under 16 years of age at any time in the year
	+ Definition of “**eligible child**” in subsection 63(3)
* Maximum deduction is limited to the lesser of:
	+ Two-thirds of income; and
	+ The sum of:
		- $8,000 in respect of each child under 7 years of age at the end of the year
		- $5, 000 in respect of each child that was under 16 years of age at any time during the year
			* Usually the deduction is only available to the lower income spouse
			* Childcare expenses: expenses incurred allow the aprent to work or study. Activities to develop the child physically and mentally were not eligible
	+ Definition of “**annual childcare expense amount”** in subsection 63(3)
* The deduction is limited to a maximum of 2.3 of the taxpayer’s earned income for the year – **paragraph 63(1)(e)**
* Less restrictive rules apply where the child has a mental or physical infirmity
* Where both the taxpayer and a “**supporting person”** care for the child, childcare expenses must normally be deducted by the person with the lower income
* **“Supporting person”** generally means a parent of the child or the taxpayer’s spouse or common law partner – **subsection 63(3)**

### Support Payments – Paragraph 60(b)

* Permits the deduction of an amount paid for the support of a spouse or common-law partner or former spouse or common law partner
* The amount must be:
	+ Payable or receivable as an allowance on a periodic basis; and
	+ Paid pursuant to a court order or written agreement
	+ “support amount” – **subsection 56.1(4) and subsection 60.1(4)**
* Taxpayer and the person must be living separate and apart when the amount is paid
* Amounts paid as child support are not deductible unless paid pursuant to an agreement entered into before May 1997, which has not been varied or amended
* An amount paid as spousal support is included in the recipient’s income – **paragraph 56(1)(b)**

### Contributions to an RRSP – Paragraph 60(i); Section 146

* Permit a deduction for amounts contributed to a taxpayer’s registered retirement savings plan of an RRSP of the taxpayer’s spouse or common-law partner – **subsection 146(5) and (5.1)**
* Maximum deduction in any year is limited to the RRSP deduction limit, which is generally defined in subsection 146(1) as the amount of any unused contributions from previous years plus the lesser of:
	+ 18% of earned income in the previous year (less pension adjustment)
	+ The RRSP dollar limit [generally equal to the “**money purchase limit”** [defined in subsection 147.1(1) for the preceding year - $27, 230 for 2020
	+ If contributions are made to a taxpayer’s RRSP that exceed the taxpayer’s RRSP deduction limit, a penalty tax of 1% per month is payable on the amount by which such excess contributions exceed $2, 000 – **subsection 204.1(2.1) and 204.2(1.1)**

## Credits

* Credit for married individuals – paragraph 118(1)(a)
	+ Provides a deduction in computing tax payable equal to the tax paid on a minimum threshold amount of income
	+ The credit is therefore justified on the basis that individuals are required to expend a minimal amount each year to cover the necessities of life and the expenditure of such amount reduce the individual ability to pay
* Credit for single individuals – paragraph 118(1)(c)
	+ Provides a deduction in computing tax payable equal to the tax paid on a minimum threshold amount of income
	+ The credit is therefore justified on the basis that individuals are required to expend a minimal amount each year to cover the necessities of life and the expenditure of such amount reduce the individual ability to pay
* Medical expense credit - section 118.2
	+ Justified on the basis that the basic cost of living for those individuals with a severe illness or a mental or physical disability is much higher which negatively impacts their ability to pay
* Disability credit – section 118.3
	+ Justified on the basis that the basic cost of living for those individuals with a severe illness or a mental or physical disability is much higher which negatively impacts their ability to pay
* Charitable gifts credit – section 118.1
	+ Arguably justified as tax expenditures on the basis that they provide a public benefit
* Tuition credit – section 118.5
	+ Arguably justified as tax expenditures on the basis that they provide a public benefit
* EI Premiums and CPP Contributions – section 118.7
* Political contributions – section 127(3) – (4.2)