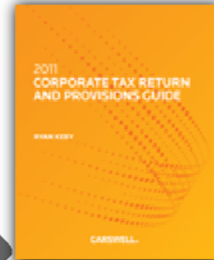
2011 CORPORATE TAX RETURN AND PROVISIONS GUIDE



The 2011 Corporate Tax Return and Provisions Guide (approx. 1,500 pages) is the **first and only comprehensive tax preparation guide available on the market** that covers both the preparation of corporate tax returns and tax provisions for accounting purposes in an integrated fashion. The 15 chapter guide is intended to answer most questions on completing Canadian corporate tax returns and accounting tax provisions. The Guide also discusses other corporate tax compliance requirements and core shareholder taxation issues. Text boxes and quick reference tables are used throughout the guide to highlight key concepts, tips, and traps and extensive references are made to authoritative sources.

As an example of the integrated approach taken in the guide, in Chapter 2, approximately 200 common reconciliation adjustments between book income and taxable income (including all items listed in Schedule 1 of the T2 return) are discussed from a tax return and tax provision perspective. In respect of each reconciliation item, the relevant tax rules and schedules of the tax return are discussed. Additionally, the impact of each adjustment on the corporation's effective tax rate is considered. The allocation of T2 Schedule 1 reconciliation adjustments between permanent and temporary differences is necessary to reconcile the current and deferred tax provisions and to prepare the effective tax rate reconciliation, which assists in revealing any errors in the tax provision calculation.

As tax legislation and tax accounting reporting standards increasingly become more complex, more sophisticated tax data management and reporting tools and resources are needed. The 2011 Corporate Tax Return and Provisions Guide is a comprehensive and invaluable resource designed to assist external and internal tax professionals.

SAMPLE

The guide is available in print and on *Taxnet Pro*; for more information please call 1-866-609-5811 or go to http://www.gettaxnetpro.com or http://www.carswell.com

2011 Corporate Tax Return and Provisions Guide

Chapter 2 – Net Income or Loss for Tax Purposes

Contents

¶2000 Income for Tax Purposes
- ¶2005 Book Income versus Income for Tax Purposes
- ¶2010 "Profit" for Tax Purposes
- ¶2015 International Financial Reporting Standards (IFRS)
- ¶2020 Business Income versus Property Income
- ¶2025 General Limitation on Deduction of Business Expenses
- ¶2030 Expenses Incurred Prior to Incorporation

¶2100 Schedule 1 Reconciliation Adjustments
- ¶2105 Accounting Fees
- ¶2110 Advertising Expenses
- ¶2115 Allowable Business Investment Losses (ABILs)
- ¶2117 Allowance for Doubtful Accounts
- ¶2120 Amortization of Intangible Capital Property
- ¶2125 Appeals
- ¶2130 Appraisal Fees
- ¶2135 Architect Fees
- ¶2137 Automobile Expenses
- ¶2140 Bad debts
- ¶2150 Bank and Collection Charges
- ¶2155 Barter Transactions
- ¶2160 Bonuses and Salaries
- ¶2165 Branch Losses
- ¶2170 Brokers' Charges
- ¶2175 Builders' Second Mortgages
- ¶2180 Business Cessation Costs
- ¶2185 Business Promotion Expenses
- ¶2190 Capital Cost Allowance (CCA)
- ¶2195 Capital Gains (Losses)
- ¶2200 Capital Items Expensed (Current versus Capital Expenses)
- ¶2205 Capital Leases
- ¶2207 Capital Taxes
- ¶2210 Carrying Charges
- ¶2220 Club Dues and Green Fees
- ¶2225 Commodity Futures
- ¶2230 Contingent Liabilities
- ¶2235 Contract Cancellation Payments
- ¶2240. Contractors' Completion Method
- ¶2245. Convention and Training Expenses
- ¶2246. Conversion of Property to (or from) Inventory
- ¶2250 Credit Union Interest Bonus Payments
- ¶2255 Crown Royalties
- ¶2260 Cumulative Eligible Capital Deduction (Tax Amortization)
- ¶2265 Damages

SAMPLE

¶2270 Debt Forgiveness
¶2275 Debt Issues Expenses
¶2278 Deep Discount Debts
¶2280 Deferred and Prepaid Expenses
¶2285 Deferred Profit Sharing Plan (DPSP) Contributions
¶2290 Deferred Tax Expense
¶2295 Depletion
¶2300 Depreciation
¶2305 Development Expenses
¶2310 Directors' Fees
¶2315 Disability-Related Modifications
¶2320 Discounts and Premiums on Debts
¶2325 Dividends
¶2332 Donations and Gifts
¶2335 Eligible Capital Property (Gain on Sale)
¶2340 Employee Profit Sharing Plan (EPSP) Contributions
¶2345 Equity Investments (Book Income or Loss)
¶2347 Exchangeable Debentures
¶2350 Exempt Income
¶2355 Exploration Expenses
¶2360 Farmers and Fishermen
¶2365 Financing Fees
¶2370 Fines and Penalties
¶2375 Flow-Through Share Tax
¶2380 Foreign Accrual Property Income (FAPI)
¶2385 Foreign Affiliate Property Income
¶2390 Foreign Exchange Gains or Losses
¶2395 Foreign Exchange Included in Retained Earnings
¶2400 Foreign Tax Deduction
¶2405 Gain on Disposal of Assets for Book Purposes
¶2410 Government Grants and Subsidies
¶2415 Gifts
¶2420 GST/HST Input Tax Credits
¶2425 Guarantee Fees
¶2430 Hedge Gains and Losses
¶2435 Holdbacks
¶2440 Illegal Payments
¶2445 Income Taxes (Current)
¶2450 Inducement Payments
¶2451 Indexed Debts
¶2452 Instalment Sales Reserves
¶2455 Insurance Proceeds
¶2460 Interest and Penalties on Taxes
¶2465 Interest Expense
¶2475 Interest Income
¶2479 International Banking Centres (IBCs)
¶2480 Inventory
¶2485 Investment Counsel Fees
¶2490 Investment Tax Credits
¶2495 Land Carrying Charges

SAMPLE

¶2500 Landscaping
¶2505 Lease Payments
¶2510 Legal and Accounting Fees
¶2515 Life Insurance Premiums
¶2520 Limited Partnership Losses
¶2525 Loss on Disposal of Assets for Book Purposes
¶2526 Merger and Acquisition Fees
¶2527 Management Fees
¶2528 Mark-to-Market Rules (Financial Institutions)
¶2530 Meals and Entertainment Expenses
¶2535 Mining Taxes
¶2540 Motor Vehicle Expenses
¶2545 Non-Deductible Book Expenses
¶2550 Non-Resident Loans: Imputed Interest Income
¶2555 Non-Taxable Book Income
¶2560 Other Comprehensive Income (IFRS)
¶2565 Partnership Income and Losses
¶2570 Patronage Dividends
¶2575 Pension and Profit Sharing Plan Contributions
¶2580 Personal Services Businesses
¶2585 Political Donations
¶2587 Prescribed Debts
¶2590 Property Taxes
¶2595 Qualifying Environmental Trusts
¶2597 RCA Contributions
¶2600 Recapture Income (CCA or SR&ED Pool)
¶2605 Recovery of Hydrocarbons
¶2610 Registered Pension Plan (RPP) Contributions
¶2615 Related Party Transactions
¶2620 Rent Expense
¶2625 Repairs and Maintenance
¶2630 Reserves
¶2650 Resource Deductions
¶2660 Returnable Containers
¶2663 Reward Programs
¶2665 Sales Tax Assessments
¶2670 Shareholder Benefits
¶2675 Share Issue Expenses
¶2680 Site Investigation Costs
¶2685 Soft Costs on Construction and Renovation of a Building
¶2690 SR&ED Expenditures
¶2695 Stock Option Expenses
¶2699 Shares or Options Issued in Exchange for Property or Services
¶2700 Terminal Losses (Depreciable Property)
¶2705 Theft, Defalcation, or Embezzlement
¶2710 Thin Capitalization Interest Deduction Limitation
¶2715 Unearned Revenue (Undelivered Goods and Services)
¶2720 Unpaid Amounts (General)
¶2721 Unpaid Remuneration
¶2723 Upstream Foreign Affiliate Loans

SAMPLE

¶2725 Unvouchered Expenses
¶2730 Utilities Service Connections
¶2735 Warranties
¶2740 Write-Down of Capital Properties (Book)
¶2745 Voluntary Payments and Miscellaneous Receipts

¶2800 Year-End Planning Considerations

Income for Tax Purposes

¶2005 Book Income versus Income for Tax Purposes

Normally, because of the many differences between taxable income (based on the ITA) and book income (based on GAAP) computation rules, the net income (loss) reported on a corporation's financial statements will not be the same as a corporation's net income (loss) for tax purposes. Schedule 1: *Net Income (Loss) for Income Tax Purposes*, of Form T2 is used to reconcile the net income (loss) reported on a corporation's financial statements with the corporation's net income (loss) for tax purposes. The starting point of this reconciliation is the corporation's financial statements net income or loss after income tax and extraordinary items (Sch. 1: Line A). In most tax preparation programs, this Line will automatically be populated after the GIFI Schedules (see ¶1500) are completed.

To compute net income for tax purposes, add the taxable items and the non-allowable expenses listed on Lines 101–199 of Schedule 1 and subtract the non-taxable items and eligible expenses listed on Lines 401–499 of Schedule 1. Additions and deductions from book income required to compute income for tax purposes identified on Lines 101–128 and 401–417 of Schedule 1 are the most common additions and subtractions required to compute net income for tax purposes. However, several other adjustments may apply. Use Lines 290–294, "Other additions," on page 2 of Schedule 1 to add other amounts to income for tax purposes and use Lines 390–394, "Other deductions," on Page 3 of Schedule 1 to deduct other amounts from income for tax purposes.

Each of the separate line-items on Schedule 1, in addition to many other common adjustments required to compute income for tax purposes, are discussed individually in this Chapter. In respect of each reconciliation adjustment, the treatment of the adjustment for tax provision purposes is also mentioned; tax provisions are discussed in detail in Chapter 15. A permanent differences quick reference table is available under ¶15110 and a timing differences quick reference table is available under ¶15220. Permanent differences are Schedule 1 adjustments which do not reverse. Timing differences are Schedule 1 adjustments that reverse and give rise to taxable or deductible temporary differences. Only permanent differences impact the effective tax rate of a corporation (see ¶15415). The effective tax rate of a corporation for a period is equal to total income tax expense (reported on the income statement) divided by net income for book purposes before taxes.

It should be noted that the following T2 Schedules may also be required to complete Schedule 1:

- Schedule 6: *Summary of Dispositions of Capital Property* (see Ch. 4);
- Schedule 8: *Capital Cost Allowance (CCA)* (see Ch. 5);
- Schedule 10: *Cumulative Eligible Capital Deduction* (see Ch. 5);
- Schedule 12: *Resource-Related Deductions* (see Ch. 5);
- Schedule 13: *Continuity of Reserves* (see ¶2630);
- Schedule 16: *Patronage Dividend Deduction* (see ¶2570);
- Schedule 17: *Credit Union Deductions* (see ¶2250); and

SAMPLE

- Form T661: *Scientific Research and Experimental Development (SR&ED) Expenditures Claim* (see Ch. 9).

¶2010 "Profit" for Tax Purposes

A corporation resident in Canada (see ¶1010) is taxed on its income from all sources, both within and outside Canada. The taxation of non-resident corporations is discussed in Chapter 7.

ITA 9 provides that income for a taxation year from a business is the "profit" therefrom for the year. The determination of profit for tax purposes is a legal matter. Profit is generally determined by deducting from gross revenue the costs of carrying on the business established in accordance with provisions of the ITA, or, if the ITA is silent, in accordance with well-accepted business principles, including GAAP. If there is a conflict between GAAP and any specific provision of the ITA, the specific provision of the ITA takes precedence. Also, any Tax Court decision that interprets a provision of the ITA takes precedence over GAAP.

From a practical perspective, the CRA's general position is that a corporation should apply GAAP consistently with the provisions of the ITA in determining profit for tax purposes unless a provision of the ITA or relevant jurisprudence permits or requires a departure from GAAP.

In the landmark decision of *Canderel Limited v The Queen*, [1998] 2 C.T.C. 35, at pages 54 and 55 of the judgment, the Supreme Court of Canada set out the following principles for calculating profit under the ITA:

1) The determination of profit is a question of law;

2) Profit is determined by setting against the revenues from the business for that year the expenses incurred in earning said income;

3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year;

4) The taxpayer is free to adopt any method which is not inconsistent with the provisions of the *Income Tax Act*, established case law principles or "rules of law" and well-accepted business principles;

5) Well-accepted business principles, which include but are not limited to the formal codification found in GAAP, are not rules of law but interpretative aids on a case-by-case basis, depending on the facts of the taxpayer's financial situation; and

6) On reassessment, once the taxpayer has shown that he has provided an accurate picture of income for the year, which is consistent with the ITA, the case law, and well-accepted business principles, the onus shifts to the Minister to show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture.

In summary, where the ITA is silent (i.e., where the treatment of an amount is not specially dictated by the provisions of the ITA or related jurisprudence), a corporation may have several acceptable options for computing profit for tax purposes. GAAP, including IFRS, is only one component of acceptable business practices that may be applicable in determining the acceptable treatment of an amount for tax purposes.

SAMPLE

For the most part, consistent with GAAP, the provisions of the ITA require that profit for tax purposes be computed using the accrual method. However, a corporation is generally recognized by the courts as having certain freedom in applying accounting principles. For example, even in matters in which the ITA is silent, the income computation practices of a corporation for tax purposes may differ from how the corporation computes income under GAAP.

In the significant decision of *Publishers Guild of Canada Ltd v MNR*, [1957] C.T.C. 1 (Ex. Ct.), the Court stated (page 17):

> I cannot express too strongly the opinion of this Court that, in the absence of statutory provision to the contrary, the validity of any particular system of accounting does not depend on whether the Department of National Revenue permits or refuses its use. What the Court is concerned with is the ascertainment of the taxpayer's income tax liability. Thus the prime consideration, where there is a dispute about a system of accounting, is, in the first place, whether it is appropriate to the business to which it is applied and tells the truth about the taxpayer's income position and, if that condition is satisfied, whether there is any prohibition in the governing income tax law against its use. If the law does not prohibit the use of a particular system of accounting then the opinion of accountancy experts that it is an accepted system and is appropriate to the taxpayer's business and most nearly accurately reflects his income position should prevail with the Court if the reasons for the opinion commend themselves to it.

The flexibility suggested by the foregoing was illustrated in *Tower Investment Inc*, [1972] C.T.C. 182 (FCTD), in which the owner of a new apartment project was able to defer and deduct initial advertising expenses over a three-year period. Also, in *AE LePage Ltd*, [1969] Tax A.B.C. 763, organizational expenses incurred over a 3 to 4 year period were allowed to be deducted in the final year in which the project was abandoned. It should also be highlighted that merely because a corporation amortizes an otherwise deductible expense for GAAP purposes does not mean that for tax purposes deduction of the full amount cannot be made in the year paid (see for example *Canderel* and *The Queen v Oxford Shopping Centres Ltd*, [1981] C.T.C. 128 (FCA); aff'g [1980] C.T.C. 7 (FCTD)).

Where accounting income and income for tax purposes differ because of a departure from GAAP in computing income for tax purposes (i.e., where another acceptable method of computing income is followed), a Schedule 1 adjustment will be required. For example, the tax treatment of hedge gains and losses may differ for tax and book purposes (¶2430). Also, because a corporation amortizes an otherwise deductible expense for GAAP purposes does not mean that for tax purposes deduction of the full amount cannot be made in the year the expenditure is paid (see ¶2110 and ¶2505).

From a practical perspective, where a provision of the ITA does not have the effect of altering the GAAP concept of "profit", the CRA will normally accept a computation of "profit" in the ordinary accounting sense. The CRA's general position is that a corporation should apply GAAP consistently with the provisions of the ITA in determining profit unless a provision of the Act permits a departure from GAAP or well-accepted business principles (VDs 2008-0288691E5, 2003-0051241E5).

The CRA interprets the meaning of obtaining "an accurate picture of a taxpayer's profit" in VDs 2012-0435081E5 (legal and accounting fees relating to a business combination), 2010-0367611I7 (cross-currency swap), 2009-0345921I7 (derivatives), 2009-0348961I7 (foreign exchange gains and losses), 2008-0288691E5 (an amount offset against the cost of a property under GAAP may have to be included in computing income in the year received for tax purposes), 2007-0257121I7 (whether cushion gas is inventory), 2007-0233551I7 (whether fees incurred with respect to a proposed conversion to an income trust are deductible), 2003-0036515 (method of reporting income by a utility), 2003-0023137 (penalty or

bonus payment made on the early redemption of an outstanding debt obligation), 2003-0054061I7 (timing of recognition of management fee income), 2002-0160807 (whether foreign currency denominated accounts receivable should be translated at the year-end exchange rate where the receivables are hedged by forward currency contracts), 2002-0141627 (treatment of land development costs), 2001-0072367 (whether earned but unpaid royalties should be included in income for tax purposes), and 2000-0056045 (treatment of tenant inducements). In VD 2008-0289021E5, the CRA states an adjustment to the value of a debt for accounting purposes due to a fluctuation in interest rates does not represent a gain or loss for income tax purposes.

Under the ITA, the accrual method is generally required to be followed by virtue of ITA 12(1)(a) and (b), which require the inclusion in income for tax purposes not only of all amounts received in the year in the course of business but also of all amounts receivable for work done or goods sold in the year. ITA 20(1)(1), (m) and (n) (see ¶2630) provide for the deduction of reserves for doubtful debts, returnable containers, unearned income, etc. required to be included in income under ITA 12(1)(a) and (b).

"Profit" from a business, as determined under ITA 9, is the starting point for computing taxable income. ITA 12(1)(a) and (b) apply after profit is computed under ITA 9. In many instances, ITA 9 and 12 may overlap. In this respect, a reserve may be claimable under ITA 20 when an amount is included in income under either ITA 9 or 12(1)(a); see *Ellis Vision Inc. v. R.*, [2004] 2 C.T.C. 2208 (TCC) and under ¶2643.

See also ¶2450 (inducement payments).

ITA 2(3), 9(1), 12(1)(a), (b), 20(1)(1), (m) and (n), ITTN-41, ITTN-38, ITTN-30, ITTN-16, *Oxford Shopping Centres Ltd*, [1981] C.T.C. 128 (FCA); aff'g [1980] C.T.C. 7 (FCTD), *Tower Investment Inc*, [1972] C.T.C. 182 (FCTD), *The Queen v Metropolitan Properties Co Limited*, [1985] 1 C.T.C. 169 (FCTD); rev'g [1982] C.T.C. 2254 (TRB), VDs 2008-0288691E5, 2003-0051241E5, 2006-0215491C6, 2006-0178661E5, 2009-0330391C6, 2004-0061651E5

¶2011 Losses from a Business

A loss from a business is computed by applying the provisions of the ITA regarding the computation of income from a business. A business loss (or non-capital loss) for tax purposes which cannot be deducted in full in the taxation year may be carried over to other years within specified limits and applied to reduce the taxable income of other years; see ¶3200.

ITA 9(2), 111

¶2015 International Financial Reporting Standards (IFRS)

The adoption of IFRS in Canada is discussed in Chapter 15. A corporation's convergence to IFRS may affect the computation of the corporation's profit in accordance with ITA 9. In particular, where the ITA is otherwise silence and income for tax purposes is computed in accordance with GAAP, a change in GAAP will affect income for tax purposes. Regarding the conversion from Canadian GAAP to IFRS, in ITTN-41 the CRA states:

> Given the extent of the statutory rules that override accounting treatment, we expect that taxable income will not be significantly affected by the change; however, the computation of taxable income could be much more complex. We expect to issue an Income Tax Technical News during 2009 outlining our views on the impact of the conversion to IFRS [see ITTN-42]…
>
> The ITA does not specify that financial statements must be prepared following any particular type of accounting principle or standard… It is our view that financial statements based on IFRS would be an acceptable starting point to determine income for tax purposes. In addition, where IFRS are used by a

SAMPLE

> particular entity, it is our position that references to GAAP in the ITA can be read as references to IFRS, and all references to GAAP in any CRA publication can also be read as references to IFRS for those entities that report under IFRS.

It should be noted that the CRA has stated that in appropriate situations, financial statements prepared in accordance with US GAAP would also be an acceptable starting point to determine income for tax purposes (for example, in the case of a corporation that is required to prepare U.S. GAAP financial statements and to file these with the securities regulators in the United States where the corporation is permitted to file US GAAP financial statements for Canadian securities purposes; see VD 2011-0403641E5).

Regardless of the GAAP used as a starting point for computing income for tax purposes, the computation is ultimately a question of law which cannot be resolved solely by reference to GAAP.

Because the determination of income for tax purposes is not necessarily dependent upon the accounting standards adopted by a corporation, in those instances in which the convergence to IFRS has adverse tax consequences, a corporation may choose to compute its income for tax purposes in accordance with a method other than IFRS (there is no rule that financial statements used for financial reporting purposes are also required to be used for tax purposes). However, such a decision would need to be cost-effective and is unlikely to be taken in most situations. Costs to consider would include the cost of keeping separate records for IFRS and tax purposes. Also, if necessary, it would need to be illustrated to the CRA (or the tax courts) that the non-IFRS method of computing income (for example, the method under pre-changeover Canadian GAAP) presents a true picture of profit and is in accordance with well-established business principles.

For many corporations, as noted by the CRA in ITTN-41, the conversion to IFRS will not have a material impact on income for tax purposes. With the possible exception of changes in book income resulting from differences between IFRS and pre-changeover Canadian GAAP revenue recognition and inventory valuation standards, any changes to book income as a result of the adoption of IFRS will generally be adjusted on Schedule 1 and will not have a net effect on the computation of income for tax purposes. There may, however, be new or larger Schedule 1 adjustments that arise as a result of the adoption of IFRS. For example, differences between IFRS and pre-changeover Canadian GAAP may give rise to new or larger Schedule 1 adjustments with respect to: the treatment of business acquisition costs, including contingent consideration (certain additional expenses deductible under IFRS may be required to be capitalized to the cost of shares for tax purposes); the valuation of property plant and equipment (fair value reporting, which is not allowable for tax purposes, is available under IFRS in certain circumstances); and items required to be capitalized to property plant and equipment (generally, IFRS requires additional amounts that may be deductible for tax purposes, such as interest, to be capitalized to the cost of fixed assets as compared to pre-changeover Canadian GAAP standards).

A corporation's adoption of IFRS may also affect thin capitalization computations (which are in part based on "retained earnings"; see ¶2710) and computations of a corporation's taxable capital employed in Canada (certain rules, such as the small business limit reduction and the SR&ED expenditure limit, depend in part on a corporation's taxable capital; see ¶1400). In this respect, in VD 2010-0390601E5, the CRA states if a corporation decides to report its assets under fair value for its 2010 year under IFRS and restates its 2009 financial statements for the purpose of providing comparative results, the corporation would not be required to file an amended T2 return for the 2009 taxation year. Thus, an increase in retained earnings reported in the restated 2009 financial statements would not impact the small business deduction calculation or the corporations Ontario capital tax liability for the 2009 taxation year. The CRA does not consider such a restatement of 2009 retained earnings to be an error in respect of the originally filed 2009 T2 return.

Certain changes have been made to the T2 return to accommodate IFRS. On Line 270 of Form T2, the CRA requires a corporation to identify whether it has adopted IFRS. Also, Schedule 1 was amended to add Lines related to amounts reported as "other comprehensive income". Certain Lines were also added to the GIFI Forms (for example, Line 3580 was added to the equity section to report "accumulated other comprehensive income" and Line 9998 was added to the income statement to report "total other comprehensive income").

ITTN-41, ITTN-42, VDs 2011-0403641E5, 2006-0178661E5, 2009-0330391C6, 2009-0316371C6, cra.gc.ca/tx/bsnss/tpcs/frs/menu-eng.html, cica.ca/ifrs, acsbcanada.org/strategic-planning/publicly-accountable/index.aspx

Transitional Adjustments

The impact of various accounting policy changes upon the adoption of IFRS by a corporation may require adjustments to the opening balance sheet. Appropriate Schedule 1 adjustments should be made when necessary to ensure that amounts are not deducted or included in income for tax purposes more than once as a result of the conversion to IFRS.

In certain jurisdictions that have converted from a local GAAP to IFRS, the relevant tax authority has allowed for the phasing in of IFRS adjustments which had an immediate impact on income for tax purposes. However, based on VD 2011-0399761C6:

> It is the CRA's general view that in circumstances where a change in accounting policy is warranted, the necessary adjustments to income resulting from the change in accounting policy should be made to the taxpayer's income for the first year in which the new accounting method is applied pursuant to subsection 9(1). Where accounting adjustments as a result of conversion from GAAP to IFRS are made to retained earnings, such adjustments should, in our view, be considered in determining taxable income in the first year in which the taxpayer uses IFRS.
>
> As stated in Income Tax Technical News No. 42, first time adopters of IFRS may need to make adjustments on Schedule 1 of a T2 return to ensure that all revenues and expenses are fully reported, and reported only once. In the situation described, the CRA would expect that the difference between the actuarial liability balance reported for December 31, 2010 under Canadian GAAP and the amount restated as an investment contract liability balance at January 1, 2011 under IFRS, that is recorded as an adjustment to retained earnings, be included or deducted in computing income in the 2011 year.

VD 2011-0399761C6

SAMPLE

¶2020 Business Income versus Property Income

It is necessary to distinguish income from a business and income from property for certain purposes. Subdivision b of the ITA covers both business income and income from property.

A "business" is defined in the ITA as including "a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(c), section 54.2 and paragraph 110.6(14)(f), an adventure or concern in the nature of trade . . . ". The expansive definition of a business contained in the ITA is not exhaustive. The courts have generally found that a "business" includes any endeavour that occupies time, labour and attention with a view to profit.

Income from property is generally income yielded from holding property. Common forms of income from property include interest, dividends, rents and royalties. "Property" is defined in the ITA as "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". In *Fasken Estate*, [1948] C.T.C. 265 (Exch.), "property" was held to include rights under a trust.

Income from property does not included capital gains and losses arising from the disposition of property (see Ch. 4). This rule is important, for example, in applying interest deductibility rules (see ¶2465). The treatment of capital gains is governed by subdivision c of the ITA.

The question of whether income was derived from a business or from a property often arises in the context of real estate. Depending on the size of the operation and the extent of additional services provided to the occupants by the owner or landlord, rental income derived from renting real estate may be considered either income from property or income from a business. The distinction is important as CCA on rental property and leasing property is limited to the amount of net income derived therefrom (see ¶5165). However, the restriction does not apply to a corporation whose principal business is renting or leasing property.

It is worth mentioning that from the perspective of personal taxpayers, under the income attribution rules, income from any property transferred by an individual to a spouse, common-law partner or child under the age of 18 years is attributed to the transferor for income tax purposes; however, income from a business is not attributed to the transferor.

ITA 9, 74.1, 248(1)"business", "property", ITR 1100(11) and (15), *Dansereau*, [2002] 1 C.T.C. 19 (FCA), *Stewart, [2002] 3 C.T.C. 439 (SCC)*, CRA Guide T4036, IT-73R6, IT-459

¶2025 General Limitation in Respect of Deductible Business Expenses

In order to be deductible from income for tax purposes, an expense is required to be made for the purpose of gaining or producing income by virtue of ITA 18(1)(a). Income need not necessarily result from the specific expense in order for it to be deductible.

ITA 18(1)(a) was considered in *BC Electric Co Ltd*, [1958] C.T.C. 21 (SCC), in which it was observed that virtually all expenditures of a business enterprise are made for the purpose of earning income. The Court stated: "[s]ince the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of [ITA 18(1)(a)] whether it be classified as an income expense or as a capital outlay".

The significance of paragraph 18(1)(a) was explained in *Royal Trust Company*, [1957] C.T.C. 32 (Exch.) as follows (paras. 27 and 33):

> Thus, it may be stated categorically that in a case under the *Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of [paragraph 18(1)(a)] of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of [paragraph 18(1)(a)] and, therefore, within its prohibition…
>
> The essential limitation in the exception expressed in [paragraph 18(1)(a)] is that the outlay or expense should have been made by the taxpayer "for the purpose" of gaining or producing income "from the business". It is the purpose of the outlay or expense that is emphasized, but the purpose must be that of gaining or producing income "from the business" in which the taxpayer is engaged. If these conditions are met the fact that there may be no resulting income does not prevent the

SAMPLE

> deductibility of the amount of the outlay or expense. Thus, in a case under the *Income Tax Act*, if an outlay or expense is made or incurred by a taxpayer in accordance with the principles of commercial trading or accepted business practice and it is made or incurred for the purpose of gaining or producing income from his business, its amount is deductible for income tax purposes.

The mere fact that a shareholder may have a personal interest in the subject matter of an activity in which the corporation of which he or she is a shareholder incurs expenditures does not preclude the deductibility of such expenditures. The essential test is whether the expenditures are made for the purpose of gaining or producing income from the business, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances.

The question of when an expense is actually incurred for purposes of ITA 18(1)(a) was considered in *Burnco Industries Ltd et al*, [1984] C.T.C. 337 (FCA); rev'g [1981] C.T.C. 518 (FCTD). In *Burnco*, the Court denied the deduction a taxpayer claimed in respect of the estimated cost of backfilling its mining excavations on the basis that an obligation to do something (in this case, the obligation to backfill which was required by the license agreement for extracting the gravel) which may in future entail the necessity of paying money is not an expense for purposes of ITA 18(1)(a). See also under ¶2230 (Contingent Liabilities).

As a general rule, costs incurred as a direct result of business operations are considered to be a cost of the business. For example, in *Imperial Oil Limited*, [1947] C.T.C. 353 (Exch), damages paid as a result of a collision between Imperial's oil tanker and another vessel were found to be a deductible operating cost. At paragraph 16, the Court stated:

> It is no answer to say that an item of expenditure is not deductible on the ground that it was not made primarily to earn the income but primarily to satisfy a legal liability. This was the kind of argument that was expressly rejected by the High Court of Australia in the *Herald & Weekly Times, Ltd* case (1932), 48 CLR 113 and it should be rejected here. In a sense, all disbursements are made primarily to satisfy legal liabilities. The fact that a legal liability was being satisfied has, by itself, no bearing on the matter. It is necessary to look behind the payment and enquire whether the liability which made it necessary — and it makes no difference whether such liability was contractual or delictual — was incurred as part of the operation by which the taxpayer earned his income. Where income is earned from certain operations, as it was by the appellant from its marine operations, all the expenses wholly, exclusively and necessarily incidental to such operations must be deducted as the total cost thereof in order that the amount of the profits or gains from such operations that are to be assessed may be computed. Such cost includes not only all the ordinary operations costs but also all moneys paid in discharge of the liabilities normally incurred in the operations. When the nature of the operations is such that the risk of negligence on the part of the taxpayer's servants in the course of their duties or employment is really incidental to such operations, as was the fact in the present case, with its consequential liability to pay damages and costs, then the amount of such damages and costs is properly included as one of the items of the total cost of such operations. It may, therefore, properly be described as a disbursement or expense that is wholly, exclusively and necessarily laid out as part of the process of earning the income from such operations.

Imperial Oil Ltd. was distinguished by the Supreme Court of Canada in *65302 British Columbia Ltd.* [2000] 1 C.T.C. 57 (SCC) (discussed under ¶2265) in which the Court found the scope of deductible business expenses was broader under ITA 18(1)(a) than in the *Income War Tax Act*. Given the differences in wording, the Court found that it was not necessary that “expenses need be incidental...” in the sense that they were unavoidable, in order to be deductible.

SAMPLE

With respect to site reclamation expenses, in VD 9413377, the CRA states "[i]n summary, expenditures made voluntarily or in compliance with a legal requirement, to clean-up or reclaim a site where the condition that is corrected or modified is a direct result of a business operation will be considered to be business expenses".

Consolidated Textiles Limited, [1947] C.T.C. 63, 3 D.T.C. 958 (Exch) generally established that in order for an expenditure to be considered to have been incurred for the purpose of earning income from business, it is not required that a direct source of income be traced to the expenditure.

Whereas ITA 18(1)(a) limits the right to deduct expenditures to those made or incurred for the purpose of earning income from a business or property, ITA 18(1)(b) provides that no deduction may be made for "capital" expenditures or losses unless they are expressly permitted under other provisions of Part I of the ITA. The most common examples of permissive deductions of otherwise capital expenses include CCA (i.e. depreciation for tax purposes), which is deductible under ITA 20(1)(a) (see Chapter 5), and interest, which is deductible under ITA 20(1)(c) (see ¶2465). The distinction between capital and revenue expenditures is not easy to define and the nature of the business may be a determining factor; see under ¶2200 regarding factors to consider in determining whether an expense is current in nature or capital in nature. The latter question can be complex and is the subject of vast jurisprudence.

All expenses which may be deducted from income for tax purposes are also subject to a test of reasonableness by virtue of ITA 67, which provides: "[i]n computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances". ITA 67 is essentially an anti-avoidance rule that seeks to curb the contrived reduction of income through the deduction of inordinate amounts of expenses (of an otherwise deductible nature) that are wholly under the control of the corporation. As discussed under ¶2527, the provision could apply, for example, to deny a deduction in respect of unreasonable management fees paid between related corporations (such expenses may also be denied under ITA 18(1)(a) if they are not incurred for the purpose of earning income; see for example *Entreprises Réjean Goyette Inc.*, 2009 CarswellNat 3096 (TCC)). ITA 67 could also be applied to restrict a deduction in respect of salaries and wages paid to family members in the context of an owner-managed business; see below under ¶2160 and ¶8150.

Generally speaking, in the context of arm's length transactions, in the past the CRA has been reluctant to invoke ITA 67. As a general rule, the Courts have found that in assessing the reasonableness of particular expenses, it is not the place of the Courts or the CRA to second-guess the business acumen of a taxpayer whose commercial venture may turn out to be less profitable than anticipated.

ITA 18(1)(a), (b), 67, VDs 2010-0373441C6, 2011-0393551E5, 2007-0246871R3, 2006-0181651I7, *Royal Trust Company*, [1957] C.T.C. 32 (Ex. Ct.), *Symes*, 1993 CarswellNat 1178 (SCC), *Keeping*, [2001] 3 C.T.C. 120 (FCA), IT-487: *General Limitation on Deduction of Outlays or Expenses*, ITTN-22, ITTN-30, Michael Flatters, "The Distinction Between Income and Capital in the Income Tax Act," *2005 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2005), 16:1-15, David Spiro et al, "Updating the Trilogy: the Courts Confirm a More Practical Approach to Paragraph 18(1)(b)", XII(1) Corporate Finance (Federated Press) 1274-76 (2005)

¶2030 Expenses Incurred Prior to Incorporation

Questions may arise concerning the effective date of commencement of a business by a newly incorporated company. Legally, a corporation cannot have income before the date of its incorporation. The CRA has issued IT-364: *Commencement of Business Operations*, to assist in the determination of when a business commences for tax purposes. The CRA deals with the situation where the commencement or purchase of a business and related transactions occur before the actual date of incorporation in IT-454: *Business Transactions Prior to Incorporation*, and VD 2005-0159391E5.

SAMPLE

The CRA will normally accept the accounting for pre-incorporation transactions by a "newly" formed corporation if the following conditions are met: a) the facts clearly indicate that it is the intention of those persons who authorize the transactions that the business will be carried on by a corporation; b) the period of time between the commencement or purchase date and the incorporation date is relatively short or, if not, the delay is not due to any action taken or not taken by the parties involved; c) there is no dispute between the persons authorizing the transactions and the newly formed corporation as to who will account for the transactions; d) the effect on the combined tax liabilities of the parties involved is negligible; and e) the corporation adopts any written contract made it its name or on its behalf before it came into existence in respect of the pre-incorporation transactions it is accounting for.

When a corporation is formed for the purpose of taking over an existing business, the profits earned prior to the actual date of incorporation belong to and are taxable in the hands of the person formerly carrying on the business, regardless of any understanding to the contrary that may have been reached by the parties.

Within 24 months of obtaining its listing on the TSX Venture Exchange (Tier 2), a Capital Pool Company (CPC) (discussed under ¶1210) is required to identify an appropriate business as its "qualifying transaction" and have entered into an agreement in principle to acquire the business (normally through a reverse takeover). The TSX Venture Exchange Policy 2.4 states:

> The only business permitted to be undertaken by a CPC is the identification and evaluation of assets or businesses with a view to completing a Qualifying Transaction. Until the completion of the Qualifying Transaction, a CPC must not carry on any business other than the identification and evaluation of assets or businesses with a view to a potential Qualifying Transaction.

When asked whether general and administrative expenses incurred by a CPC are deductible before the corporation has identified its "qualifying transaction", the CRA did not provide a definitive response, stating:

> Considering the nature of the business activity of a CPC in relation to the general views of CRA from IT-364 and the observations made in jurisprudence, noted above, in our view, during phase 1 of its operations, for tax purposes, a CPC may be considered to have commenced its operations and may be eligible to deduct its general and administrative expenses incurred during that phase. Whether such expenses are capital or current in nature is a question of fact.

IT-454, IT-364, VD 2005-0159391E5

¶2100 Net Income for Tax Purposes (Sch. 1)

The basic principles involved in determining the deductibility of an outlay or expense have been outlined above. In this section, in alphabetical order, the tax treatment of various items of income and expenses are listed and described.

On Schedule 1, do not deduct charitable donations, taxable dividends, or carry-over net capital losses, non-capital losses, farm losses, or restricted farm losses. A corporation is required to deduct these items from net income for income tax purposes to arrive at "taxable income"; see Chapter 3.

¶2105 Accounting Fees

See under ¶2510 (Legal and Accounting Fees).

SAMPLE

¶2110 Advertising Expenses (Sch. 1: Lines 226, 311, 312)

Subject to the special rules outlined below regarding foreign advertising expenses, most advertising expenses are deductible in the year incurred for tax purposes provided they are reasonable. In the unusual case in which advertising expenses are unreasonable and prohibited from deduction by virtue of the general expense limitation provision in ITA 67 (see ¶2025), the unreasonable portion of the expenses should be added to income for tax purposes on Line 226 of Schedule 1.

As an exception to the current deduction of advertising expenses, if substantial advertising expenses are deferred and amortized for book purposes, for tax purposes, a deduction can normally be claimed either in the year the expense was incurred (in which case a Schedule 1 adjustment would be required; see Sch. 1: Line 409) or the book treatment of the expense could be followed based on the argument that such treatment reflects a more accurate picture of profit (in which case a Schedule 1 adjustment would not be required). In *Tower Investment Ltd*, [1969] Tax A.B.C. 769, the Court allowed the appellant to spread a $153,300 advertising expenditure over a three-year period. In most cases, a corporation will prefer an immediate deduction for tax purposes even if advertising costs have been deferred for book purposes. In such a case, amortization of advertising expenses for book purposes should be added back to income for tax purposes on Schedule 1 (see ¶2280).

In its Audit Manual (available on *Taxnet Pro*), the CRA states advertising or sales expense accounts "are often used as a "catch all" expense account" (para. 13.9.22). CRA auditors are advised to review material items charged to advertising and sales accounts to ensure to assess whether any entertainment expenses (see ¶2530), donations (see ¶3005–¶3025), commissions (see ¶1825: Source Deductions), gratuities or "non-accountable allowances" (see ¶2025: General Business Deduction Limitation) were included in advertising or sales expenses accounts.

ITA 9(1), 18(1)(a), 67, *Tower Investment Ltd*, [1969] Tax A.B.C. 769, *Morley v Lawford and Co*, 14 TC 229, *Riedle Brewery Limited*, [1938-39] C.T.C. 304, IT-417R2 (para. 4)

¶2111 Foreign Advertising Expenses (Sch. 1: Line 226)

Most foreign advertising expenses are deductible. However, as a special rule, expenses for advertising directed primarily at the Canadian market in foreign radio and television broadcasts or in non-Canadian newspapers are not deductible for tax purposes. Also, 50% of advertising expenses in periodicals with less than 80% original Canadian content are not deductible for tax purposes. Non-deductible foreign advertising expenses deducted in computing book income should be added to income for tax purposes on Line 226 of Schedule 1.

In its Audit Manual (available on *Taxnet Pro*), the CRA notes (at 13.9.22):

> In many situations the U.S. parent corporation handles all sales originating in the U.S. market while a Canadian subsidiary handles sales originating in the Canadian market. The products sold are essentially identical. Advertising costs are incurred by the U.S. corporation from advertisements placed in the U.S. publications that are sold in both Canada and the United States. The Canadian subsidiary reimburses the parent corporation for costs relating to the publications sold in Canada. These charges are generally disallowed under the provisions of section 19 of the ITA. The same principle applies to advertising on U.S. television networks and radio stations by virtue of section 19.1 of the ITA. These provisions do not apply in situations where the subsidiary's primary market is in the U.S. as the advertising is then directed at the U.S. market.

SAMPLE

Advertising is directed at the Canadian market if it is designed to encourage Canadian readers, viewers and listeners to patronize a specific source of product or service available in Canada.

The advertising costs are deductible where a Canadian taxpayer/registrant advertises for an export market in a foreign publication with no circulation in Canada and the advertising is directed primarily to markets outside Canada provided the costs were incurred to gain or produce income and are reasonable in the circumstances. Examples of costs considered deductible are:

- Advertisements in a travel magazine directed at American readers with circulation in both Canada and the U.S. by a Canadian company operating a hotel chain in Canada.
- Advertising costs by a Canadian company operating a fly-in fishing or hunting lodge in Canada in U.S. sporting magazines with some circulation in Canada. Over 80% of the customers of the lodge are U.S. residents and advertisements are directed primarily to a market outside Canada.
- Advertisements on U.S. television stations with viewing audiences in Canada by a Canadian company operating a major tourist attraction in Canada. Where the main purpose of the advertisements is directed at encouraging American tourists to patronize the Canadian establishment while visiting the geographic area, the advertisements are considered directed at the U.S. market. A significant number of the visitors to the attraction should be from the U.S. Canadian advertising media is used to reach potential Canadian customers. The advertising aimed at the American public is to include material indicating that the advertising is aimed primarily at the American tourist visiting Canada.

Compliance tests carried out with respect to sections 19 and 19.1 of the ITA have indicated that:

- Non-allowable costs are frequently added back on the T2S(1) schedule of the subsidiary or affiliated Canadian corporation.
- Canadian companies are usually responsible for their own advertising in Canada. Where advertisements are placed by parent companies in U.S. periodicals with a Canadian circulation there is frequently no charge to the Canadian subsidiary either as an advertising expense or management fee. In some cases where Canadian companies placed advertising in U.S. or other foreign periodicals they were reimbursed for the costs by the parent company whose product they were marketing.

When verifying the possibility of non-compliance with respect to advertising costs, auditors should look beyond the taxpayer/registrant's advertising agency billings or invoices to determine the nature of the services. It may not be obvious that U.S. advertising is involved and the auditor should determine exactly what advertising was placed by the agency on behalf of the Canadian client. A copy of the advertisement placed is often attached to the purchase invoice. Where the advertising is for radio or television, a copy of the script is usually included. When reviewing the advertising expenses of larger companies, it may be useful to obtain pertinent information from the advertising department of the taxpayer/registrant.

ITA 19(1), 19.1(1), 19.01(4), VD 2004-0071381E5

Tax Provision Note: Non-deductible foreign advertising expenses added to income for tax purposes are a permanent difference that increases the effective tax rate of the corporation (see ¶15110, ¶15420).

SAMPLE

***¶2112 Foreign Broadcasting Expenses (Non-Canadian Advertising Expenses – Broadcasting)** (Sch. 1: Line 311)*

As mentioned directly above, expenses in respect of advertising appearing on foreign radio and television broadcasts and directed primarily at Canadian consumers are not deductible for tax purposes. However, a deduction may generally be claimed in respect of other foreign advertising expenses, including those directed primarily at a foreign market. An amount should be deducted on Line 311 of Schedule 1 if the amount is deductible for tax purposes but was included in the amount added to income for tax purposes on Line 226 of Schedule 1.

Line 311, ITA 19.1(3), VD 2006-0185441E5, 9907815

***¶2113 Periodicals (Non-Canadian Advertising Expenses – Printed Materials)** (Sch. 1: Line 312)*

The expense limitation in respect of advertising in foreign newspapers under ITA 19 does not apply to a "Canadian issue" of a "Canadian newspaper" or to an issue of a newspaper that would qualify as a Canadian issue of a Canadian newspaper except for the fact that: (i) its type was wholly set in the United States, or was partly set in the United States and the remainder in Canada, or (ii) it was wholly printed in the United States, or partly printed in that country and the remainder in Canada. Additionally, ITA 19.01 generally permits 100% deductibility of expenses or outlays for advertising space in an issue of a periodical where the advertisement is directed at the Canadian market provided the issue contains at least 80% non-advertising Canadian editorial content. Where the non-advertising Canadian editorial content in the issue is less than 80%, ITA 19.01 provides for 50% deductibility. To qualify as a periodical, a publication is required to be printed at least twice a year. An amount should be deducted on Line 312 of Schedule 1 if the amount is deductible for tax purposes but was included in the amount added to income for tax purposes on Line 226 of Schedule 1.

ITA 19.01(3), (4), VD 2003-0048425

¶2115 Allowable Business Investment Losses (ABILs) (Sch. 1: Line 406, Sch. 6)

ABILs are required to be reported in Part 7 of Schedule 6 and are discussed in Chapter 4 under ¶4500. ABILs are generally equal to 50% of capital losses arising from dispositions of shares or debt of a "small business corporation" (see ¶4510).

An ABIL is included in computing a corporation's "non-capital loss" for a taxation year and it may be carried back three years and forward ten years and applied against all sources of income.

After the 10 year carryforward period, an ABIL is considered a regular capital loss (see ¶3210) that can be carried forward indefinitely (unless control of the corporation is acquired, in which case the ABIL expires; see ¶3401). For a loss to be an ABIL, the shares or debt are required to be disposed of to a person with whom the corporation was dealing at arm's length (see ¶6005) or the shares or debt must be deemed to have been disposed of because the investee is bankrupt or insolvent (see ¶4420).

ITA 39(1)(c), 50(1), ITA 248(1)"allowable business investment loss", IT-484R2, IT-419R2, *Abrametz*, [2009] 4 C.T.C. 173 (FCA), Maureen Donnelly et al., "Substantiating an ABIL Deduction: An Analysis of the Key Elements," (2010), vol. 58, no. 2 *Canadian Tax Journal*, 229-276

Tax Provision Note: The 50% non-deductible potion of an ABIL is a permanent difference that increases the effective tax rate of the corporation (see ¶15110, ¶15420). The balance of any unused ABIL available for carryforward (Sch. 4: Part 6) at the end of the year is a deductible temporary difference (see ¶15220). A rate reconciliation adjustment will be required if the deductible temporary difference with respect to the

SAMPLE

carryforward ABIL is offset by a valuation allowance that increases the effective tax rate of the corporation (see ¶15233, 15420). See also the example under ¶2195 with respect to carryforward capital losses (the same principles apply).

¶2117 Allowance for Doubtful Accounts

See under ¶2637.

¶2120 Amortization of Intangible Capital Property (Sch. 1: Line 106)

Book amortization of intangible capital properties (or of other long-term assets or deferred costs) should be added to income for tax purposes on Line 106 of Schedule 1. As discussed under ¶2025, ITA 18(1)(b) prohibits the deduction of any amount in respect of an outlay or replacement of capital, or an allowance in respect of depreciation, obsolescence or depletion, except as expressly permitted by a provision of the ITA. For tax purposes, an eligible capital deduction (i.e. tax amortization) or other form deduction may be available in respect of intangible capital properties; see under ¶2260 and ¶5300 (Eligible Capital Property).

ITA 18(1)(b), IT-143R3, IT-123R6, IT-417R2, IT-99R5

Tax Provision Note: Amortization of intangible capital property added to income for tax purposes normally does not increase the effective tax rate of the corporation. The difference between book amortization added to income for tax purposes and cumulative eligible capital deducted from income for tax purposes (see ¶2260) is a timing difference (see ¶15220, ¶15500: Example Note 2). As an exception, a write-down of goodwill for book purposes is a permanent difference where deferred taxes have not been recorded with respect to the carrying value of the goodwill (see ¶15310, ¶15420).

For example, Canco adds $10,000 of book amortization to income for tax purposes on Schedule 1 and deducts $4,883 of tax amortization (see ¶2260) from income for tax purposes on Schedule 1 related to a customer list in the period. The customer list was acquired in the prior taxation year for $100,000. Canco does not expect to recover the carrying value of the customer list through a sale (see ¶15202). Canco records a deferred tax recovery for the period of $1,280:

A. Tax base at end of period (Sch. 10 Line 300)	B. Carrying value of intangible assets at end of period (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
$64,867	$80,000	($15,133)	($3,783)	($5,063)	$1,280

Notes:
($10,000 Amortization - $4,883 CEC Deduction) x 25% = $1,292
$100,000 x 75% = $75,000; $75,000 x .07 = $5,250 CEC deduction claimed in prior year
$75,000 - $5,250 = $69,750; $69,750 x .07 = $4,883 CEC deduction claimed in current year
$69,750 - $4,883 = $64,867 Closing CEC balance (Sch. 10: Line 300)
$90,000 - $69,750 = $20,250 Opening temporary difference
$20,250 x 25% = $5,063 Opening DTL
Under former Canadian GAAP, even though the customer list is not expected to be recovered through a sale, the tax base of the asset would have included the $25,000 ($100,000 x 25%); HB Part V: 3465.12(d).

¶2125 Appeals

SAMPLE

The cost of preparing, instituting and prosecuting an appeal from an assessment of tax, interest or penalties under the ITA or any provincial income tax statute is deductible in the year the expense is incurred. A deduction is also allowed in respect of similar expenses incurred in objecting to or appealing from: an assessment of any foreign tax claimed as a tax credit or any related interest or penalty; a decision of the Canada Employment and Immigration Commission, the Canada Employment and Insurance Commission or board of referees or umpire under the *Unemployment Insurance Act* or the *Employment Insurance Act*; or an assessment or decision under the *Canada Pension Plan* or a provincial pension plan (for example the *Quebec Pension Plan*).

Expenses to contest another person's assessment are generally deductible if the corporation has a pecuniary or other interest in the outcome that is not overly remote.

Expenses incurred to contest a GST assessment would normally be deductible under ITA 9(1) based on ordinary profit computation principles.

ITA 9, 60(o), *Flood*, [2006] 3 C.T.C. 2345 (TCC), IT-99R5 (para. 6)

¶2130 Appraisal Fees

The treatment of the cost of an appraisal of assets used in a corporation's business depends on the purpose for which the appraisal is made. If made for the purpose of maintaining adequate insurance coverage, the cost is normally viewed as a normal deductible business expense. The cost of an appraisal made for a prospectus for the purpose of issuing additional shares in a corporate reorganization would normally be deductible in equal portions over a 5-year period (see ¶2365). The cost of an appraisal for the purpose of helping to fix the sale price of a business, not being incurred in the course of business or for the purpose of earning income, would not be deductible and would not qualify as an "eligible capital expenditure". However, depending on the circumstances, it may be considered a cost of disposition for the purposes of determining any capital gain or loss on the sale (see ¶4105).

A corporation's reasonable costs of surveying or valuing a capital property for the purpose of its acquisition or disposition are added to the ACB (see ¶4110) of that property to the extent that such costs are not deducted by the corporation in computing income for any taxation year or attributable to any other property. Where the asset is not acquired, such cost would normally qualify as an eligible capital expenditure (see ¶5305).

In respect of depreciable property, such costs may form part of the capital cost of the depreciable property reported on Schedule 8. Generally, a corporation's capital cost of a depreciable property is the corporation's laid-down cost when acquiring that asset, including duty, freight, installation, acquisition costs, etc.

In each of the above cases, a Schedule 1 adjustment is required if the book and tax treatment of the appraisal fees expense differ.

In VD 2011-0411971C6, the CRA stated that appraisal fees in respect of capital property incurred for financial reporting purposes (i.e., to report using a fair value method) would be deductible as a current expense.

ITA 9(1), 13(7.5), 18(1)(b), 20(1)(e), 53(1)(n), ITA 1102(14.3), IT-143R3: *Meaning of Eligible Capital Expenditure* (paras. 20–22)

¶2135 Architect Fees

SAMPLE

The cost of architectural services, plans and estimates for new buildings or additions to buildings is treated as part of the capital cost of such assets. If such costs are deducted from book income, they should be added to income for tax purposes on Schedule 1 and included as a capital asset addition on Schedule 8. Architect fees may be an "eligible capital expenditure" if they do not lead to actual construction (see ¶5305).

ITA 14(5), *Sherbrooke Street Realty Corp* (1951), 3 Tax A.B.C. 376

¶2137 Automobile Expenses

See under ¶2540 (Motor Vehicle Expenses).

¶2140 Bad debts (Sch. 1: Lines 206, 304)

¶2141 Capital Debts (Advances, etc.) (Sch. 1: Line 206, Sch. 6)

Where a debt that is capital in nature (such as a loan made for the purposes of earning interest income) is written off for book purposes, the loss should be added to income for tax purposes on Line 206 of Schedule 1. For tax purposes, if a debt held on capital account is established to be bad in a taxation year, a corporation may elect to have disposed of the debt at the end of that taxation year and to have reacquired it at the beginning of the subsequent taxation year at a cost equal to nil, thereby realizing a capital loss (see ¶4420). Such a capital loss should be reported on Schedule 6. As further discussed under ¶4420, a debt is generally considered to be a bad for tax purposes when the corporation has exhausted legal means of collection or the debtor has become insolvent. Generally, 50% of capital losses incurred in a taxation year may be applied to offset taxable capital gains realized in the year or in any of the three preceding taxation years (see ¶3210).

In respect of a bad debt of a small business corporation, a corporation may be able to claim an ABIL; see ¶4500.

ITA 50(1), IT-159R3, IT-442R, IT-323, CRA Guide T4037, *Hopmeyer*, [2007] 2 C.T.C. 218 (FCA)

Tax Provision Note: The 50% non-deductible portion of a capital loss is a permanent difference that increases the effective tax rate of the corporation (see ¶15110, ¶15420). The balance of any allowable capital losses carried forward at the end of the year (Sch. 4: Part 2) is a deductible temporary difference (see ¶15106). A rate reconciliation adjustment will be required if the deductible temporary difference with respect to the carryforward capital loss balance is offset by a valuation allowance that increases the effective tax rate of the corporation (see ¶15233, 15420). See the example under ¶2195.

¶2142 Trade Debts (Sch. 1: Line 304)

Bad debts resulting from trade accounts receivable, or from loans made by a moneylender, are deductible from income for tax purposes and normally do not give rise to a Schedule 1 adjustment. If, however, there is a difference in the timing between the recognition of a bad debt for book and tax purposes, the non-deductible book expense should be added to income for tax purposes on Line 304 of Schedule 1 and the tax deduction, when available, should be claimed on Line 206 of Schedule 1.

ITA 20(1)(p), which allows for the deduction of bad debts on trade account, is a permissive provision. However, in paragraph 5 of IT-442R: *Bad Debts and Reserves for Doubtful Debts*, the CRA states its position that:

SAMPLE

> a bad debt may be claimed in a taxation year only if the debt became bad in that year regardless of how long the debt may have been outstanding. It also follows that a deduction for a debt that became bad in one taxation year cannot be deferred and claimed in a subsequent taxation year. Where it is considered that a part of a debt is collectible and a part is not, a portion only of the debt may be viewed as a bad debt.

Premiums paid in respect of credit insurance to protect against incurring excessive losses on bad debts are deductible in computing income from a business. Any claims recovered are included in income as an offset against bad debts.

In terms of determining when a trade debt may be considered bad for tax purposes, in paragraph 6 of IT-442R, the CRA states:

> There are no specific conditions that must be met before a debt may be classed as a bad debt. Such a decision should be made only after determined efforts to collect the debt have been unsuccessful or there is clear evidence to indicate that it has in fact become uncollectible. If a debt is merely doubtful of collection, it should not be claimed as a bad debt but should be considered for purposes of a reserve for doubtful debts. The fact that a recovery is made after a debt is written off does not negate the correctness of a claim for a bad debt if the recovery could not reasonably have been foreseen at the time the debt was written off.

In its Audit Manual (available on *Taxnet Pro*), the CRA further states (sec. 13.9.22):

> The following should be considered when reviewing bad debt expenses: Does the bad debt expense include any amount receivable from the proprietor, partner, shareholder or family member? Were all amounts written off previously included in income (if income is reported on a cash basis, there is no bad debt expense)? Does the taxpayer/registrant report any bad debt recoveries (ensure that recoveries are included in income)? Where the taxpayer/registrant uses the services of a collection agency, review available correspondence. Are bad debts written off prematurely? Where merchandise is repossessed, how does the taxpayer/registrant return the goods to inventory? Are the repossessed goods sold at reduced prices? Where the amount written off is a large amount, is there evidence that every means of collection was attempted? Review the T1/T2 of the debtor. Is the taxpayer/registrant still carrying on business with the debtor? Is the debtor still in business? Is the debtor still solvent? Determine if a reserve for doubtful accounts is more appropriate than a bad debt write-off? Where the taxpayer/registrant is claiming an ITC based on the bad debt write-off, ensure that GST/HST was remitted on the original sale and that the ITC is calculated in accordance with legislative requirements.
>
> Audit procedures should include the following: review of current year write-offs; comparison of current year's bad debt expense to prior years; determine whether collection action was taken prior to write-off.

A reasonable reserve can be claimed for tax purposes in respect of potential bad debts; see ¶2637.

With respect to a sale of accounts receivable, see ¶6525 and Form T2022: *Election in respect of the sale of debts receivable*.

ITA 20(1)(p), 9(1), *Mills Estate*, 2011 CarswellNat 2412 (FCA)

Tax Provision Note: An amount added to income for tax purpose in respect of a bad debt deducted for book purposes but not tax purposes is a timing difference that does not increase the effective tax rate of

SAMPLE

the corporation (see ¶15220). The deductible temporary difference is equal to the balance of the debt that has not been written off for tax purposes at the end of the year. Normally, the allowance for doubtful accounts with respect to accounts receivable will be equivalent for book and tax purposes such that a deferred tax asset will not arise. Where the reserve deducted for book purposes exceeds the reserve deducted for tax purposes, see the example under ¶2480 with respect to a non-deductible inventory reserve (the same principles apply).

¶2143 Proceeds of Disposition of Depreciable Property (Sch. 1: Line 304)

Proceeds of disposition credited to a class of depreciable property (see ¶5135) but not collected may be deducted from income in the year in which such amount becomes a bad debt by virtue of ITA 20(4) (similar relief exists in respect of a loss on the sale of a mortgage taken in security for proceeds of disposition). The corporation may deduct the lesser of: i) the amount of the bad debt, and ii) the amount, if any, by which the corporation's capital cost of the property exceeds any amounts actually realized by the corporation on account of the proceeds of disposition. To the extent that the loss from the deemed disposition of the bad debt has not been deducted under ITA 20(4), the loss will normally constitute a capital loss.

ITA 20(4), 50(1), IT-220R2 (para. 3)

¶2144 Proceeds of Disposition of Eligible Capital Property (Sch. 1: Line 304)

A deduction is available in computing the taxable income of a corporation in respect of a bad debt on account of proceeds of disposition of eligible capital property (see ¶5315). To the extent of the amount of the bad debt, the deduction permitted corresponds to the previous income inclusion in respect of the disposition under ITA 14(1)(b), plus recaptured amortization, plus the eligible capital expenditure pool balance.

ITA 20(4.2), IT-123R4 (paras. 19, 20)

¶2145 Recovery of a Bad Debt

A corporation is required to include in income for a later year any amounts recovered in that year in respect of bad debts or loans previously written off. The book and tax treatment of the recovered bad debt will normally be consistent and a Schedule 1 adjustment will not be required. For example, if a debt is deducted as being bad in 2010 but payment is received on account thereof either in part or in full in 2012, the amount received is brought into income for tax purposes of the corporation in 2012.

The inclusion in income of a recovered debt applies regardless of whether the debt has been paid by the original debtor or by a guarantor of such debts or whether it is paid in kind or in cash.

In respect of a recovery of a bad debt that was held on capital account, the recovery results in a capital gain which should be reported on Schedule 6 (see ¶4420). The amount included in book income in respect of a recovered debt that was held on capital account should be deducted on Schedule 1 from income for tax purposes.

ITA 12(1)(i), (i.1), 20(1)(p), 20(4.2), 39(11), *Société d'ingénierie Cartier Ltée*, [1986] 1 C.T.C. 166 (FCTD), IT-442R, IT-220R2 (para. 3)

Tax Provision Note: The 50% non-taxable portion of a capital gain in respect of a recovered bad debt on capital account is a permanent difference that decreases the effective tax rate of the corporation (see ¶15110, ¶15420).

SAMPLE

¶2150 Bank and Collection Charges

Costs of collection, discounts, drafts and the like in connection with a business are deductible for tax purposes.

¶2155 Barter Transactions

Where goods or services are exchanged between corporations without using money, there are imputed income tax consequences if the goods or services are of a kind generally provided in the course of the corporation's business or profession or included in inventory of the business. The fair market value, or a reasonable estimate, of what is provided will be considered an income receipt or proceeds of disposition (as the case may be). A Schedule 1 adjustment will not be required where the book and tax treatment of the barter transaction are equivalent, which will normally be the case.

Bartering capital property or eligible capital property of a business is also required to be recognized in an amount equivalent to fair market value.

ITA 9(1), IT-490, *Linett*, [1985] 2 C.T.C. 2037 (TCC), VD 2008-0280701E5, Krishna, Vern, "Payments in Kind and Barter — Inclusion in Income — Valuation" (1985) 1:20 Can. *Current Tax* J-93

¶2160 Bonuses and Salaries

As a general rule, reasonable bonuses paid or payable to employees are permitted as deductions from income for tax purposes in the year paid or incurred, provided they are paid within 180 days of year-end; see ¶2720.

Amounts of salary or bonuses paid or payable to an owner-manager (including bonuses paid to reduce the taxable income of a CCPC to the business limit; see ¶8150), are normally deductible on the basis that the owner's expertise, know-how, managerial skills and effort are responsible for the company's profits. The CRA will generally not question the reasonableness of owner-manager salaries and bonuses paid to Canadian residents who are actively involved in the day-to-day operations of the company. This position does not extend to remuneration paid to spouses or other family members of the principal shareholder or to principal shareholders that are non-residents. Also, in ITTN-30, the CRA states this generally policy would not apply in a situation in which a CCPC pays the remuneration out of proceeds generated from a major a sale of business assets (including the sale of the entire business or of a large division). The CRA notes it "would not generally be concerned with situations where there is a sale of some of the assets, which is incidental to the normal business operations".

At the 2011 CTF Ontario Tax Conference, the CRA stated it may consider remuneration paid from the proceeds of a major sale of business assets to an owner-manager to be reasonable depending on the facts of the particular situation.

Even in the case of regular employees, as mentioned under ¶2025, it is normally difficult to question the business expediency of a salary, or rental, for example, even if paid to someone not dealing at arm's length with the corporation. Also, the recipient of the amount paid will normally pay personal tax in respect of the amount such that the CRA is content to consider the overall tax consequences on both payer and payee to be reasonable. The CRA may, however, take action in extraordinary circumstances. In VD 2000-0038695, the CRA states:

> In our view, one of the primary factors to be considered when determining the reasonableness of the amount of salary and/or bonus is the recipient's contribution to the business. Where a corporation

SAMPLE

> pays a salary and/or bonus out of business profits to a manager who is actively engaged in the business of the corporation, it is unlikely that the reasonableness of the deduction will be questioned unless it results in an undue tax advantage. The [CRA] does not and do not intend to develop criteria relative to the ownership and management structure of a Canadian-controlled private corporation in relation to the determination of whether the amount of salaries and bonuses will be considered reasonable.

The CRA is more likely to question the reasonableness of bonuses and salary paid to an owner-manager's minor children or spouse, particularly when the bonuses and salaries are perceived by the CRA merely to be an income-splitting measure designed to take advantage of the lower personal tax brackets of the spouse and children. Nonetheless, salaries and bonuses paid the spouse and children of an owner-manager are deductible provided the compensation is reasonable in relation to the services provided. The Courts have allowed bonuses paid to family members to be deducted in certain cases; however, in certain other cases, the courts have denied a deduction.

In VD August 1990-223, the CRA states:

> A determination of the reasonableness of the amount of remuneration paid to any particular employee requires consideration of the duties performed by the individual, as well as the time spent in carrying out those duties. Furthermore, where possible, comparisons should be made between the remuneration paid to the individual and the remuneration paid to employees who perform similar services for employers of similar size in similar businesses. Also the reasonableness of a salary to an employee who is the spouse of, or a member of the immediate family of, the employer would be subject to question where it is felt that income-splitting is involved.

In *V.R. Enterprises Ltd.*, 1974 CarswellNat 265 (TRB), the Court set forth the following criteria for determining whether a bonus is deductible (paras. 16, 17):

> Even though salaries and bonuses may sometimes be used interchangeably, I do not believe that all bonuses are deductible expenses. Before a bonus can be considered as an integral part of salary and a deductible expenses, it must, in my view, meet certain criteria. Some of the criteria would be:
>
> 1. The amount of bonuses paid or accrued must be reasonable in comparison with the profit earned by the company and the services rendered by the recipients.
>
> 2. The services for which the bonuses are paid must be real and identifiable.
>
> 3. Though the quantum of the bonuses, which are usually based on the amount of profit realized by a corporation, need not necessarily be precisely determined beforehand, there must be some justification for expecting an amount of income over and above the regular yearly salary.
>
> 4. There must be some relationship between the bonuses paid or accrued and the income earned or to be earned at least in the form of a well-established and well-known incentive.
>
> 5. Bonuses to be paid or accrued in a particular year must be established within a reasonable time from the moment the corporation's profit for that year has been determined.
>
> Although there are, no doubt, other applicable criteria, it would seem to me that bonuses that do not meet these criteria would simply be a profit-sharing arrangement having no connection with the earning of income and would therefore not be considered as deductible outlays or expenses.

SAMPLE

In *Ambulances B.G.R. Inc.*, 2004 CarswellNat 1054 (TCC), relatively large bonuses paid to adult children were held to be deductible on the basis that they represented reasonable compensation for exceptional services performed.

In *Costigane*, [2003] 3 C.T.C. 2087 (TCC), amounts paid for bookkeeping services by a dentist to a financial services company owned by a family trust (of which the dentist's minor children were the beneficiaries) were found to be unreasonable when compared to the cost of the dental staff doing the work directly. However, the Court accepted a reduced mark-up of 15% on such services.

In *Mépalex Inc.*, 2002 CarswellNat 4727 (TCC), bonuses and salary paid to the owner's minor children were disallowed as unreasonable. The Court noted that the children's effort entitled them to only minimal remuneration. Also, in *Doug Burns Excavation Contracting Ltd*, [1983] C.T.C. 2566 (TCC) bonuses of $100,000 paid in one year and $15,000 in the next to the spouse of the corporation's majority shareholder were disallowed on the basis that the general clerical functions for which the spouse received a regular salary did not justify such bonuses.

In VD 2004-0072741R3, the CRA states a shareholder/manager bonus could be considered reasonable if it created a non-capital loss which could be carried back to offset income from a preceding taxation year provided the payment was within the scope of the CRA's policy with respect to the reasonableness of shareholder/manager remuneration.

ITA 67, *The Queen v Ken and Ray's Collins Bay Supermarket Ltd*, [1975] C.T.C. 504 (FCTD), *G W Dorman Pulp Chip Company Ltd*, [1981] C.T.C. 2005 (TRB), *Safety Boss Ltd.*, [2000] 3 C.T.C. 2497 (para. 10), ITTN-22, ITTN-30, IT-215R, VDs 2007-0246871R3, 2004-0092931R3, 2004-0072741R3, 2002-0173335, 2000-0013085, 9805745

¶2161 Christmas and Special Occasion Gifts

Under the CRA's administrative policies, employers are allowed to give employees two non-cash gifts (awards) a year, on a tax-free basis, where the total cost of the gifts (awards) to the employer does not exceed $500. Also, a separate non-cash long service/anniversary award is non-taxable to the employee for up to $500 (it must be for at least 5 years of service or 5 years since the last such award and these rules do not apply to non-arm's length employees, such as shareholders and family members of closely-held corporations). A corporation can deduct the cost of such gifts and awards.

The CRA's administrative policy does not apply to cash or near-cash gifts, such as gift certificates. Also, if the cost of the gift exceeds the $500 threshold, the full fair market value of the gifts or awards will be included in the recipients' employment income.

cra.gc.ca/gifts, T4130, ITTN-40, ITTN-15, IT-470R, VDs 2010-0359501E5, 2005-0153611E6

¶2162 Customer or Client Christmas Gifts

Subject to the normal test of reasonableness (see ¶2025), customer or client Christmas gifts are generally considered expenses incurred to earn income and are deductible from income for tax purposes.

In *A S Herrmann Ltd*, 1 Tax A.B.C. 208 (TAB), the Court held that amounts expended by the corporation to buy Christmas presents for persons of influence among its customers were necessarily laid out to earn income. However, in a later case, the Court noted *A S Herrmann* should not be taken as authority for the broad principle that gifts were always deductible under the *Income War Tax Act* (*Mr Z v MNR*, 3 Tax A.B.C. 50).

A gift of beverages (e.g. a bottle of wine) to customers and suppliers of a corporation is subject to the 50% deduction limitation in ITA; see ¶2530 (Meals and Entertainment Expenses).

See also ¶2185 (Business Promotion Expenses) and ¶2332 (Donations and Gifts).

ITA 18(1)(a), 67, VD 2004-0088721E5

¶2165 Branch Losses

Business losses incurred in foreign countries may be deducted from income earned in Canada in the determination of income of the Canadian resident corporation. Tax issues related to operating a foreign branch are discussed in Chapter 7 under ¶7040 (Branches Carried on through a Permanent Establishment).

ITA 3

¶2170 Brokers' Charges

Commissions paid to brokers or investment dealers for selling an issue of a corporation's bonds or shares are deductible under ITA 20(1)(e) over a five-year period; see under ¶2365 (Financing Fees).

ITA 20(1)(e), IT-341R4 (para. 20)

¶2175 Builders' Second Mortgages

Every amount receivable in respect of property sold in the course of business in the year is required to be included in income. In the case of a builder, this will include the full sale price of the building even if the builder agrees to take back a second mortgage from the purchaser in part payment. However, where the amount is not payable in full until after the end of the taxation year, a reserve may be deducted equal to the profit element that is not payable until after the end of the taxation year (see ¶2452). A separate reserve may be available where the amount is due in the year but collection is doubtful (see under ¶2638).

ITA 12(1)(b), (e), 20(1)(l), 20(1)(n), *MNR v Burns*, [1958] C.T.C. 51; aff'd 1959 CarswellNat 342

Tax Provision Note: An amount deducted from income for tax purposes in respect of an instalment sale is a timing difference that does not decrease the effective tax rate of the corporation (see ¶15220). The taxable temporary difference is equal to the amount required to be added to income for tax purposes in the following year (i.e. the closing balance of the reserve reported on Sch. 13). Instalment sale reserves added to income for tax purposes in the current year reverse the taxable temporary difference outstanding at the end of the prior year. See the example of the computation of deferred taxes in respect of an instalment sale reserve under ¶2630.

¶2180 Business Cessation Costs

Provided former business assets are not used for personal purposes after the cessation of a business and continued efforts are made to sell business assets after normal operations have ceased, expenses incurred to sell former business assets are deductible in computing income for tax purposes.

Génier, H., 2010 CarswellNat 4884 (TCC), *Heard*, [2001] 4 C.T.C. 2426 (TCC), *Mikhail*, [2002] 2 C.T.C. 2612 (TCC), and *Langille*, 2009 CarswellNat 2376 (TCC)

¶2185 Business Promotion Expenses

SAMPLE

Business promotion expenses are akin to advertising. Giveaway items and sponsorship of sports teams are examples of business promotion expenses. Such expenses are generally considered deductible provided they are reasonable (see ¶2025, ¶2110).

Olympia Floor & Wall Tile Ltd, [1970] C.T.C. 99 (Ex ct), *Leffler*, [1971] Tax A.B.C. 717

¶2190 Capital Cost Allowance (CCA) (Sch. 1: Line 403; Sch. 8)

CCA, which may be deducted from income for tax purposes, is for all practical purposes synonymous with the accounting term "depreciation". As discussed further in Chapter 5, under the CCA system, eligible assets are grouped into prescribed classes, and each class is allotted a maximum percentage CCA rate. The dollar amount of the balance outstanding in each class is referred to as the undepreciated capital cost (UCC) of the class. UCC of the class is increased by the capital cost of eligible assets acquired during the year that fall within the class and decreased by the net proceeds of disposition of eligible assets (to the extent of the capital cost of such assets) that fall within the class and that are disposed of during the year. CCA is claimed for tax purposes at the end of the year. The diminishing-balance method (rather than the straight-line method) is used in most cases. Any CCA claimed is deducted from the UCC balance of the class of assets at the end of the year.

For an alphabetical list outlining the CCA class of depreciable properties, see ¶5000. In respect of a disposition of depreciable property, see ¶2600 (Recapture Income) and ¶2700 (Terminal Losses).

Depreciation of fixed assets for book purposes is added to income for tax purposes on Schedule 1 (see ¶2300).

ITA 20(1)(a), IT-128R, IT-478R2, IT-285R2, IT-464R, IT-472, IT-477, IT-418, IT-327, IC 84-1

Tax Provision Note: The difference between CCA deducted from income for tax purposes on Schedule 1 and depreciation added to income for tax purposes on Schedule 1 is a timing difference (see ¶15220, ¶15500: Example Note 1). For example, Canco adds $10,000 of depreciation (see ¶2300) to income for tax purposes on Schedule 1 and deducts $20,000 of CCA from income for tax purposes in the period. Canco acquired $30,000 of equipment during the period and did not dispose of any depreciable property. Canco records a deferred tax expense for the period of $2,500:

A. Tax base (UCC) at end of period (Sch. 8)	B. NBV of fixed assets at end of period (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
$90,000	$120,000	($30,000)	($7,500)	($5,000)	($2,500)

Notes:

($20,000 CCA - $10,000 Depreciation) x 25% = $2,500
$80,000 Opening UCC + $30,000 Additions - $20,000 CCA = $90,000 Closing UCC
$100,000 Opening NBV + $30,000 Additions - $10,000 Depreciation = $120,000 Closing NBV

¶2195 Capital Gains (Losses) (Sch. 1: Line 113; Sch. 6)

Only 50% of capital gains (referred to as "taxable capital gains") are included in income for tax purposes. Capital gains and losses, which are reported on Schedule 6, are discussed in Chapter 4. A corporation may

SAMPLE

realize a capital gain or loss upon a sale of a depreciable or non-depreciable capital property (such as securities). A capital gain or loss may also arise, for example, if a corporation: exchanges one property for another; gives property as a gift; exercises a conversion option; settles or cancels a debt; or transfers property to a related party. A capital gain is generally equal to net proceeds of disposition (¶4105) less the ACB (¶4110) of the property. A capital gain or loss is generally synonymous with an accounting "gain" or "loss" on a disposition of a fixed asset

Ordinary capital losses can only be applied to offset capital gains and are not deductible from ordinary income. As discussed under ¶4500, ABILs realized on shares or debt of a small business corporation can be offset against ordinary income. Capital losses can be carried back three years and carried forward indefinitely.

Book gains should be deducted and book losses should be added to income for tax purposes on Schedule 1 (see ¶2405 and ¶2525).

In respect of a capital gain, a reserve can be claimed for tax purposes in respect of outstanding proceeds at the end of the taxation year; see ¶2635.

With respect to a disposition of eligible capital property, see ¶2335.

A capital loss cannot be realized on a disposition of depreciable property; however, a terminal loss may arise (see ¶2700).

ITA 3(b), 38(1)(a), 39, CRA Guide T4037, IT-459, IT-218R, IT-479R, IT-395R2, IT-442R, IT-403R, VD 2009-0305951E5

Tax Provision Note: The 50% non-taxable portion of a capital gain is a permanent difference that decreases the effective tax rate of the corporation (see ¶15110, ¶15420). Conversely, the 50% non-deductible portion of a capital loss is a permanent difference that increases the effective tax rate of the corporation. The balance of any allowable capital losses carried forward at the end of the year (Sch. 4) is a deductible temporary difference (see ¶15106). A rate reconciliation adjustment will be required if the deductible temporary difference with respect to the carryforward capital loss balance is offset by a valuation allowance that increases the effective tax rate of the corporation (see ¶15233, 15420).

For example, Canco realizes a capital loss in the period of $10,000 on a sale of shares held as a portfolio investment. The disposition of the shares is reported on Schedule 6. The capital loss is not utilized in the period and a $5,000 allowable capital loss is available for carryforward at the end of the year (Sch. 4: Line 280 x 50%). A loss on the sale of shares reported for book purposes of $10,000 is added to income for tax purposes on Line 111 (see ¶2525) of Schedule 1. Canco has unrealized capital gains outstanding at the end of the year against which the carryforward capital loss can be utilized; as such, a valuation allowance is not required in respect of the deferred tax asset related to the carryforward capital loss balance. Canco records a deferred tax recovery and a deferred tax asset of $1,250 ($5,000 x 25%) for the period. The rate reconciliation with respect to the capital loss is computed as follows:

Effective tax rate (tax provision / NIBT) ($1,250 / $10,000)	12.50%
Permanent differences (($5,000 x 25%)/$10,000))	12.50%
Total	25.00%
Statutory rate	25.00%

SAMPLE

¶2200 Capital Items Expensed (Current versus Capital Expenses) (Sch. 1: Line 206)

As discussed under ¶2025, a deduction from income for tax purposes is not permitted for "capital" expenditures or losses unless they are expressly allowed under a provision of the ITA (for example, ITA 20(1)(a) permits the deduction of CCA in respect of depreciable property). The distinction between capital and revenue expenses is not easy to define. The nature of the business may be the determining factor. Generally, a capital expenditure is an expenditure that has the purpose of creating or protecting a capital asset. It should be noted that as an administrative practice, the cost of assets of small value and short life are often allowed as an expense by the CRA when such amounts are expensed for book purposes.

It is often difficult to determine whether an expenditure is a current expense or is a capital. *British Insulated v. Atherton*, 10 T.C. 155, at 192, is often quoted in the Canadian courts as a useful guide for a non-exhaustive definition of a capital expenditure: "When an expenditure 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, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital".

In *Canada Steamship Lines Ltd.*, [1966] C.T.C. 255 (Ex Ct), President Jackett stated (p. 5207):

> Things used in a business to earn the income — land, buildings, plant, machinery, motor vehicles, ships — are capital assets. Money laid out to acquire such assets constitutes an outlay of capital. By the same token, money laid out to upgrade such an asset — to make it something different in kind from what it was — is an outlay of capital. On the other hand, an expenditure for the purpose of repairing the physical effects of use of such an asset in the business — whether resulting from wear and tear or accident — is not an outlay of capital. It is a current expense.

The Court has also stated: "[i]n a rough way I think it is not a bad criterion of what is capital expenditure against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year" (*Vallambrosa Rubber Co. v. Farmer* (Surveyor of Taxes), 5 T.C. 529 at p 536).

Professor Krishna summarized the principles established by the Courts to distinguish such expenditures as follows (Krishna, Vern. *The Fundamentals of Canadian Income Tax* (10th ed. 2009; available on *Taxnet Pro* and *TaxPartner*) at p 334):

1) The character of the advantage or the duration of the benefit (the more enduring the benefit the more likely that the expenditure is on account of capital);

2) Recurrence and frequency of the expenditure (the more frequent the expenditure the less enduring the benefit);

3) Identification of the payment as a surrogatum for expenditures that would be on account of capital or revenue (a substitute for a capital expenditure is more likely a capital expenditure).

Because of the inherent difficulty in determining whether certain expenses are capital or current outlays, there is vast jurisprudence on the subject matter. Excerpts from some of the more significant cases are provided below, followed by a summary of the CRA's policies on the issue derived from various CRA publications.

SAMPLE

In *Algoma Central Railway*, [1968] C.T.C. 161 (SCC), the Court concluded that an amount Algoma paid to have a geological survey completed was deductible as a current expense incurred to earn income from its business. The survey was undertaken with the object of ascertaining the mineral potential of the region through which the railway ran in the hope that others could be persuaded to develop the area and thus stimulate Algoma's growth. The Court found that the expenditure was not incurred to bring into existence an advantage for the enduring benefit of the business. At paragraph 25 of *Algoma Central Railway*, [1967] C.T.C. 130 (Exch.), after analyzing the relevant jurisprudence, the Court stated:

> In all these cases, and in the other cases referred to in the various decisions to which reference was made during the argument, the "advantage" that was held to be of an enduring benefit to the taxpayer's business was the thing contracted for or otherwise anticipated by the taxpayer as the direct result of the expenditure. In all such cases it was the "advantage" so acquired that, it was contemplated, would endure to the benefit of the taxpayer's business. In my view, the information received by the appellant here, in consideration of the expenditures in dispute, is not such an "advantage" of an enduring benefit to the taxpayer's business.

At paragraphs 3 and 4 Supreme Court of Canada decision, the Court stated:

> Parliament did not define the expressions "outlay ... of capital" or "payment on account of capital". There being no statutory criterion, the application or non-application of these expressions to any particular expenditures must depend upon the facts of the particular case. We do not think that any single test applies in making that determination and agree with the view expressed, in a recent decision of the Privy Council, *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia*, [1966] A.C. 224, by Lord Pearce. In referring to the matter of determining whether an expenditure was of a capital or an income nature, he said, at p. 264:
>
>> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer.
>
> The learned President, after considering all the facts in the present case, decided that the expenditures in issue were not of a capital nature within the provisions of Section 12(1)(b) of the *Income Tax Act*. We agree with his conclusion. Hence, the appeal should be dismissed with costs.

In *Johns-Manville Canada Inc.*, [1985] 2 C.T.C. 111 (SCC), the Court found that expenditures to acquire land adjoining an expanding pit mining operation to ensure slope stability as excavation proceeded were incurred for the purpose of earning income in the course of regular day-to-day business operations. As the land acquired did not add to or preserve the ore body and was consumed in the course of mining, the expenditures were considered incidental to the production and sale of the output of the mine. The fact that land purchases were recurring and a direct result of the business operations was significant to finding that the outlay was an expense on account of income.

In *Canada Starch Co Ltd*, [1968] C.T.C. 466 (Exct), the appellant, in the course of bring a new product to market, incurred expenditures on market research, industrial designs and advertising and, in addition, paid $15,000 to a competitor in order to induce it to drop its opposition to the registration of the appellant's trademark. The Court found the expenses were deductible on current account, noting that the value of a trademark, like the value of goodwill, is a by-product of the process of operating a business (unless purchased from a third party as an already existing asset). The Court noted that registration of the

SAMPLE

trademark did not create the business or commercial reality of the trademark but was merely a statutory device for improving the legal protection of the trademark. The Court stated (para. 6):

> In other words, as I understand it, generally speaking,
>
> a) on the one hand, an expenditure for the acquisition or creation of a business entity, structure or organization, for the earning of profit, or for an addition to such an entity, structure or organization, is an expenditure on account of capital, and
>
> b) on the other hand, an expenditure in the process of operation of a profit-making entity, structure or organization is an expenditure on revenue account.

In *Pantorama*, [2005] 2 C.T.C. 336 (FCA), the Court held that amounts expended to ensure that a business could continue to be operated profitably was on revenue rather than capital account. In the case, the Court permitted a deduction for payments to a contractor that found locations and negotiated leases and lease renewals for the company's stores. On the other hand, in *Rona Inc.*, [2003] 4 C.T.C. 2974 (TCC), the Court found that certain fees related to the construction of new stores were on capital account even though the company was expanding and building new stores every year. The Court stated: "[e]ngaging in a planned phase of expansion of the business structure over a lengthy period of adding new sales outlets does not make a capital outlay an income expense" (para. 38). In *Pantorama*, the Court noted (paras. 21, 22, 24 and 25):

> As was pointed out in *Canada Starch*… at 5323 (in a passage cited by Archambault J. in *Rona*, supra, at paragraph 37), moneys spent towards the creation or the expansion of a commercial structure is on capital account as this type of expenditure gives rise to an asset of an enduring nature. However, once a structure is in place, moneys paid each year to insure that it can continue to be exploited profitably are on revenue account.
>
> In the present case, the nature of the payments is made clear when it is appreciated that they had to be made since 1979 and there is no suggestion that the appellant's business can continue without these payments being made every year (compare *John-Manville*, supra, page 5384). What this shows, unequivocally in my view, is that the payments are required to insure the ongoing operation of the appellant's business. . . .
>
> What the appellant had in view in paying the variable fees every year was its continued profitability having regard to evolving consumer needs and preferences. . . .
>
> Finally, I believe that it can safely be said that the Minister would not have raised the assessments in issue if the services provided by Snowcap had been obtained in-house, and paid for in the form of salaries, travel expenses, etc. If that is so, the fact that the appellant made a decision to outsource this aspect of its business should have no bearing on the tax treatment of the expenditure (compare *International Colin Energy Corp. v. R.*, 2002 D.T.C. 2185 (T.C.C. [General Procedure]) at paragraphs 45 and 46).

In *Wescast Industries*, [2011] 2 C.T.C. 2201 (TCC), the corporation's advances of working capital to bring a Hungarian subsidiary into production were found to be capital in nature. The taxpayer attempted to argue the amounts paid were on current account because they gave rise to substantial benefits to the taxpayer's Canadian operations. For support, the taxpayer cited *Valiant Cleaning Technology*, [2009] 1 C.T.C. 2454 (TCC), in which the Court stated, "advances of working capital made to a subsidiary, if they are made for the dominant purpose of safeguarding the parent's business from financial damage that it would otherwise suffer as a result of the subsidiary failing to meet its commitments, may properly be

SAMPLE

treated by the parent as expenditures on current account" (para. 20). In *Westcast*, the Court found that the purpose of the advances was to provide the Hungarian subsidiary with the necessary working capital to survive its start-up period and that the provision of working capital was part of a capital investment. The Court also found no evidence of benefits flowing to Wescast Canada in respect of the advances.

In CRA Guide T4002, the CRA provides the following summary of its position:

Criteria	*Capital expenses*	*Current expenses*
Does the expense provide a lasting benefit?	A capital expense generally gives a lasting benefit or advantage. For example, the cost of putting vinyl siding on the exterior walls of a wooden house is a capital expense.	A current expense is one that usually recurs after a short period. For example, the cost of painting the exterior of a wooden house is a current expense.
Does the expense maintain or improve the property?	The cost of a repair that improves a property beyond its original condition is probably a capital expense. If you replace wooden steps with concrete steps, the cost is a capital expense.	An expense that simply restores a property to its original condition is usually a current expense. For example, the cost of repairing wooden steps is a current expense.
Is the expense for a part of a property or for a separate asset?	The cost of replacing a separate asset within that property is a capital expense. For example, the cost of buying a compressor for use in your business operation is a capital expense. This is the case because a compressor is a separate asset and is not a part of the building.	The cost of repairing a property by replacing one of its parts is usually a current expense. For instance, electrical wiring is part of a building. Therefore, an amount you spend to rewire is usually a current expense, as long as the rewiring does not improve the property beyond its original condition.
What is the value of the expense? (Use this test only if you cannot determine whether an expense is capital or current by considering the three previous tests.)	Compare the cost of the expense to the value of the property. Generally, if the cost is of considerable value in relation to the property, it is a capital expense.	This test is not a determining factor by itself. You might spend a large amount of money for maintenance and repairs to your property all at once. If this cost was for ordinary maintenance that was not done when it was necessary, it is a maintenance expense, and you deduct it as a current expense.
Is the expense for repairs to the used property that you acquired made to put it in suitable condition for use?	The cost of repairing used property that you acquired to put it in a suitable condition for use in your business is considered a capital expense even though in other circumstances it would be treated as a current operating expense.	Where the repairs were for ordinary maintenance of a property that you already had in your business, the expense is usually current.
Is the expense for	The cost of repairs made in anticipation	Where the repairs would have been

SAMPLE

Criteria	*Capital expenses*	*Current expenses*
repairs made to an asset in order to sell it?	of the sale of a property or as a condition of sale is regarded as a capital expense.	made anyway, but a sale was negotiated during the course of the repairs or after their completion, the cost is regarded as current.

In paragraph 4 of IT-128R, the CRA expands upon the above guidelines:

> (a) Enduring Benefit — Decisions of the courts indicate that when an expenditure on a tangible depreciable property is made "with a view to bringing into existence an asset or advantage for the enduring benefit of a trade", then that expenditure normally is looked upon as being of a capital nature. Where, however, it is likely that there will be recurring expenditures for replacement or renewal of a specific item because its useful life will not exceed a relatively short time, this fact is one indication that the expenditures are of a current nature.
>
> (b) Maintenance or Betterment — Where an expenditure made in respect of a property serves only to restore it to its original condition, that fact is one indication that the expenditure is of a current nature. This is often the case where a floor or a roof is replaced. Where, however, the result of the expenditure is to materially improve the property beyond its original condition, such as when a new floor or a new roof clearly is of better quality and greater durability than the replaced one, then the expenditure is regarded as capital in nature. Whether or not the market value of the property is increased as a result of the expenditure is not a major factor in reaching a decision. In the event that the expenditure includes both current and capital elements and these can be identified, an appropriate allocation of the expenditure is necessary. Where only a minor part of the expenditure is of a capital nature, the Department is prepared to treat the whole as being of a current nature.
>
> (c) Integral Part or Separate Asset — Another point that may have to be considered is whether the expenditure is to repair a part of a property or whether it is to acquire a property that is itself a separate asset. In the former case the expenditure is likely to be a current expense and in the latter case it is likely to be a capital outlay. For example, the cost of replacing the rudder or propeller of a ship is regarded as a current expense because it is an integral part of the ship and there is no betterment; but the cost of replacing a lathe in a factory is regarded as a capital expenditure, because the lathe is not an integral part of the factory but is a separate marketable asset. Between such clear-cut cases there are others where a replaced item may be an essential part of a whole property yet not an integral part of it. Where this is so, other factors such as relative values must be taken into account.
>
> (d) Relative Value — The amount of the expenditure in relation to the value of the whole property or in relation to previous average maintenance and repair costs often may have to be weighed. This is particularly so when the replacement itself could be regarded as a separate, marketable asset. While a spark plug in an engine may be such an asset, one would never regard the cost of replacing it as anything but an expense; but where the engine itself is replaced, the expenditure not only is for a separate marketable asset but also is apt to be very substantial in relation to the total value of the property of which the engine forms a part, and if so, the expenditure likely would be regarded as capital in nature. On the other hand, the relationship of the amount of the expenditure to the value of the whole property is not, in itself, necessarily decisive in other circumstances, particularly where a major repair job is done which is an accumulation of lesser jobs that would have been classified as current expense if each had been done at the time the need for it first arose; the fact that they were not done earlier does not change the nature of the work when it is done, regardless of its total cost.

SAMPLE

> (e) Acquisition of Used Property — Where used property is acquired by a taxpayer and at the time of acquisition it requires repairs or replacements to put it in suitable condition for use, the cost of such work is regarded as capital in nature even though, in other circumstances, it would be treated as current expense.
>
> (f) Anticipation of Sale — Repairs made in anticipation of the sale of a property or as a condition of the sale are regarded as capital in nature. On the other hand, where the repairs would have been made in any event and the sale was negotiated during the course of the repairs, or after their completion, the cost should be classified as though no sale was contemplated.

The CRA also provides the following example in Guide T4002:

> Q. My brother and I own an old apartment building that we have been renting for several years. In the current tax year, we had the roof and outside walls repaired. The repairs to the roof involved waterproofing and re-shingling several patches that had developed leaks. The building is made of brick, and the outside walls were redone using the original bricks. Can we deduct these expenses in calculating our rental income for the year?
>
> A. Yes. The repairs to the building simply restored it to its original condition. As a result, they are current expenses.

Similar to the above example, in VD 2010-0382041E5, the CRA is asked whether the owner of a rental property that incurs expenses for re-roofing the property, replacing a water heater, two existing furnaces and two overhead garage doors can treat the costs as current expenditures. The taxpayer indicates that none of the expenditures resulted in an upgrade to the property. The CRA replied in part as follows:

> If a new roof clearly is of better quality and greater durability than the replaced roof, then the expenditure would generally be regarded as capital in nature. On the other hand, if an expenditure only restores the roof to its original condition using identical or equivalent quality materials, this would be an indication that it is current in nature.
>
> We have not been provided with sufficient information to comment on whether the expenditures referred to in your letter would be current or capital in nature. However, we would note that you have indicated that the expenditures did not result in an upgrade to the building which leaves the impression that the new roof, furnace, water heater and garage doors would not be betterments, which may be an indication that expenditures relating to the new roof are current in nature.

With respect to building repairs, in *Chambers*, [1998] 1 C.T.C. 3273 (TCC), Brule J. stated (paras. 14, 15):

> It would seem that if the repairs resulted in virtually the same old building as before the repairs were undertaken then such should be properly expensed, but if on finishing the repairs a virtually new building or at least quite a different building results then the repairs should be on capital account.
>
> One criteria to make such a determination apart [from] the appearance inside and out of the structure and whether or not the place had to be vacated before repairs were undertaken is the dollar amount of the repairs in relation to the value of the asset.

In its Audit Manual (available on *Taxnet Pro*), the CRA states under the heading "Auditing of Expenditures that should be Capitalized" (at 13.9.22):

SAMPLE

Review of expenditures should include ensuring that expenditures that should be capitalized have not been expensed. Audit procedures include the following:

- Ensure that mortgage payments are properly allocated to interest expense and principal.
- Query legal bills. Determine whether the expense is allowable or whether it should be capitalized. For more information see IT-99R5 — (Consolidated) *Legal and Accounting Fees* [*See also* "Legal and Accounting fees"].
- Property taxes paid in the period prior to acquisition and in the period subsequent to disposal are capital expenses [see under "Land Carrying Charges (Line 206)"].
- Installation costs, freight, customs duties and foreign exchange must be added to the acquisition cost of the capital asset.
- Major repairs or alterations and improvements must be capitalized. Examine the repair expense account to determine whether any amounts should be capitalized. In some cases the voucher may not be sufficient to determine whether an amount is a capital or current expense. Other correspondence may be available to establish the nature of the costs incurred. For more information see IT-128R *Capital cost allowance — Depreciable property*.
- Repairs done as part of a general reconditioning or improvement project may need to be capitalized.
- Where the purpose of repairs is to put the property in a saleable condition, the costs should be capitalized.
- Where buildings or equipment are acquired that are in need of major repairs or alterations, ensure that the costs of repair or alteration are capitalized.
- In some cases equipment may be purchased in components and expensed where the amount should be capitalized.
- Expenses incurred as the result of the disposal of an asset (commissions, legal expenses, transportation costs etc.) should be deducted from the proceeds of the disposal and not claimed as a current expense [see Chapter 4 under ¶4105].

If a current expense for tax purposes is capitalized to the cost of an asset for book purposes, the amount capitalized for book purposes should be deducted from income for tax purposes on Schedule 1 (see also under ¶2280). As a practical matter, expenditures capitalized to the cost of an asset under GAAP are normally also capitalized for tax purposes.

See also ¶2510 (where the purpose of legal fees is to protect, preserve or maintain rights or titles to property, the Courts have generally found the expenditure to be capital in nature); ¶2495 (carrying costs required to be capitalized in respect of vacant land) and ¶2685 (soft costs required to be capitalized during the construction or renovation of a building).

ITA 18(1)(b), *O'Rourke Marketing*, [2006] 3 C.T.C. 2248 (TCC); *Gabriel*, [2006] 2 C.T.C. 2216 (TCC); *Di Fruscia*, [2007] 5 C.T.C. 2048 (TCC); *Labrèche*, [2008] 2 C.T.C. 2051 (TCC); *Nguyen*, [2008] 2 C.T.C. 2321 (TCC); *Ruest*, [2008] 2 C.T.C. 2449 (TCC); *Albayate*, [2008] 3 C.T.C. 2253 (TCC); *Daoust*, [2009] 1 C.T.C. 2508 (TCC); *Lewin*, [2009] 2 C.T.C. 2165 (TCC); *Bishop*, 2010 CarswellNat 1438 (FCA), *Denison Mines Limited*, [1971] C.T.C. 640 (FCTD), CRA Guide T4002, IT-

475, IT-467R2, IT-364, IT-357R2, IT-187, VDs 2010-0382041E5, 2009-0348491E5, 2007-0240691I7, 2004-0070211E5, Michael Flatters, “The Distinction Between Income and Capital in the Income Tax Act,” *2005 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2005), 16:1-15, David Spiro et al, “Updating the Trilogy: the Courts Confirm a More Practical Approach to Paragraph 18(1)(b)”, XII(1) Corporate Finance (Federated Press) 1274-76 (2005), John Durnford, “The Deductibility of Building Repair and Renovation Costs”, 45(3) *Canadian Tax Journal* 395-416 (1997)

Tax Provision Note: Normally, an amount capitalized for tax purposes that was deducted for book purposes is a timing difference that does not increase the effective tax rate of the corporation (see ¶15220, ¶15500: Example Note 1). However, if the amount is added to the ACB of a non-depreciable property for tax purposes, 50% (based on the capital gains inclusion rate) of the capitalized amount is a permanent difference that increases the effective tax rate of the corporation (see ¶15420).

For example, Canco deducts $100,000 of building repair expenses during the period. For tax purposes, the repairs are added to Class 1 in Schedule 8 as the repairs improved the building beyond its original condition and are capital in nature. Canco adds the $100,000 book expense to income for tax purposes on Line 206 of Schedule 1. The opening UCC balance with respect to the building is equal to the opening NBV of the building; $1,000,000. For the period, $42,000 of depreciation is claimed for book purposes and $42,000 of CCA is claimed for tax purposes such that the net Schedule 1 adjustment with respect to depreciation is nil. Canco records a deferred tax recovery for the period of $25,000 with respect to the capitalized costs:

A. Tax base (UCC) at end of period (Sch. 8)	B. NBV of fixed assets at end of period (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
$1,058,000	$958,000	$100,000	$25,000	Nil	$25,000

Notes:

$100,000 Capitalized Expenses x 25% = $25,000
$1,000,000 Opening UCC + $100,000 Additions - $42,000 CCA = $1,058,000 Closing UCC
$1,000,000 Opening NBV - $42,000 Depreciation = $958,000 Closing NBV

¶2205 Capital Leases

In respect of a lease recorded as a capital lease for book purposes, actual lease payments made in the year should be deducted from income for tax purposes on Schedule 1. For tax purposes, the legal form of the transaction (i.e., an operating lease) is respected.

For book purposes, the recognition of a capital lease (Dr Capital asset, Cr Capital lease obligation) is based on substance over form principles. Generally, for book purposes, a capital lease is considered to have the economic character of asset ownership and the lease obligation is treated as a long-term debt. For tax purposes, whether a transaction is a lease or a sale is based on the legal relationships created by the terms of the particular agreement, rather than on any attempt to ascertain the underlying economic reality; normally, it should be clear whether a transaction constitutes a lease or a sale. For tax purposes, whether a transaction is a lease or a sale is based on the legal relationships created by the terms of the particular agreement, rather than on any attempt to ascertain the underlying economic reality.

Depreciation in respect of the capital asset recognized for book purposes (i.e. the leased asset) should be added to income for tax purposes on Schedule 1 (see ¶2300). Also, a notional interest expense is deducted from book income each year in respect of a capital lease. The notional interest deduction is based on the

SAMPLE

interest rate implicit in the terms of the lease (when lease payments are made, the book entry is: Dr Capital lease obligation, Dr Interest expense, Cr Cash). The notional interest charge is not deductible and should be add to income for tax purposes on Schedule 1.

See also under ¶2505 (Lease Payments).

ITA 9(1), ITTN-21, *Buck Consultants Ltd.*, [2000] 1 C.T.C. 93 (FCA), VDs 2008-0303651E5, 2001-0064675

Tax Provision Note: Normally, lease payments deducted from income for tax purposes in excess of depreciation of the capitalized asset and imputed interest costs added to income for tax purposes is a timing difference (see ¶15220). The carrying value of the capital lease obligation liability reported on the balance sheet at the end of the period is a deductible temporary difference (i.e., as future lease payments are deductible) while the NBV of the capitalized asset is a taxable temporary difference (i.e., as depreciation of the asset is not deductible).

¶2207 Capital Taxes

Provincial capital taxes are deductible in computing federal income for tax purposes.

For book purposes, if provincial capital taxes are classified as income taxes and are included in the amount added to income for tax purposes on Line 101 of Schedule 1, the provincial capital taxes should be deducted on a separate line on Schedule 1. If provincial capital taxes are deducted from book income and are not classified with income taxes, a separate Schedule 1 adjustment is not required (i.e., as the taxes have already been deducted from income).

Provincial capital taxes have been, or shortly will be, phased out. Manitoba's capital tax was eliminated effective January 1, 2011; Nova Scotia's capital tax will be eliminated effective July 1, 2012; Ontario's capital tax was eliminated effective July 1, 2010; Quebec's capital tax was eliminated effective January 1, 2011; and New Brunswick tax on large corporations was eliminated effective January 1, 2009. However, Newfoundland and Labrador continues to impose a capital tax on financial institutions (see ¶11180).

The CRA considers the Ontario Special Additional Tax on Life Insurance Corporations (see ¶11425) to be a capital tax which is deductible from income for tax purposes. In VD 2011-0395011E5, the CRA states:

> In our view, the SAT is a "capital tax" and not an income tax. The SAT is based on a corporation's taxable paid-up capital and is payable by a life insurance corporation regardless of whether the corporation is earning profits or operating at a loss in a particular taxation year. In the absence of a specific prohibition in the *Income Tax Act* to the contrary, provincial capital taxes have been considered to be expenditures incurred for the purpose of gaining or producing income from a business or property and therefore deductible in computing income for federal income tax purposes. The fact that the SAT payable by a life insurance corporation in a particular year may be used to reduce the amount of Ontario income tax payable by the life insurance corporation in a subsequent year does not, in our view, alter the nature of the SAT.

See also ¶2445 (Income Taxes)

ITA 9(1), VD 2009-0326941I7, 2011-0395011E5

Tax Provision Note: Provincial capital taxes are not an income tax and should not be classified as such for book purposes.

SAMPLE

¶2210 Carrying Charges

Carrying charges relating to a corporation's investment portfolio, such as interest and safekeeping charges, are deductible in computing the income derived therefrom. Safety deposit box rentals are also deductible.

Fees paid to trustees for the active management of a security portfolio, involving the making of buy and sell decisions, are deductible except to the extent permitted by ITA 20(1)(bb); see ¶2485 (Investment Counsel Fees).

Carrying charges and interest that relate to securities the income from which is exempt are prohibited from deduction.

See also ¶2495 (Land Carrying Charges).

ITA 18(1)(a), (c), 20(1)(c), VD 2010-0381561E5

¶2220 Club Dues and Green Fees (Sch. 1: Line 120)

Other than in respect of meals and entertainment expenses (see under ¶2530), there is no general prohibition against deducting reasonable expenses for business entertaining. However, ITA 18(1)(l) denies the deductibility of expenses incurred for the entertainment of clients or employees if the expense relates to the use of a yacht, camp, lodge, golf course, or facility. Also, club dues are not deductible when their main purpose is to provide “dining”, “recreational”, or “sporting” facilities.

Unlike meals and entertainment expenses, 100% of the deduction for recreation club dues and green fees is denied.

It is a question of fact whether the main purpose of a particular club is to provide dining, recreational, or sporting facilities for its members. Generally, the CRA considers ITA 18(1)(l)(ii) to apply to deny a deduction unless it can be factually established that it is not the main purpose of a club, such as a business social club, to provide dining, recreational, or sporting facilities for its members.

In paragraph 4 of IT-148R3: *Recreational Properties and Club Dues*, the CRA states “[e]xpenses incurred for food and beverages at a restaurant, dining room, banquet hall or conference room of a golf club are not subject to paragraph 18(1)(l), provided there is a genuine business purpose to the use of the facilities and the expenses are not incurred in conjunction with a game of golf or other recreational activity at the golf club”. The latter costs would be subject to the regular 50% deduction limit applicable to meals and entertainment.

Annual membership fees in professional associations and societies (such as medical, legal, accounting, architectural, and engineering professional associations) are deductible in the computation of income from the professional practice.

Lump-sum life-membership fees paid in lieu of future annual fees or dues are considered deductible if they replace annual fees that would be deductible. Lump-sum fees may be deducted in the year paid.

In paragraph 5 of IT-211R: *Membership Dues — Associations and Societies*, the CRA states initiation or admission fees paid to an organization (e.g., for call to the bar or for membership in a professional accounting institute) are eligible capital expenditures (see ¶5305) where it can be shown that the annual

SAMPLE

membership fees of the organization are allowable deductions in computing income of a business; otherwise, such fees are a non-deductible capital outlay.

ITA 18(1)(l), (b), *Jaddco Anderson Limited*, [1984] C.T.C. 137 (FCA), *Daley*, [1950] C.T.C. 254 (Exct.), IT-148R3, IT-211R, ITTN-12, VDs 2007-0236851E5, 2007-0226111I7, 2003-0029025

Tax Provision Note: Non-deductible club dues and green fees added to income for tax purposes are a permanent difference that increases the effective tax rate of the corporation (¶15420).

¶2225 Commodity Futures

See Chapter 4 under "Adventure or Concern in the Nature of Trade".

¶2230 Contingent Liabilities (Sch. 1: Line 126; Sch. 13)

ITA 18(1)(e) denies a deduction for amounts transferred or credited to a reserve, contingent account, or sinking fund except as expressly permitted by the ITA. In more general terms, unless specifically permitted under a provision of the ITA, for tax purposes, no amount as or on account of a reserve or contingent liability (i.e., an obligation that may arise out of present circumstances providing certain developments occur) is deductible in computing taxable income simply on the ground that it may be dictated by good accounting practice governing the determination of a corporation's "profit" under ITA 9(1). Examples of non-deductible contingent liabilities or reserves may include a liability accrued for the expected settlement of a legal suit or a reserve for anticipated site reclamation costs (with respect to site reclamation costs, see also ¶2595).

A distinction must be made between a reserve that would be prohibited by ITA 18(1)(e) and an amount that represents a real subsisting liability for goods or services contracted for, for the purpose of gaining or producing income from the corporation's business. For example, in *No 297* (1955), 14 Tax A.B.C. 100 (TAB), the Court held that a so-called "Reserve for Employees' Bonuses" recorded in the books was not a reserve set aside as a provision against the happening of a future uncertain event but a definite liability of the employer. In the case, the employer had agreed to set aside a fund at the end of each year of a portion of its profits for payment to its officers and employees as bonuses to be paid in the following year. On the other hand, similar accrued bonuses in *Kerr Farms Ltd*, [1971] Tax A.B.C. 804, were not considered deductible until the year in which they were paid because there was no legal obligation to make the payment until certain conditions were fulfilled. Similarly, accrued management salaries in *Supreme Mechanical Contractors Ltd v MNR*, [1971] Tax A.B.C. 202, were considered tantamount to a "reserve" not permitted under the predecessor to ITA 18(1)(e). In paragraph 9 of IT-215R, the CRA states:

> In order that an expense which is unpaid at the end of a taxation year may be deductible for tax purposes, the liability so created in respect of that expense must constitute a genuine liability of the taxpayer in that taxation year. In order for a genuine liability to exist, there must be an enforceable claim by the creditor for an ascertained amount. More generally, an amount which is due and payable at the end of a taxation year can only constitute an allowable deduction in the year in which it becomes ascertained and unconditional. For example, the credit notes issued by an automobile dealer to its customers for their used cars, which credit notes could be used later in the purchase of a car, represent a liability incurred for the purchase of stock-in-trade rather than a contingent reserve. However, a contractor's "holdbacks" payable to sub-contractors on completion of contracts are contingent accounts and a deduction is not permitted. Some examples of reserves are given below.

Credit notes given to customers by an automobile dealer to apply towards the subsequent purchase of a car were held to represent a subsisting liability incurred by the dealer on the advance purchase of the

SAMPLE

customer's old car rather than a contingent reserve as contended by the CRA in *Time Motors Ltd*, [1969] C.T.C. 190 (SCC).

In *Lakehead Newsprint Limited*, [1986] 1 C.T.C. 2442 (TCC), an amount representing retroactive wage increases established by collective bargaining was held not to be deductible in the taxation year in which agreement in principle was reached as there was no legal obligation at the end of the year to pay the amount. For book purposes, a liability was considered to have been incurred.

In *General Motors of Canada Ltd.*, [2004] 1 C.T.C. 2999 (TCC), the collective agreement between the General Motors and the CAW stated that for each overtime hour worked by employees in excess of 5% of straight time hours, the taxpayer would accrue a specified sum to the "Special Canadian Contingency Fund". This fund was to be used for specific or general purposes as agreed to between the union and General Motors. Deductions in respect of amounts accrued to the fund were disallowed by the CRA on the basis that the fund was a contingent liability. In finding in favour of the CRA, the Court agreed that any obligation on General Motors to pay an amount of the fund was a contingent obligation. The Court's conclusion was largely based on the fund's governing rules which stated that no amounts were to be paid out unless a specific funding threshold had been met and that the fund would be "utilized primarily in support of . . . [certain listed programs and plans] . . . , and then only if needed".

In *Fédération des caisses populaires Desjardins de Montréal & de l'ouest-de-Québec*, [2002] 2 C.T.C. 1 (FCA), the Court held that vacation pay earned by employees in the taxation year was deductible in that year even though it was not actually paid until subsequent years. The Court noted that once the vacation pay was earned, the legal obligation to make the employer contributions came into effect.

In paragraph 10 of IT-215R, the CRA states:

> If an employer had incurred a liability for salaries, wages or bonuses at the end of a fiscal period, the amounts accrued payable and ascertained in that period because of that liability would, subject to subsection 78(4) (see the current version of IT-109), be deductible under paragraph 18(1)(a) and would not be a reserve. For the said amounts to be deductible, the employer must not have a discretion as to the total amount to be paid to its employees and these employees must not be obliged to fulfil conditions in order to receive the said salaries, wages or bonuses. On the other hand, if at the end of the fiscal period, the employer had not incurred the liability for the salaries, wages or bonuses, it is considered that these amounts constitute a non-deductible reserve under paragraph 18(1)(e).

In *Harlequin Enterprises Ltd*, [1977] C.T.C. 208 (FCA), the Court held that books published by the corporation and delivered to wholesalers had been "sold" to them, though returnable, and had not been delivered on a "sale or return" basis as in *Sinnott News Co Ltd*, [1956] C.T.C. 81 (SCC). The corporation appealed against the disallowance of a reserve for refunds to be made on estimated returns; however, the Court upheld the disallowance of the reserve finding that the reserve was of a contingent nature. In paragraph 13 of IT-215R, the CRA states:

> Where goods are sold otherwise than on consignment or on "sale or return", any provision for possible returns of goods not sold by a customer to a third party would involve a contingency and this would constitute a non-deductible reserve pursuant to paragraph 18(1)(e), even if the customer has a contractual right to return unsold goods. Where goods are delivered on consignment or on "sale or return", income therefrom need not be recognized unless and until title has passed from the taxpayer. However, where in these circumstances the taxpayer recognizes income at the time of delivery, the Department considers that the taxpayer may claim a reasonable deduction for goods expected to be returned.

SAMPLE

Furthermore, in VD 2002-0129813, the CRA states:

> The issue of whether an amount could be excluded from income with respect to goods sold to customers, with a right of return, was dealt with by the courts in two leading cases. The Supreme Court considered the matter in the case of *Sinnott News Company Ltd. v. MNR*, [1956] C.T.C. 81, 56 D.T.C. 1047. In this case, the appellant was a wholesaler that sold magazines to retailers. The retailers had the right to return periodicals that they did not wish to retain. The company sought to deduct a reserve for the magazines expected to be returned. The Court found that, being deliveries on sale or return, Rule 4 of section 19 of the *Ontario Sale of Goods Act* applied, and that title to the goods did not pass to the retailers, nor were they liable to pay for the goods delivered, other than for goods sold by them or not returned within the agreed period. While the Court agreed that a reserve for goods expected to be returned could not be claimed, the same result was achieved by the appellant. The Court ruled that the appellant's taxable income be restated by deleting from revenue the accounts receivable that had been set up in respect of the goods subject to sale or return remaining in the hands of the retailers at the appellant's fiscal year end.
>
> The second case, heard by the Federal Court of Appeal, was *Harlequin Enterprises Limited v. M.N.R*, [1977] C.T.C. 208, 77 D.T.C. 6634. Harlequin published paperback novels, which it marketed throughout Canada and the United States. In Canada, the marketing was done by a distributor, whereby the distributor became owner of the books upon delivery but would be entitled to claim full credit for the books returned unsold. In the U.S., the distributor was given a licence to print the books and was required to pay royalties on the net sales to Harlequin. Harlequin was legally liable to give the U.S. distributor full credit for unsaleable books. Harlequin claimed a reserve for expected returns of unsold books, which was disallowed by the [CRA]. The Federal Court of Appeal affirmed the Trial Division's ruling that no reserve could be claimed. While the company was obliged to give credits for the unsaleable books there was no liability to do so until the books were returned. The liability was, therefore contingent and the amounts set aside to pay the credits were a contingent account and not deductible pursuant to paragraph 12(1)(e) of the former Act. The case was distinguished from *Sinnott News* in that title to the goods had passed to the distributor when the books were delivered, and were therefore properly included in sales.
>
> In our view, it is clear from the judgments in the *Sinnott News* and *Harlequin* cases that proceeds from the sale of goods can only be excluded from revenue when they are sold on consignment, or on a true "sale or return" basis where title to the goods does not pass to the buyer, and there is no liability to pay for the products, until the goods are either sold by the buyer, or a certain period of time has expired.
>
> Our position in this regard, is set out in Interpretation Bulletin IT-170R—*Sale of Property-When Included in Income Computation*. Paragraph 5 states that the sale price of property sold should be included in income when the vendor has an absolute, but not necessarily immediate, right to be paid. The bulletin goes on to say in paragraph 19 that where goods are reacquired (unless section 79 applies), this reacquisition does not retroactively nullify the effects of the original disposition for income tax purposes, even if the agreement restores the vendor and purchaser to their relative positions before the sale took place.

The CRA's position is that a reserve cannot be claimed in respect of potential warranty or maintenance expenses in accordance with acceptable income computation principles under ITA 9(1). For example, in VD 2001-0110895, the taxpayer noted:

> Under most software maintenance agreements, the taxpayer can usually demonstrate that software code fixes, updates, or upgrades will be provided; the only question is the timing of the service or

SAMPLE

> upgrade. Similarly, most equipment maintenance agreements include a clause requiring the vendor to provide preventive or routine maintenance on a predetermined schedule in order to ensure that the customer's business operations continue in an uninterrupted fashion. Preventive maintenance schedules for equipment are generally based on the passage of time, level of usage, historical failure rates, or some combination of these variables. It is not certain that, during those visits, preventive or routine maintenance will be required. Most software maintenance agreements generally do not provide for scheduled releases of upgrades, updates, or code fixes. Rather, these services are provided on an "as required basis".
>
> In contrast with the tax treatment, Canadian GAAP requires the revenue from these agreements to be deferred and included in income over the period of the contract.

The CRA was asked whether it would permit the taxpayer to prorate the payments received, based on the length of the maintenance contract, and include in income only the portion of the payments that relates to the contract period that pertains to the current taxation year. The CRA did not accept the taxpayer's suggested approach, stating in VD 2001-0110895:

> Subsection 9(1) provides that a taxpayer's income from a business or property is the profit from that business or property subject to the rules in Part I of the Act. The Canadian GAAP are often viewed as a reference for the profit, subject to other tax rules. In [*Foothills Pipe Lines (Yukon) Ltd.*, [1990] 2 C.T.C. 448, *Westcoast Petroleum Ltd.*, [1989] 1 C.T.C. 363, and *Burrard Yarrows Corporation*, [1986] 2 C.T.C. 313], the courts found that amounts received in advance were income for the purposes of section 9 based on the principle that if a taxpayer has a right to an amount, absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment, the amount received in advance would be considered as having been earned in the year of the receipt. In determining whether a payment received in advance should be included in income under the basic principles of determining income from a business or property for the purposes of subsection 9(1), a thorough review of all agreements or contracts must be made. This review would generally reveal whether paragraph 12(1)(a) applies or whether subsection 9(1) applies because the amount can be considered as having been earned in the year of the receipt.
>
> In particular, subparagraph 12(1)(a)(i) states that there shall be included in computing the income of a taxpayer for a taxation year:
>
> > (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 earned in the year or a previous year, or
> > >
> > > (ii).....
>
> In the present situation, while some services could be viewed as not rendered before the end of the year, it is unclear whether the amount received by the vendor has not been earned in the year of the receipt. If the vendor has a right to an amount, absolute and under no restriction as mentioned in the above court decisions, section 9 would apply because the amount would be considered earned and subparagraph 12(1)(a)(i) could not apply.
>
> If we assume that section 9 applies, it is the [CRA's] view that receipt of maintenance agreement fees creates contingent obligations for the vendor. Due to the contingent nature of obligations, paragraph

SAMPLE

> 18(1)(e) would apply to disallow any reserve in respect of the fees included in income unless expressly permitted.
>
> If the amount received is included in income under subparagraph 12(1)(a)(i), subparagraph 20(1)(m)(ii) expressly permits a reasonable amount as a reserve in respect of:
>
> > (ii) services that it is reasonably anticipated will have to be rendered after the end of the year,
>
> However, subsection 20(7) states that paragraph 20(1)(m) does not apply to allow a deduction as a reserve in respect of guarantees, indemnities or warranties. In our view, maintenance agreements for software and hardware would be considered as a form of indemnity provided to the purchasers to secure them against certain repair costs or costs of acquiring any updates.
>
> This view is based on *Sears Canada Inc. v. Her Majesty The Queen*, [1986] 2 C.T.C. 80, 86 D.T.C. 6304; upheld at the FCA [1989] 1 C.T.C. 127, 89 D.T.C. 5039, in which the court found that the Sears maintenance agreement for appliances should be characterized as indemnities to secure customers against maintenance and repair.
>
> In view of the above, the [CRA] would not allow taxpayers to prorate the receipt of maintenance agreement fees, based on the length of the maintenance contract since no reserve can be taken in respect of a portion of the amount included in income under subparagraph 12(1)(a)(i) because of the combined effects of subsection 20(7) and paragraph 20(1)(m) considering the indemnity nature of the maintenance contract. Alternatively, if the amount received is included in income under section 9, paragraph 18(1)(e) would not permit a reserve because of the contingent nature of the obligation.

Further to the above, in VD 2000-0034027, when asked whether a taxpayer is entitled to a reserve under ITA 20(1)(m)(i) for the cost of merchandise it anticipates will have to be delivered after the end of the year on the redemption of its customers' reward points in its promotional program, the CRA responded as follows:

> While we agree that the Taxpayer may not claim a 20(1)(m)(i) reserve in respect of reward points since this paragraph indicates that the reserve is only available for amounts that have been included in computing the taxpayer's income from a business in the year or in a previous year under in paragraph 12(1)(a), we are inclined to the view this item may give rise to a deductible expense in computing the Taxpayer's profit for the year under subsection 9(1) of the Act.
>
> Based on the relevant caselaw, the fact that the Taxpayer's liability in respect of unredeemed reward points is based on an estimate does not make the liability a contingent one. Further, the fact that the customer has the option of redeeming the reward points or not redeeming them does not change the nature of the liability. Accordingly, it is our view that paragraph 18(1)(e) does not apply to deny the deduction of a reserve for unredeemed reward points on credit sales. Finally, in accordance with the principles set out by the Supreme Court in *Canderel Limited*, a taxpayer is free to adopt any method for computing profit which is consistent with the provisions of the *Income Tax Act*, established case law principles or "rules of law," and well-accepted business principles.

In forming its conclusion, the CRA referred to the decisions in *Time Motors Limited*, *Féderation Des Caisses Populaires*, *Canadian Pacific Limited*, [2000] 2 C.T.C. 331 (Court of Appeal for Ontario) (the Court denied a deduction for estimated Workmen's Compensation Board reimbursement payments), and *Newfoundland Light and Power*, [1990] 1 C.T.C. 229 (FCA) (uncertified holdbacks from payments for contractors' work were held to be contingent liabilities).

SAMPLE

See also ¶2435 (Holdbacks) and ¶2643 (allowable reserve in respect of undelivered goods and services not rendered).

ITA 18(1)(e), *Industries Perron*, 2011 CarswellNat 4044 (TCC, under appeal at time of writing), *McLarty*, [2008] 4 C.T.C. 221 (SCC), *Wawang Forest Products Ltd*., [2001] 2 C.T.C. 233 (FCA), *Sears Canada Inc*, [1989] 1 C.T.C. 127 (FCA), *Amesbury Distributors Ltd*, [1984] C.T.C. 667 (FCTD), *Cummings*, [1981] C.T.C. 285 (FCA), *Canada Packers Ltd*, [1968] Tax A.B.C. 847, *Quebec Photo Service Inc et al*, [1967] Tax A.B.C. 425, *Acadia Overseas Freighters Ltd* (1962), 28 Tax A.B.C. 331, *Atlantic Engine Rebuilders Ltd*, [1967] C.T.C. 230 (SCC), IT-215R (archived): *Reserves, Contingent Accounts and Sinking Funds*, VDs 2008-0289021E5, 2003-0048241E5, 2002-0164607, 2001-0097223, 9528445, 9506157, 9424657, Perry Truster, "Contingent Liabilities Revisited" (2008) vol. 8, no. 3 *Tax for the Owner-Manager*, 2, Clark Hollands, CA and Ada Lam, CA, "Contingent Liabilities Assumed on Purchase of Business Assets: Reconciling Tax Law with Economic Reality," 2004 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2004), 2:1-28

Tax Provision Note: Provided a deduction will be available when (or if) an amount is paid in respect of a contingent liability, an amount added to income for tax purposes in respect of a contingent liability is a timing difference that does not increase the effective tax rate of the corporation (see ¶15220, ¶15500). The deductible temporary difference is equal to the balance of the contingent liability at the end of the period reported on the financial statements in respect of which an amount has not been deducted for tax purposes.

For example, Canco accrues a $100,000 liability in the period in respect of a potential law suit settlement ($100,000 is management's best estimate of the settlement cost). Canco adds the $100,000 to income for tax purposes on Line 126 of Schedule 1 and records a deferred tax recovery for the period of $25,000 (if the lawsuit is settled, the full amount paid will be deductible by Canco):

A. Tax base of contingent liability	Contingent liability at end of period (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
Nil	($100,000)	$100,000	$25,000	Nil	$25,000

¶2231 Limit for Contingent Amounts

Proposed ITA 143.4 generally reduces the amount of a corporation's expenditure that is otherwise deductible from income for tax purposes or that otherwise forms part of a capital property to the corporation if the corporation has a right to reduce or eliminate the amount that the corporation is required to pay in respect of the expenditure. The proposed provision is a response to the decision in *Collins* [2010] 3 C.T.C. 100 (FCA), in which the Court held that the taxpayers could deduct interest expenses as they accrued even though the taxpayers' had a right to reduce the amount payable in respect of the interest expenses at the end of the particular agreement. The Court found that the interest amounts payable were not contingent but rather, the issue was whether the taxpayers might exercise a settlement option in the particular loan agreements which would eliminate the need to make the interest payments. The Court stated (paras. 24, 25):

> In this case the appellants are accrual basis taxpayers. Therefore, they are entitled to deduct interest as it accrues, regardless of the date on which payment is due. The appellants correctly claimed deductions for interest accrued at the rate of 10% per year as stipulated in paragraph 6(ii) of the Amending Agreement. They are entitled to that deduction even though they were not obliged to pay the full amount of the interest in the year of accrual, and even though the lender would be obliged, if the appellants exercised the settlement option, to forgive most of the obligation to pay principal and interest.

SAMPLE

> The situation is analogous to that of a limited recourse mortgage loan, where the right of the lender to recover the principal and interest is limited to the proceeds of sale of the mortgaged property at the end of the term. Even if it is absolutely certain that the value of the property will not cover the mortgage debt, the full amount of the debt remains a legal obligation of the borrower unless and until the mortgaged property is sold (see, for example, *McLarty v. R.*, [2008] 2 S.C.R. 79, 2008 SCC 26 (S.C.C.)).

A "right to reduce" an expenditure is broadly defined in proposed ITA 143.4(1) as a right to reduce or eliminate an amount, including a right that is contingent upon the occurrence of an event, or in any other way, but only if it is reasonable to conclude, having regard to all the circumstances, that the right will become exercisable. Proposed ITA 143.4(2) overlaps with ITA 18(1)(e) discussed above; however, ITA 143.4 is broader in that it applies to a "right to reduce" an expenditure. Also, the proposed rule applies to any expenditure whereas ITA 18(1)(e) only applies in computing the income of a taxpayer from a business or property.

The CBA/CICA Joint Committee on Taxation raised concerns with respect to the overly broad draft definition of a "right to reduce" in a submission to the Department of Finance dated 2011-11-07 (available on *Taxnet Pro*). The Joint Committee highlighted that the rules may apply to legitimate commercial arrangements that contain standard adjustment provisions. Also, the Joint Committee noted that the proposed rules would be difficult to apply in practice (the definition requires a taxpayer to determine "if it is reasonable to conclude, having regard to all the circumstances, that the right will become exercisable").

Hayley J. Brown, "Draft Legislation on Deduction for Contingent Amounts," *Canadian Tax Focus*, Vo 2, No. 1, Feb. 2012

¶2235 Contract Cancellation Payments

A payment received as consideration for the cancellation of a contract, if in the nature of damages, is not included in income for tax purposes (where a contract damage payment that is not taxable has been included in book income, the amount should be deducted from income for tax purposes on Schedule 1). However, if a contract termination payment is intended to compensate for profits that would have accrued under the contract, the payment is normally considered income from the business for tax purposes. Alternatively, a contract cancellation payment is generally considered to be a capital receipt if it relates to the loss of a capital asset. In such a case, the amount included in book income should be deducted on Schedule 1 and the proceeds of disposition should be reported on Schedule 6. A contract cancelation payment may also be considered an eligible capital amount in certain circumstances and included in income under ITA 14 (see T2 Sch. 10 and ¶5310).

The nature of a contract termination payment is sometimes difficult to determine. Whether a contract termination payment is on capital or income account is discussed in VD 2004-0071951I7, in which the CRA states:

> The general rule is that compensation received for the cancellation of a trade contract is on income account. However, it is clear that in appropriate circumstances compensation paid for the cancellation of a trade contract may be a capital receipt. Those circumstances, noted in *T. Eaton Company Limited v. The Queen*, [1999] 2 C.T.C. 380, 99 D.T.C. 5178 (FCA), as the "Fleming exception", are where the cancellation of a contract destroys or materially cripples the whole structure of the recipient's business…
>
> In *T. Eaton Company Limited*, the taxpayer received a payment for the cancellation of a participation clause in its lease. The court ruled that the cancellation of the participation clause had the effect of

SAMPLE

> reducing the value of the leasehold interest. The participation clause was not only an integral component of the lease, but it also profoundly affected the value of a capital asset, namely, a leasehold estate in land. Therefore, the compensation paid for the diminution in value of the leasehold interest, a capital asset, was on capital account.
>
> In *BP Canada Energy Resources Co.*, the taxpayer had entered into long-term contracts wherein natural gas was supplied indirectly to customers in California. These contracts formed a significant part of the structure of the appellant's business. Under the terms of these contracts, certain reserves on particular fields were dedicated to particular contracts. The contract termination payments were not merely for the cancellation of a supply agreement. The payments were an aspect of the entire decontracting arrangements that involved a major restructuring of a significant part of the appellant's business. The Court found that the dedication of the gas reserves on the lands to particular contracts affected the value of the associated contracts and, reciprocally, the commitment of the contracts to particular fields affected the value of these lands, which were obviously capital assets. Put more simply, the lands were an integral part of the contracts. Similar to the analogy of the effect of the participation clause on the leasehold interest in *T. Eaton Company Limited* discussed above, the cancellation of the contracts reduced the value of the associated capital assets, the lands. Further, the Court found that the payments made to the appellant were not based on the income that the appellant expected to receive from the contracts, and were not made to compensate for a loss of a "stream of income"….
>
> It is our general view that when the method used to calculate the termination payment is based on lost future profits, and the taxpayer is able to obtain another supplier and continue to carry on business, then it is reasonable to conclude that the compensation received for the cancellation of the contract should be included in computing income.

A payment received by an agent as compensation for the cancellation of the agency agreement is a capital receipt when the agency constitutes the whole or main part of the recipient's business. However, it is an income receipt when the agency was only one of several and its termination did not seriously impact the recipient's business as a whole.

In respect of the payor, payments for the cancellation of trading contracts will in most cases be regarded as permissible deductions in computing income for tax purposes.

As discussed under ¶2505, an amount paid or payable by a landlord to a tenant for the cancellation of their lease is deductible under ITA 20(1)(z) or (z.1) (see also ITA 18(1)(q)).

The treatment of break fees in the context of mergers and acquisitions is discussed under ¶2512.

See also ¶2265 (Damages).

ITA 9(1), 18(1)(a), (b), 67, IT-365R2, IT-461, *Van den Berghs v. Clark*, 19 T.C. 390, *National Paving Co.*, [1955] C.T.C. 353, *Parsons-Steiner Ltd.*, [1962] C.T.C. 231 (Ex ct), *Avco of Canada Ltd*, 16 Tax A.B.C. 144, *James Vernor Co*, 3 Tax A.B.C. 146, *Bomag (Canada) Limited*, [1984] C.T.C. 378 (FCA), *Anglo-Persian Oil Company v Dale*, 16 T.C. 253, VD 2011-0429691I7

Tax Provision Note: If a contract termination payment is considered a capital receipt, the 50% non-taxable portion of the capital gain recognized for tax purposes is a permanent difference that reduces the effective tax rate of the corporation (¶15420).

¶2240 Contractors' Completion Method (Sch. 1: Lines 316, 238)

SAMPLE

In respect of contractors, generally, where a construction project may reasonably be expected to be completed within two years from the date of commencement, under the CRA's administrative policies, revenue (including holdbacks) may be deferred and included in taxable income in the year in which the work is physically completed. Normally, the CRA will accept the date the final engineer's or architect's certificate is issued as the date of physical completion. Additions to a job requiring extra work to be performed that will postpone completion of the job from one taxation year to a later one should be treated as a separate contract.

In IT-92R2: *Income of Contractors*, the CRA states a contractor that chooses to adopt the completion method is required to do so in respect of all short-term contracts and is required to use the same method consistently from year to year. Also, where the completed contract method is used, a contractor is required to defer to the year in which a short-term contract is completed all the direct costs of that contract incurred in a previous year. Furthermore, under the completion method, a loss on a short-term contract is taken into account only in computing the income of the year in which the contract is physically completed.

The deferment of income in respect of short-term contracts was held to have no legal basis in the cases *Wilson*, [1960] C.T.C. 1 (Exch) and *J. Colford Contracting Co.*, [1960] C.T.C. 178 (Exch); [1962] C.T.C. 546 (SCC). Notwithstanding case law, however, in view of the practical difficulties involved, the CRA continues to accept the completed contract method in the case of short-term contracts.

The amount deducted from Schedule 1 in computing taxable income in the prior taxation year in accordance with the completed contract method is required to be added to income for tax purposes on Line 238 of Schedule 1 in the subsequent year (i.e., as the revenue has not yet been recognized for tax purposes but was included in book income in the prior year). Any new reserve claimable at the end of the year should be deducted from income for tax purpose on Line 316 of Schedule 1.

Other considerations in respect of the contractor’s completion method include:

- It is acceptable for a contractor to include all amounts that have been billed to a purchaser in income, including holdbacks that are not receivable, but in such a case, the contractor is required to report the income on this basis consistently from year-to-year;

- A non-arm's length relationship between two taxpayers does not necessarily affect a taxpayer's ability to exclude holdbacks receivable in computing taxable income as described in paragraph 3 of IT-92R2;

- A corporation that processes data to create survey maps to sell would not meet the definition of a contractor under IT-92R2. Also, the construction of electrical power substations and transmission lines would likely not fall within the scope of the CRA’s administrative positions set forth in IT-92R2;

- An amount received by a contractor for selling or assigning a contract to another contractor is considered an income receipt. Similarly, the purchase price is considered a deductible expense to the purchaser when incurred;

- Where a contractor is required to post security to guarantee performance of a contract, any increase or decrease in the market value of the security during the period of the contract is considered a capital gain or loss and is not included in computing the profit or loss from the contract.

ITA 9(1), 20(1)(m), IT-92R2, VDs 2007-0228811E5, 2002-0158335, 2004-0069261E5

SAMPLE

Tax Provision Note: An amount deducted from income for tax purposes in respect of the use of the completed contract method is a timing difference that does not decrease the effective tax rate of the corporation (see ¶15220). The taxable temporary difference is equal to the amount required to be added to income for tax purposes in the following year (i.e. the closing balance of the reserve). Completed contract reserves added to income for tax purposes in the current year reverse the taxable temporary difference outstanding at the end of the prior year. See the example under ¶2630 with respect to instalment sale reserves claimed for tax purposes (the same principles apply).

¶2245 Convention and Training Expenses

A corporation that sends officers or employees to attend a convention related to its line of business can deduct the expense provided they are reasonable (see ¶2025).

ITA 20(10) grants a taxpayer the right to deduct expenses incurred in attending as many as two conventions each year, provided that they relate to the taxpayer's business or profession and are located within the territorial scope of its interests. In IT-131R2: *Convention Expenses*, the CRA states (paras. 9–11)

> The provisions of subsection 20(10) apply to corporations as well as to individual taxpayers and, where the rules of a particular convention allow a corporation to register at the convention quite independently of who its officers may be, a corporation can "attend" a convention through one or more of its agents or employees. A corporation generally will be subject to the usual limitation of two conventions per year in connection with its business but may send more than one representative to each.
>
> However, a corporation which has diversified business interests and many employees may take the limit of two conventions per year to apply to each such interest. For example, a large integrated oil company might be interested in conventions of personnel people, accountants, chemists, geologists, and other groupings and the limit would be applicable separately to each.
>
> Intracompany meetings, seminars, courses, etc., will not be regarded as conventions as far as employees of the company and its parent, subsidiary or associated companies are concerned but the rule of reasonableness in section 67 will still apply both to the amounts and the locale. The employees of an association organizing a convention would be considered as attending an intracompany meeting. Additional details in this respect may be found in the current version of IT-357, *Expenses of Training*.

If convention expenses can be justified as incurred for income-earning purposes and are not on account of capital, they should be deductible despite not meeting the requirements of ITA 20(10). ITA 20(10) provides for a permissive deduction notwithstanding ITA 18(1)(b); 18(1)(b) would apply if the convention expenses were capital in nature; see ¶2025. ITA 20(10) was added to the ITA to overrule the decision in *Griffith*, [1956] C.T.C. 47 (Exch.), in which the Court was of the view that the expenses for attending a convention were not incurred with the object of obtaining actual or immediate gain or profit and were thus capital in nature. In *Shaver*, [2004] 2 C.T.C. 2125 (TCC); aff'd [2005] 1 C.T.C. 89, the Court also found that convention expenses were capital in nature; concluding that (paras. 43 and 44):

> [I]t is my understanding from the evidence that although there is a profit-making component involved in attending the seminars in question, the acquisition of new skills and increased knowledge by the attendees forms an integral part of those seminars. The fact that some members may already possess some of those skills is not a bar to classifying the expenses incurred by them as being capital in nature. On this point, I reiterate what the Income Tax Appeal Board said (subsequently confirmed by

SAMPLE

the Exchequer Court of Canada) in *Griffith*, supra, at page 473, before concluding that the expenses at issue there were capital expenditures:

> ...That such is the effect of conventions seems to be acknowledged by the appellant himself who admitted that, although in attending conventions it was not his primary purpose to increase his knowledge, nevertheless he might incidentally have done so, and he recognized that conventions are a medium through which one is kept aware of the progress being made in the field in which one's specialty lies.

I therefore conclude on the first issue of travel expenses that the Minister did not err in treating them as expenses incurred in the course of a "convention" within the meaning of subsection 20(10) of the Act and consequently in limiting such expenses to two conventions per taxation year.

The portion of a convention fee attributable to food, beverages or entertainment is only 50% deductible for tax purposes; see under ¶2530.

A convention is considered a formal meeting of members for professional or business purposes unlike a training course that generally has a classroom format for teaching a subject in accordance with a formal course of study. Training expenses are deductible by a corporation provided they are reasonable. In paragraph 7 IT-357R2, the CRA states:

> An employer may normally deduct expenses incurred in respect of an employee's training, regardless of whether it is the employer or the employee who benefits from the training, provided that such expenses are reasonable in the circumstances (see 5 above). If it is the employee and not the employer who benefits from the training, a taxable benefit under paragraph 6(1)(a) results. Reference should be made to the comments under the heading "Tuition Fees" in the current version of IT-470. A corporate employer may not deduct training costs which have been included in a shareholder's income under subsection 15(1) [see ¶2670].

The CRA does not consider training costs to be deductible in all circumstances. In paragraphs 2–4 of IT-470, the CRA states:

> Where a training or educational course results in a lasting benefit to the taxpayer, the costs incurred in connection with the course are considered to be capital in nature. The deduction of these capital expenditures as current expenses is disallowed by paragraph 18(1)(b); however, where these expenditures were incurred in respect of a business of the taxpayer, they would qualify as "eligible capital expenditures (see the current versions of IT-123 and IT-143). A lasting benefit to the taxpayer is considered to occur where a new skill or qualification for a business is acquired. Thus, training costs incurred by the taxpayer in connection with a course which he or she takes to obtain a credit for a degree, diploma, professional qualification or similar certificate would be considered capital in nature. Where, on the other hand, the taxpayer takes a training course merely to maintain, update or upgrade an already existing skill or qualification with respect to his or her business or profession, expenses incurred in connection with such a course are not considered to be capital in nature and their deduction as current expenses is not disallowed by paragraph 18(1)(b). Thus, for example, costs incurred in connection with a course taken to enable a professional to learn the latest methods of carrying on his or her profession may be allowable, even if the course relates to an area of the profession in which the professional was not previously involved actively though qualified to be so involved.

SAMPLE

> The following are examples of cases where costs of training are considered to be capital expenditures, the deduction of which is disallowed by paragraph 18(1)(b), because the training is taken to acquire a new skill or qualification:
>
> (a) A medical general practitioner is training to qualify as a specialist.
>
> (b) A lawyer is taking an engineering course that is unrelated to his or her legal practice.
>
> (c) A taxpayer is taking a university or other course leading to a degree or other certificate. (Note, however, that costs incurred in connection with a course of the type described in 4 below will not be disallowed merely because the course is conducted at, or under the sponsorship of, a university.)
>
> (d) A professor employed by a university takes a course during a sabbatical (see also comments regarding duration of training in 5 below) in order to acquire a new skill needed for a sideline business.
>
> The following are examples of cases where training expenses are not considered to be capital in nature and thus their deduction as current expenses is not disallowed by paragraph 18(1)(b), because the training is taken merely to maintain, update or upgrade an existing skill or qualification:
>
> (a) A professional development course is taken as required or recommended by a professional body to maintain professional standards.
>
> (b) A tax course is taken by a lawyer or accountant who is qualified to do tax work, whether or not he or she has previously been actively involved in such work.
>
> (c) A course on modern building materials is taken by an architect.
>
> (d) A course on electronic ignitions is taken by the owner of an automobile repair shop.

In *Tiede*, [2011] 3 C.T.C. 2153 (TCC), a photography training course was considered an eligible capital expenditure. However, in *Setchell*, [2006] 2 C.T.C. 2259 (TCC), a 4-week SAP computer training course was allowed as a business expense; at paragraph 22 the Court stated:

> The general principle is that training costs will be deductible as a current expense if they are incurred to maintain, update or upgrade an already existing skill or qualification. This aptly describes Mrs. Setchell's circumstances. In my view, the expenses that Mrs. Setchell incurred to attend the course offered by SAP are not capital.

Article XXV.8 of the Canada-U.S. Tax Treaty provides that expenses incurred by a citizen or resident of a Canada with respect to any convention (including any seminar, meeting, congress or other function of a similar nature) held in the U.S. are deductible to the same extent that such expenses would be deductible if the convention were held in Canada.

ITA 20(10), 67, 67.1(3), 18(1)(h), *Shaver*, [2004] 2 C.T.C. 2125 (TCC); aff'd [2005] 1 C.T.C. 89, *Leduc*, [2008] 5 C.T.C. 2515 (TCC), *Griffith*, [1956] C.T.C. 47 (Exct), IT-131R2, IT-357R2: *Expenses of Training*, VDs 2009-0347581E5 (French), 2008-0295831E5, 2007-0239511M4, 2005-0132981E5, 2004-0087791E5, 2004-0078941E5, 2004-0072821E5

¶2246 Conversion of Property to (or from) Inventory

SAMPLE

The ITA does not specifically address a conversion of income-use property from inventory to capital property or *vice versa*; the CRA sets forth its views on the matter in IT-102R2: *Conversion of Property, Other than Real Property, from or to Inventory* (IT-218R deals with a conversion of real estate from capital property to inventory)

Where capital property is converted to inventory, a disposition is not deemed to take place for tax purposes (IT-102R2: para. 8; IT-218R: para. 15). For the purpose of computing the business profit on a later disposition of that inventory, the fair market value at the date of conversion is considered to be the cost of the inventory. In calculating the capital gain or loss on the sale of the property, the ACB is based on the original cost of the property and not on its fair market value at the date of the conversion. To the extent that the gain has been included in computing the business income of the corporation, the amount included reduces the capital gain on the disposition. To the extent there is a capital loss on the disposition, the amount of the loss is reduced by the business loss, if any, deductible in computing the corporation's income. The CRA recognizes that this procedure may produce anomalous results. As such, a corporation may take the position that a notional disposition of the property took place at the date of the conversion and report a capital gain or capital loss on that basis. Under this option, the amount of the capital gain or loss will be determined at the date of the conversion of the property, and the fair market value of the property at that time will be considered the proceeds of disposition of the property. The amount of the capital gain or capital loss determined will be reported for income tax purposes in the year of the actual disposition of the property.

Where depreciable property is converted to inventory, there is no deemed disposition for tax purposes. The property continues to be depreciable property but ceases to be depreciable property of a prescribed class. Therefore, in calculating the UCC of the particular class at any time after the conversion, the capital cost of the converted property is excluded, which will ordinarily result in recapture of CCA claimed on the property before conversion since the accumulated CCA in respect of the property remains in the calculation. However, a corporation may treat the transaction as if a disposition had taken place. As such, the UCC (instead of being reduced by the capital cost) will be reduced, at the time of conversion, by the lesser of the fair market value of the property at that time (considered the proceeds of disposition) and the capital cost. This may result in a reduction of recapture or the creation of a terminal loss. A notional disposition of this kind has no effect on the amount of the business profit or loss on the disposition of the inventory which is calculated by comparing the fair market value at conversion (the cost) with the proceeds of sale.

Where a corporation is a dealer in a certain type of property (normally automobiles or machinery and equipment), no capital gain is recognized when that property which was acquired for leasing purposes is transferred to inventory.

The property would initially be treated as depreciable property subject to CCA at the appropriate rate. When the property is transferred to inventory, the cost for purposes of computing the trading gain or loss is either the UCC of the property, or the price that would have been paid at that time if the property had been purchased in an arm's-length transaction, depending on the procedure consistently followed by the corporation. This cost is also considered the proceeds of disposition of the depreciable property. Since the date of disposition of the property normally follows quite closely after the date of conversion, for CCA purposes it is acceptable to treat the conversion of the property as the disposition of the property. However, a dealer may prefer to carry the property in inventory from the date of acquisition to the date of disposition. For purposes of valuing the property in inventory, it is generally acceptable to value the property at the amount that would have been its UCC if the property had been classified as depreciable property.

SAMPLE

Where property held in the inventory of a business is converted to a capital property in circumstances where the conversion may be considered permanent, a disposition of the property is not deemed to have taken place at that time for tax purposes. The cost of sales in that year should be reduced by an amount charged to that account in respect of the converted property. Normally this would be the cost of the property but may be market value if the converted property was carried in inventory at market value. The amount by which cost of sales for the year was reduced would be considered the capital cost of the capital property. If the property becomes depreciable property, that amount would be included in the appropriate class for purposes of computing CCA. On the eventual disposition of the property, the normal rules relating to the disposition of capital property would apply.

Where stock-in-trade is transferred temporarily from the corporation's inventory for the purpose of renting the property on a short-term basis, the property may be classed as capital property while it is being rented.

As in the case of a permanent conversion from inventory to capital property, the cost of sales in that year should be reduced by the amount charged to that account in respect of the converted property and that amount is viewed as the capital cost of the capital property. If the property remains on hand at the end of the corporation's fiscal period, CCA at the appropriate rate may be claimed. When the property is sold, the CCA class will be credited with the lower of the capital cost, as determined above, and the selling price of the property. This amount will also be added to the cost of sales for the year in which the property was sold. The selling price will be included in the sales for the year. Any recapture or terminal loss will be calculated in accordance with the ordinary rules. A conversion is generally not considered to have taken place where a property that was purchased primarily for resale is temporarily leased in a business to earn income and the intention of the corporation is always to sell the property in the near future.

In *CAE Inc.*, 2011 CarswellNat 4334 (TCC, under appeal to FCA at time of writing), CAE built flight simulators that were leased before their sale. While they were rented, some of the simulators were treated as depreciable property eligible for CCA. Despite the fact that a contextual analysis of the ITA supports that a gain on a disposition of depreciable property is a capital gain rather than income, the Court found that depreciable property is not necessarily capital property. At paragraph 122, the Court stated:

> The fact that paragraph (b) of the definition of the term "capital property" in section 54 excludes "depreciable property" does not mean that, under the Act, the sale of depreciable property necessarily gives rise to a capital gain [(paragraph (a) of the definition of "capital property" in section 54 of the Act includes "any depreciable property of the taxpayer")]. The Act leaves open the possibility that the sale of an item of depreciable property will give rise to income or a capital gain, depending on the circumstances. In other words, the Act leaves open the possibility that depreciable property will be part of inventory at the time of its sale.

ITA 13(21)(f), 40, 39(1)(a), 1102(1)(b), *Bodine*, 2011 CarswellNat 1502 (FCA) (there was a change of use when a farm property was transferred to a partnership to sell the property), *Jacobson Holdings Ltd.*, [1986] 1 C.T.C. 87 (FCTD), *Sharkey v. Wernher* (1955), 36 TC 275 (British House of Lords); *Pinehill Investments Limited*, [1967] Tax A.B.C. 233, *J. Bert Mac Donald*, [1970] C.T.C. 17, 70 (Exch); *Canadian Kodak Sales Ltd.,* [1954] C.T.C. 375 (Exch), *Dorothy May Hughes*, [1984] C.T.C. 101, IT-102R2: *Conversion of Property, Other than Real Property, from or to Inventory*, VD 2005-0156181I7, 2004-0097181I7, 2002-0149987, 2000-0035017, Daniel Sandler, "Character Rolls: Property Transfers and Characterization Issues," (1996), vol. 44, no. 3 *Canadian Tax Journal*, 605-679, Carl MacArthur, "CAE Inc.: Depreciable Property or Inventory?," *Canadian Tax Highlights*, Vol. 20, No. 3, March 2012

¶2250 Credit Union Interest Bonus Payments (Sch. 1: Line 315; Sch. 17)

The definition of a credit union is discussed under ¶10040 (Credit Unions Deduction). Generally, a credit union is a corporation, association or federation incorporated or organized as a credit union or cooperative

credit society which meets any one of three conditions related to the sources of its revenue or its members.

Generally, a credit union may deduct both "bonus interest payments" and payments made pursuant to "allocations in proportion to borrowing" (commonly referred to as "interest rebates") if made within the year or within 12 months thereafter to members of the credit union.

A "bonus interest payment" is generally an amount credited to a member in the year which is computed on the basis of either the amount of money standing to the member's credit with the credit union or the amount of interest payable to the member thereon. The calculation is required to be made at the same rate as that which is applied to other members of the credit union of the same class. An allocation in proportion to borrowing for a tax year means an amount a credit union credits to a member that is entitled to, or will receive, this amount.

Complete the appropriate parts of Schedule 17 to calculate the allowable interest bonus payments deduction for the year. The total of Lines 305 and 315 of Schedule 17 should be entered on Line 315 of Schedule 1. The payment made in proportion to borrowing should be calculated at a rate that is related to: i) the amount of interest payable by the member on money the member borrowed from the credit union; or ii) the amount of money the member borrowed from the credit union (Sch. 17: Part 1). The CRA's views is that the total allocation in proportion to borrowings to members is not restricted to profits made exclusively on the use by the credit union of borrowed funds but may be any amount chosen by the credit union and may include taxable capital gains. Bonus interest payments should be calculated at a rate that is related to: i) the interest payable by the credit union on money standing to the member's credit, or ii) the amount of money standing to the member's credit (Sch. 17: Part 2). The amount the credit union credited to the member is required to bear the same rate as the interest or money that the credit union similarly credited to all other members of the credit union of the same class.

A credit union claiming allocations for bonus interest payments and allocations in proportion to borrowing should also complete Part 3 of Schedule 17 to calculate the additional deduction available to credit unions to reduce Part I tax; this deduction is discussed under ¶10040.

ITA 137(2), (6), Form T2004, IT-483 (archived): *Credit Unions* (see para. 21), VD 2005-0161981E5, 9636405

¶2255 Crown royalties

For taxation years beginning after 2007, ITA 18(1)(m) was repealed. Formerly, the deductible portion of crown royalties was 0% before 2003; 10% in 2003; 25% in 2004; 35% in 2005; 65% in 2006; and is 100% after 2006. A Schedule 1 adjustment is no longer required in respect of crown royalties.

ITA 18(1)(m), IC 86-3, IT-438R2

¶2260 Cumulative Eligible Capital Deduction (Tax Amortization) (Sch. 1: Line 405; Sch. 10)

The definition of "eligible capital property" is discussed under ¶5305. Generally, eligible capital property refers to intangible capital property, such as purchased goodwill (if shares of a corporation are acquired, the price paid for the shares may include an element of consideration for the goodwill of the business; however, goodwill purchased in this manner is not eligible capital property), the cost of customer's lists unless otherwise deductible as an expense, trademark and copyright costs, and incorporation expenses. Eligible capital property, which is reported on Schedule 10, can be amortized for tax purposes at a rate of 7%, but only applied to 75% of the undeducted balance of the eligible capital expenditure. Enter the

SAMPLE

current year cumulative eligible capital deduction from Column L in Schedule 10 on Line 405 of Schedule 1.

Appreciation in the value of eligible capital property is taxed at a 50% recognition rate; see ¶2335 and ¶5310.

ITA 20(1)(b), IT-123R6, IT-143R3, IT-99R5, IT-291R3, IT-341R4, IT-187, ITTN-38

Tax Provision Note: A cumulative eligible capital deduction claimed for tax purposes in the year normally does not decrease the effective tax rate of the corporation. The difference between book amortization added to income for tax purposes and cumulative eligible capital deducted from income for tax purposes is a timing difference (see ¶15202, ¶15220, ¶15500: Example Note 2). As an exception, a write-down of goodwill for book purposes is a permanent difference where deferred taxes have not been recorded with respect to the carrying value of the goodwill (see ¶15310, ¶15420). See also the example under ¶2120.

¶2265 Damages

Damages are generally deductible under the ITA. In *65302 British Columbia Ltd.* [2000] 1 C.T.C. 57 (SCC), the Court found that expenses do not have to be unavoidable in order to be deductible and in the absence of a specific provision in the ITA indicating otherwise, a penalty is deductible in computing income from a business where a corporation can establish that the penalty was incurred for the purpose of gaining or producing income from that business (except in limited cases where an act is so egregious or repulsive that the fine or penalty cannot be justified as being incurred for an income earning purpose). In *McNeill*, [2000] 2 C.T.C. 304 (FCA), the Court reasoned that if a fine or penalty for a breach of law is deductible because nothing in ITA 18(1)(a) precludes it, it follows that court ordered damages for breach of a contract should also be deductible. The Court was also not satisfied that the appellant's actions were so egregious that the damages awarded were not justified as being incurred for the purpose of producing income.

A corporation is not required to have attempted to prevent the act or omission that resulted in the damages from the amount incurred to be deductible. Rather, the corporation is only required to establish that there was an income-earning purpose for the act or omission resulting in the damages (it is not relevant whether the purpose was achieved).

Damages paid on account of capital may be added to the cost of the relevant property or may be eligible capital expenditures (see ¶5305).

As discussed under ¶2370, the deductibility of amounts characterized as a fine or penalty is specifically limited under the ITA.

From the perspective of the recipient of a damages payment, an amount received by a corporation in lieu of the performance of the terms of a business contract by the other party to that contract may be either an income or capital receipt depending on whether the receipt relates to the loss of an income-producing asset (in which case it will be capital in nature) or is compensation for the loss of income (in which case it will constitute business income). In *Commissioner of Inland Revenue v. Fleming and Co. (Machinery) Ltd.*, 33 T.C. 57 (H.L.), the Court stated:

> [W]here for example, the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no

SAMPLE

> more than a surrogatum for the future profits surrendered, the compensation received is in use to be treated as a revenue receipt and not a capital receipt…
>
> [W]hen the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organization and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilization of a capital asset and is therefore a capital and not a revenue receipt.

In respect of a capital receipt, if the amount received relates to a particular asset that is sold, destroyed or abandoned, it will be considered proceeds of disposition of that asset or a part thereof. Where the amount relates to a particular asset that was not disposed of, the amount will reduce the cost of that asset to the corporation. Where the amount does not relate to a particular asset, the amount may constitute an "eligible capital amount" for the purposes of ITA 14 (see ¶5310).

In VD 2011-0429691I7, the CRA makes the following comments with respect to the tax treatment of amounts received as a result of an out of court settlement with respect to a claim related to the wrongful termination of a licence agreement:

> In determining the correct tax treatment of a settlement payment the Canadian courts have relied on the common law concept referred to as the "surrogatum principle". This principle essentially determines the tax consequence of a settlement payment by looking to the real nature, character and purpose of the payment and not necessarily the name given to it by the parties. More simply stated, the income tax treatment of a settlement payment is determined by making reference to the income tax treatment that would have been accorded to the particular item or amount that the settlement payment is intended to replace.
>
> In several instances, in determining whether a receipt of contractual damages is considered as compensation for the destruction of, or material crippling of, the whole profit-making apparatus of the taxpayer's business, or was compensation to fill a hole in the taxpayer's commercial profits, the courts have considered a variety of factors, including future events, that will help it establish the seriousness or degree of the impact or dislocation to the particular business. For instance, in *Amaco Plumbing & Heating Co. Ltd. v MNR*, 90 DTC 1381 (TCC), the court noted that the taxpayer did not suffer any permanent damage (within a period of two years its profits were back to normal). As such, it found that the particular payment was on account of income (i.e., the cancellation of the contract did not result in a material dislocation of the taxpayer's business structure). Accordingly, if the evidence more clearly suggests that the structure of the taxpayer's business could (or did) absorb the impact of the breach or termination of the particular contract or agreement the courts generally consider this to be a normal business risk and the amount of the compensation is more likely to be treated as income as opposed to capital.
>
> The courts have also held that subsequent evidence of damage to the business, loss of revenue, or termination of employees may be unnecessary where the contract forms the basis of an entire business. For instance, in *MNR v. Import Motors Ltd.*, 73 DTC 5530 (FCTD), the cancellation of an automobile distributorship arrangement was found to have seriously crippled the whole of the taxpayer's profit making structure as the wholesale division simply ceased to exist (i.e., it represented the loss in value of a capital asset with enduring value). As such, the court considered the amount received by the taxpayer to be compensation for the loss of a substantial portion of its business (i.e., a capital receipt) even though the court noted that there was some evidence that suggested that the payment could be considered as compensation for the loss of trading profits (i.e., an income receipt).

SAMPLE

> This may also be the case where the taxpayer has identified a separate business that is seriously affected even though the overall income of the taxpayer may not be significantly affected.
>
> Similarly, in *Valley Equipment Limited v The Queen*, 2008 DTC 6200 (FCA), the court found that the rights of the taxpayer under a John Deere dealership agreement constituted property within the meaning of subsection 248(1) of the Act and that these rights were unlawfully taken when the dealership agreement was unilaterally cancelled by the franchisor. This action ultimately entitled the taxpayer to compensation for property unlawfully taken. In this case, the court found that damage award received by the taxpayer was taxable as a capital gain as it was consideration for the taxpayer abandoning its right to continue as a John Deere dealer such that there was a mutual exchange of property which brought the matter squarely within the parameters of paragraph 40(1)(a) of the Act…
>
> [T]he fact that a taxpayer's rights under a business contract… or its right to sue for breach of those rights could be considered as property for the purposes of the Act does not automatically mean that any damage award or settlement would always be on account of capital. In *CNR v MNR*, 88 DTC 6340 (FCTD), the court considered and rejected such a position in the following statement:
>
>> With respect to purpose, the essential question is to determine what the compensation - whether paid pursuant to a contract, a court award of damages, or otherwise - is intended to replace. In some cases the contract providing for compensation may be clear. The measure employed for calculating compensation is not always determinative: potential lost income may be taken into account in calculating the capital sum to be paid. Nor on the other hand does the fact that an amount is paid as damages for breach of a contract necessarily make it a capital sum and not income. On the contrary it appears to me that whatever the source of the legal right to the compensation, be it the contract or the law of damages, the substantive issue is: what is the amount intended to replace?

The CRA goes on to state that the following questions would be relevant in determining the tax treatment of damages received in respect of the cancelation of a license agreement: was the reduction in the Taxpayer's gross revenue/profit sufficient enough so as to destroy or materially to cripple its profit-making apparatus or has the taxpayer's business sufficiently recovered; did the taxpayer have to significantly reduce staffing levels and was this reduction permanent; were there any significant changes to the taxpayer's business structure; was the taxpayer required to dispose of significant assets as a result of the termination of the agreement; was this the end of the taxpayer's business; and what was the term of the agreement and was it near expiry. If it were determined that damages were received on account of capital, the CRA stated it may consider the receipt an eligible capital amount under ITA 14. The CRA highlighted that the former mirror image test in the "cumulative eligible capital" definition in ITA 14(1) was replaced in 2006. As a consequence of the amendments to ITA 14, the CRA's opinion is that "it might be easier to establish that damages in respect of the unilateral cancellation of a business contract would be subject to the income inclusion under [ITA 14(1)] where such amount does not reduce the cost or capital cost of any property or result in a disposition of a specific capital property".

The treatment of break fees in the context of mergers and acquisitions is discussed under ¶2512.

See also ¶2235 (Contract Cancellation Payments).

ITA 9(1), 18(1)(a), 67.6, IT-467R2: *Damages, Settlements and Similar Payments*, IT-365R2: *Damages, Settlements and Similar Receipts*, VDs 2008-0280801E5, 2007-0253271E5, Jocelyn Blanchet, "Purchase and Sale of Assets: The Treatment to the Vendor of Contingent Liabilities Assumed," *Report of Proceedings of Sixty-First Tax Conference*, 2009 Tax Conference (Toronto: Canadian Tax Foundation, 2010), 11:1-22, Joel A. Weinstein, QC, "Damages, Fines, and Penalties: An Update," *Report of Proceedings of Fifty-Second Tax Conference*, 2000 Tax Conference (Toronto: Canadian Tax Foundation, 2001), 7:1-29

SAMPLE

¶2270 Debt Forgiveness (Sch. 1: Lines 220, 314)

The debt forgiveness rules are discussed under ¶3300.

A gain on the settlement of a debt for tax purposes should be added to income for tax purposes on Schedule 1 of Line 220. Generally, ITA 80 applies where an obligation that is capital in nature is settled without any payment or by the payment of an amount less than the principal amount thereof. The resultant gain is applied to reduce losses or the cost base of property to the corporation. If a balance remains, the balance may be transferred to a related corporation to offset losses and the cost base of property of that corporation. To the extent the remaining balance of the forgiven amount is not transferred to a related corporation, 50% of the balance is included in income for tax purposes of the particular corporation.

The forgiveness of a past-due trade accounts payable by a corporation's creditor is not income to the corporation for the year in which the amount is forgiven. Moreover, there is no authority to reopen the assessment of any earlier taxation year in order to disallow the deduction of the forgiven amount in the year in which the debt was incurred. However, if the debt was incurred in the same taxation year as that in which all or part of the debt is forgiven, the CRA would likely only consider the net amount that the corporation was required to pay as the cost of the goods acquired. When the forgiveness is in the form of a discount on future purchases, the amounts forgiven may also be included in income.

A gain recorded for book purposes upon the forgiveness of a debt obligation of a corporation that is capital in nature should be deducted from income for tax purposes on Line 314 of Schedule 1. A debt obligation is normally capital in nature (as opposed to trade in nature) where the debt was incurred to purchase or invest in capital property or to finance a capital project.

ITA 9(1), 80(13), Form T2154, Form T2027

Tax Provision Note: When a loan owed by a corporation is forgiven, the 50% non-taxable portion of a gain recognized in respect of the forgiven amount is a permanent difference that reduces the corporation's effective tax rate (see ¶15110, ¶15420). A reduction of the tax base of properties and tax pools in respect of the forgiven amount will normally reverse temporary differences.

¶2275 Debt Issues Expenses (Sch. 1: Line 208)

Debt issue expenses deducted for book purposes in the year should be added to income for tax purposes on Line 208 of Schedule 1. The deduction available for tax purposes in respect of such debt issue expenses is described under ¶2365 (Financing Fees).

ITA 18(1)(b), 20(1)(e)

Tax Provision Note: An amount added to income for tax purpose in respect of debt issue expenses is a timing difference that does not increase the effective tax rate of the corporation (see ¶15220). The deductible temporary difference is equal to the unamortized balance of financing fees at the end of the taxation year available for future deduction under ITA 20(1)(e).

For example, Canco adds $25,000 of financing fees deducted during the period for book purposes to income for tax purposes on Line 208 of Schedule 1. As permitted under ITA 20(1)(e), Canco deducts $5,000 of the financing fees from income for tax purposes for the period on Schedule 1. Canco records a deferred tax recovery for the period of $5,000:

A. Tax base of unamortized financing fees	NBV of deferred financing fees (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
$20,000	Nil	$20,000	$5,000	Nil	($5,000)

Note: The deferred tax asset (DTA) (see ¶15206) with respect to unamortized financing fees at the end of the period is $5,000. In the following taxation year, Canco would deduct another $5,000 of financing fees on Schedule 1 and would record a deferred tax expense of $1,250 ($5,000 x 25%). The DTA at the end of Year 2 would be $3,750 ($15,000 x 25%; or $5,000 - $1,250).

¶2278 Deep Discount Debts

See under ¶2278.

¶2280 Deferred and Prepaid Expenses (Sch. 1: Lines 116, 409)

Subject to the exception for farmers and fishers who elect to report income using the cash method, no deduction can be claimed for tax purposes for an outlay or expense for services to be rendered after the end of the taxation year or for interest, tax (other than tax on insurance premiums), rent, royalty or insurance expenses relating to a period after the end of the corporation's taxation year. Expenses that are prepaid may be deducted only in the taxation year to which they relate. If a prepaid expense is deducted for book purposes, the portion of the expense related to future periods should be added to income for tax purposes on Line 116 of Schedule 1.

Normally, the treatment of prepaid expenses for tax and accounting purposes will be consistent and a Schedule 1 adjustment will not be required in respect of such expenses.

ITA 18(9), IT-261R: *Prepayments of Rents*

¶2281 Running Expenses Deferred for Book Purposes (Sch. 1: Line 409)

Generally, for tax purposes, "running expenses" may be deducted in the year they are incurred unless the prepaid expense rule in ITA 18(9) applies to prevent the deduction on a current basis. When running expenses that are deductible for tax purposes are deferred and amortized for book purposes, generally, the entire amount of the expense can be deducted on Line 409 of Schedule 1 in the year the expense is incurred.

Examples of deductible running expenses capitalized for book purposes may include deferred start-up costs, deferred organization expenses, lease inducements, tenant inducements, deferred advertising costs, and costs related to incomplete contracts.

The determination of whether a particular expense is a "running expense" is a question of fact. The courts have described "running expenses" as expenses that are not referable or related to any particular item of revenue and would include any expenses that are necessarily incurred on a continuing and recurring basis for the general purpose of producing income (see IT-417R2). Under GAAP, the matching principle generally requires that outlays or expenses be deducted in computing profit in the year in which they may reasonably be regarded as being productive of revenue. The Courts have generally found that subject to ITA 18(9) or another provision of the ITA which may apply to a particular expense, the "matching

SAMPLE

principle" under GAAP is not a requirement of the ITA. For example, in *Toronto College Park Ltd.*, [1998] 2 C.T.C. 78 (SCC), in which tenant inducement payments were permitted to be deducted in the year incurred, the Court stated:

> The most that can be said in favour of the matching principle is that in cases where expenses can be related directly to specific items of future revenue, it may yield a more accurate picture of income to offset the expenses against the future revenue, notwithstanding that the actual expenditures were made or incurred in another year. This is not always the case, however, and the matching principle certainly should not be applied in a case such as the present one, where no linkage to future revenue has been found.

A similar decision was made in *Canderel* (see under ¶2010).

The CRA recognizes that an expense is deductible in the year it is incurred or paid regardless of the treatment of the expense under GAAP. In VD 9413377, the CRA states:

> Her *Majesty The Queen v. Burnco Industries Ltd.*, [1984] C.T.C. 337, 84 D.T.C. 6348 (FCA), considers the time a cost is incurred with respect to being deducted as expense in determining income. At page 6348 Pratte, J. said that an amount can not be considered to be a deductible expense unless it has been incurred and the taxpayer is obligated to pay money. Also, *I.B. Pedersen Limited v. Her Majesty the Queen*, [1994] 1 C.T.C. 2355, 94 D.T.C. 1085 (T.C.C.) concluded that a reserve for future reclamation and site maintenance costs was not deductible. An obligation to make an expenditure in the future does not qualify as an expense.
>
> In *Oxford Shopping Centres Ltd. v. Her Majesty The Queen*, [1980] C.T.C. 7, 79 D.T.C. 5458 (FCTD) the amount in question had been paid to The City of Calgary. At page 5466 Thurlow, A.C.J. comments that while the "matching principle" applies to expenses related to particular items of income, the principle does not apply to business operating expense even though the deduction of a particularly large expense in the year it is paid will distort the income for that particular year. While GAAP called for Oxford's expenditure to be amortized, the Federal Court-Trial Division concluded that the amount was a business expense deductible in the year it was paid. In support of his conclusion, Thurlow, A.C.J. refers to the decisions *Associated Investors of Canada Limited v. Minister of National Revenue* (1967), 2 Ex. C.R. 96, *Vallambrosa Rubber Co. Ltd. v. Farmer* (1910), 5 T.C. 529, *Naval Colliery Co. Ltd. v. C.I.R.* (1928), 12 T.C. 1017, *Tower Investment Inc.*, [1972] C.T.C. 182, 72 D.T.C. 6161 and *Minister of National Revenue v. Canadian Glassine Co. Ltd.*, [1976] C.T.C. 141, 76 D.T.C. 6083. In addition we would add a reference to *Lawrence H. Mandel v. Her Majesty the Queen*, [1978] C.T.C. 780 #2, 78 D.T.C. 6518 (FCA) confirmed by the Supreme Court of Canada in *Lawrence H. Mandel v. Her Majesty the Queen*, [1980] C.T.C. 130, 80 D.T.C. 6148, where it was concluded that a contingent amount for the purchase of a motion picture film was not a cost of the film.
>
> In summary, an expense for the purpose of gaining or producing income from a business is deductible in computing income for the period it is incurred or paid, whichever is earlier.

It is important to highlight that a non-capital expense incurred to earn income is deductible on a current basis even if the expenditure in question is material in comparison with the relative cost of the business operations. In *Oxford Shopping Centres Ltd.*, the Court noted that an expense on account of income is deductible in computing income for the year it is incurred even if the deduction will distort income for that particular year.

SAMPLE

Where an expense deducted in the year incurred for tax purposes is deferred and amortized for book purposes, book amortization of the deferred costs should be added to income for tax purposes each year on Line 116 of Schedule 1.

See also ¶2505 (Lease Payments) and ¶2235 (Contract Cancellation Payments).

ITA 18(9), 9(1), 18(1)(a), (b), *Canderel*, [1998] 2 C.T.C. 35 (SCC), *Bueti*, [2008] 1 C.T.C. 18 (FCA), *Glueckler Metal Inc.*, [2003] 3 C.T.C. 2645 (TCC), *Tower Investment Inc.*, [1972] C.T.C. 182 (FCTD); *Canadian Glassine Co.*, [1974] C.T.C. 63 (FCTD); *Oxford Shopping Centres Ltd.*, [1981] C.T.C. 128 (FCA), *Cummings*, [1981] C.T.C. 285 (FCA). ITTN-16, IT-417R2, IT-261R, IT-364, IT-454, IT-487, VD 2005-0159391E5

Tax Provision Note: A running expense capitalized for book purposes that is deducted in the year incurred for tax purposes is a timing difference that does decrease the effective tax rate of the corporation (see ¶15220). The taxable temporary difference is equal to the carrying value of the deferred expense reported on the financial statements at the end of the period.

For example, Canco capitalizes a $100,000 lease inducement payment made to a tenant in the period for book purposes (the deferred expense will be amortized over the term of the lease). There are no conditions attached to the inducement payment and Canco deducts the entire amount from income for tax purposes on Line 409 of Schedule 1 in the current period. No amount is written off in the period in respect of the deferred expense for book purposes. Canco records a deferred tax expense for the period of $25,000 and a deferred tax liability of $25,000 with respect to the carrying value of the deferred expense written off for tax purposes in the current year:

A. Tax base of deferred expense	NBV of deferred expense at end of period (Financial statements)	C. Closing Temporary Difference (A – B)	D. Closing DTA (DTL) (C x Substantively enacted tax rate)	E. Opening DTA (DTL) (enter amount from prior year)	F. Deferred tax recovery (expense) for period (D - E)
Nil	$100,000	($100,000)	($25,000)	Nil	($25,000)

¶2285 Deferred Profit Sharing Plan (DPSP) Contributions

See under ¶2575 (Pension and Profit Sharing Plan Contributions).

¶2290 Deferred Tax Expense (Sch. 1: Line 102)

A deferred tax expense (see ¶15240) recorded for book purposes is not deductible and should be added to income for tax purposes on Line 102 of Schedule 1. Similarly, a deferred tax recovery should be deducted in computing income for tax purposes.

ITA 9(1), 18(1)(e), (t), VD 2003-0027217

¶2295 Depletion (Sch. 1: Line 105)

Depletion deducted for book purposes should be added to income for tax purposes on Line 105 of Schedule 1. For tax purposes, see ¶2650 (Resource Deductions).

ITA 18(1)(b), IT-125R4, IT-400, IT-476R

SAMPLE

Tax Provision Note: Depletion added to income for tax purposes normally does not increase the effective tax rate of the corporation. The difference between depletion added to income for tax purposes and resource pool balances deducted from income for tax purposes is a timing difference (see ¶15220). See also the example under ¶2190; the same principles apply except that the balance of resource pools at the end of the year reported on Schedule 12 is the tax base rather than the balance of UCC reported on Schedule 8.

¶2300 Depreciation (Sch. 1: Line 104)

As discussed under ¶2025, ITA 18(1)(b) prohibits the deduction of any amount in respect of an outlay or replacement of capital, or an allowance in respect of depreciation, obsolescence or depletion, except as expressly permitted by some other provision of Part I of the ITA.

ITA 20(1)(a) gives a corporation a statutory right to a deduction in respect of the capital cost of depreciable property; see ¶2190 (Capital cost allowance). Depreciation of fixed assets deducted from book income for the year should be added to income for tax purposes on Line 104 of Schedule 1.

ITA 18(1)(b), IT-267R2

Tax Provision Note: Depreciation added to income for tax purposes normally does not increase the effective tax rate of the corporation. The difference between depreciation added to income for tax purposes and CCA deducted from income for tax purposes is a timing difference (see ¶15220, ¶15500: Example Note 1). See also the example under ¶2190.

¶2305 Development Expenses (Sch. 1: Line 212)

See under ¶2650 (Resource Deductions).

¶2310 Directors' Fees

Director's fees paid by a corporation are allowable deductions to the extent that they are reasonable (see ¶2025).

Withholding tax requirements in respect of directors’ fees are discussed under ¶1825 (Source Deductions).

Payments made by a corporation of management and director's fees for services performed for its subsidiary were disallowed on the ground that the taxpayer did not itself carry on any business in *Valeriote Electronics Limited*, [1988] 1 C.T.C. 2091 (TCC).

ITA 9(1), 18(1)(a), 67

¶2315 Disability-Related Modifications

Expenses incurred for eligible disability-related modifications made to a building can be expensed for tax purposes in the year the expenditures are incurred. If such expenses were capitalized for book purposes, a deduction should be claimed on Schedule 1.

Eligible disability-related modifications include changes made to accommodate wheelchairs and expenses paid to install disability-related devices and equipment. A deduction is also available for costs relating to prescribed disability devices or equipment. This would include, for example, visual fire alarm indicators,

SAMPLE

telephone devices, listening devices for group meetings, and disability-specific computer software and hardware attachments.

ITA 20(1)(qq), (rr), ITR 8800, 8801

Tax Provision Note: Disability-related modification costs capitalized for book purposes that are deducted in the year incurred for tax purposes is a timing difference that does not decrease the effective tax rate of the corporation (see ¶15220, ¶15500: Example Note 2). See also the example under ¶2281 with respect to running expenses deducted in the year incurred for tax purposes and deferred and amortized for book purposes (the same principles apply).

¶2320 Discounts and Premiums on Debts

See under ¶2468.

¶2325 Dividends (Sch. 1: Lines 204, 209, 214, 303, 402; Sch. 3)

As a general rule, dividends received from other Canadian corporations and foreign affiliates (see ¶7250) may be deducted in computing the taxable income of the recipient corporation. As a result, subject to certain restrictions, corporate profits may pass tax-free between intermediary corporations subject to certain restrictions. Under the ITA, dividends are deductible from taxable income rather net income for tax purposes. The deductibility of dividends is discussed in Chapter 3 under ¶3100.

A deduction is not available in computing taxable income in respect of certain dividends received by a Canadian corporation, such as dividends received from a non-resident corporation other than a foreign affiliate. Also, a full deduction may not be available in respect of a dividend received that was prescribed to have been paid out of the taxable surplus of a foreign affiliate (see ¶7250).

With respect to private corporations, refundable Part IV tax levied on dividend income is discussed under ¶8200. Generally, the purpose of the dividend refund rules is to place the shareholders receiving such dividends in much the same tax position as if they had received the investment income or made the capital gains themselves, without the intervention of the corporation.

Part IV.1 tax on dividends received on taxable preferred shares is discussed under ¶10120 and Part VI.1 tax on dividends paid on taxable preferred shares is discussed under ¶10125. Generally, the special taxes in Parts IV.1 and VI.1 are intended to ensure that the availability of the dividend tax credit for individual shareholders and the intercorporate dividend deduction for corporate shareholders is supported by tax paid on income distributed as a dividend.

Dividends paid by a corporation to its shareholders are not deductible from income for tax purposes as they are a distribution of income after it is earned.

See also ¶2570 (Patronage Dividends).

ITA 9(1), 18(1)(a), (b)

Tax Provision Note: An exception normally applies such that deferred taxes are not recognized in respect of outside basis differences related to investments in subsidiaries (see ¶15110 and ¶15315). With respect to refundable taxes, see ¶15410. Dividends in respect of portfolio investments deducted from income for tax purposes are a permanent difference that decreases the effective tax rate of the corporation.

SAMPLE

¶2326 Accrued Dividend Income *(Sch. 1: Lines 204, 303)*

Dividend income accrued for book purposes in a taxation year should be deducted in computing income for tax purposes on Line 303 of Schedule 1. The dividend should be added to income for tax purposes on Line 204 of Schedule 1 in the year the dividend is actually received.

ITA 12(1)(j), (k), IT-269R4

Tax Provision Note: Accrued dividends give rise to a taxable temporary difference to the extent that a deduction will not be available when the dividends are received.

¶2327 Deemed Dividends *(Sch. 1 Line 209)*

As discussed under ¶3125, a dividend may be deemed to have been paid or received by a corporation under several provisions of the ITA. For example, a deemed dividend may arise where there is an increase in the PUC of shares held without a corresponding increase in the net asset value of the corporation whose shares are held. A deemed dividend may also arise in respect of amounts paid by a Canadian resident corporation on the redemption, acquisition or cancellation of any of the shares of any class of its capital stock (except to the extent the amount paid represents a return of PUC), or where distributions are made by a Canadian resident corporation on the winding-up, discontinuance or reorganization of its business (except to the extent the distribution represents a return of PUC). Deemed dividend income realized in the year should be added to income for tax purposes on Line 209 of Schedule 1.

ITA 84(1), (2), (3), IT-463R2, IT-88R2, IT-432R2, IT-126R2, IT-126R, IT-474R, ITTN-7, ITTN-33

¶2328 Dividend Stop-Loss Adjustments *(Sch. 1: Line 213)*

The ITA contains a series of stop-loss rules applicable where certain dividends were received prior to the disposition of a share. In general, if a corporation realizes a loss on the disposition of a share, one of the dividend stop-loss rules may apply to reduce the amount of the loss to the extent that the cost has been recovered by the corporation previously on the receipt of certain specified dividends. There is no offsetting addition to the cost of the shares and the loss is permanently denied. In respect of shares held as capital property, these rules are discussed under ¶4220.

A dividend stop-loss rule in ITA 112(4) may apply to reduce the amount of a non-capital loss on a share held as inventory (other than a mark-to-market property of a financial institution). Such a denied loss that has been deducted in computing book income should be added to income for tax purposes on Line 213 of Schedule 1. The amount of the loss reduction equals the total of: 1) taxable dividends received on the particular share to the extent that the dividends were deductible under ITA 112, 113, 138(6) or 115(1) in computing the corporation's taxable income and 2) dividends other than taxable dividends received on the share by the corporation. In respect of a partnership, the loss reduction is equal to the total of all dividends received by the partnership on the particular share.

With respect to the above stop-loss rule, consistent with the dividend stop-loss rules applicable to shares held as capital property, ITA 112(6)(a) excludes from the categories of "dividend" and "taxable dividend" a capital gains dividend (within the meaning assigned by ITA 131(1)). Taxable and non-taxable dividends are also excluded from the application of ITA 112(4) if they are received in circumstances in which the standard 365-day and 5% ownership tests are satisfied. In particular, ITA 112(4.01) excludes a dividend from the loss reduction rules where: i) the corporation owned the particular share throughout the 365-day period before the disposition and ii) the dividend was received at a time when the corporation and persons not dealing at arm's length with the corporation did not own more than 5% of the shares of any class of

SAMPLE

the payer corporation. However, as discussed under ¶4220, Budget 2011 eliminated this exception in respect of public corporations that realize a loss on a disposition of shares held as inventory or as capital property.

The application of the stop-loss rules is suitably modified for those circumstances in which a share is held by a financial institution as mark-to-market property. ITA 112(5.2) provides the principal stop-loss rule for shares held by a financial institution as mark-to-market property; the provision takes into account the adjustments that have occurred on each deemed disposition of the share. Where ITA 112(5.2) applies, a complex formula adjusts the proceeds of disposition of the relevant shares in a manner that ensures that the overall loss on the shares is reduced by the appropriate amount of specified dividends received by the financial institution. The proceeds of disposition are adjusted instead of the amount of any loss generally in order to adequately take into account the annual deemed disposition of shares held as mark-to-market property under ITA 142.5(2). ITA 112(5.3) provides that the adjustment is relevant only for the purpose of calculating any gain or loss from the share and does not affect the amount at which the shares are deemed to be reacquired under ITA 142.5(2)(b).

ITA 112(4)–(5.6), IT-328R3

Tax Provision Note: A loss denied under the dividend stop-loss rules is permanently disallowed and increases the effective tax rate of the corporation.

¶2329 Dividends Credited to Investment Account for Book Purposes *(Sch. 1: Line 214; Sch. 3)*

Dividends received during the year and credited to an investment account for book purposes (i.e., Dr Cash, Cr Investment account) under the equity method of accounting should be added to income for tax purposes on Line 214 of Schedule 1. The equity method of accounting is generally employed in respect of investments in which the corporation has a 20% to 50% interest. Where the equity method is used in respect of an investee, dividends and other distributions received from the investee reduce the carrying amount of the investment. Normally, a deduction from taxable income is available in respect of such dividends included in income for tax purposes.

Dividends received in respect of shares held that are accounted for using the cost method of accounting are included in book income and a Schedule 1 adjustment is not required in respect of such investments.

ITA 12(1)(j), (k), IT-269R4, IAS 28

Tax Provision Note: Deferred taxes are normally not recognized in respect of the carrying value of investments in subsidiaries provided the parent corporation is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future (see ¶15110 and ¶15315).

¶2330 Capital Dividends *(Sch. 1: Line 402; Sch. 3; Form T2054)*

Capital dividends are discussed under ¶8300. Generally, capital dividends can be paid in respect of the non-taxable portion of certain gains of private corporations which accrued during the period in which the private corporation held the property. An election is required to be filed to treat a dividend as having been paid out of the capital dividend account (CDA) of a private corporation. The CDA is part of the system for integrating the corporate and shareholder tax of private corporations. The rules generally seek to preserve the character of the non-taxable portion of capital gains and certain other non-taxable receipts of a corporation in the hands of its shareholders.

SAMPLE

A capital dividend is not subject to tax in the hands of shareholders resident in Canada.

See ¶4121 in respect of capital gains dividends received from investment corporations, mortgage investment corporations, or mutual fund corporations.

ITA 83(2), 89(1) "capital dividend account", IT-66R6, IT-67R3, IT-146R4, IT-149R4, IT-430R3

¶2332 Donations and Gifts (Sch. 1: Line 112; Sch. 2)

Charitable donations and related gifts deducted in computing book income should be added to income for tax purposes on Line 112 of Schedule 1. Donations are deducted from taxable income by virtue of ITA 110.1. As discussed under ¶3005–3025, donations deductible from taxable income are recorded on Line 311 of Form T2 and reported on Schedule 2. Thus, donations added to income for tax purposes on Schedule 1 may then be deducted when computing taxable income, such that the net adjustment is nil.

Where a deduction is not available under ITA 110.1 in respect of a donation (for example, where the donation is not made to a registered charity), a deduction of the donated amount as an advertising expense (see ¶2110) or business promotion expense (¶2185) is available provided the donation was made for the purposes of earning income and the amount is reasonable (see ¶2025).

Occasionally, gifts are made for business promotion purposes and may be indistinguishable from advertising expenses. Gifts made to non-qualified donees for the purpose of producing income are generally deductible in computing income for tax purposes and not subject to the deduction limitation in respect of donations discussed under ¶3005. There is nothing in the ITA requiring a corporation to prove an increase in sales in order that an expense be deductible for the purpose of earning income within ITA 18(1)(a); however, a corporation should be prepared to provide evidence to the CRA that the expense was incurred to earn income and that the amount was reasonable in the circumstances. If a donation is deducted from income for tax purposes on the grounds that it is an advertising or business promotion expense (or was otherwise incurred to earn income from a business or property), the amount should not be added to income for tax purposes on Schedule 1 and should not be reported on Schedule 2.

In *Olympia Floor & Wall Tile Ltd*, [1970] C.T.C. 99 (Exch.), the Court allowed for a deduction, as a regular business expense, of gifts of between $8,000 and $10,000 annually made to certain charitable organizations. In the case, the appellant demonstrates to the Court that a significant portion of its business arose directly out of the goodwill generated in the business community as a result of the gifts. A similar decision was made in *Impenco Ltd*, [1988] 1 C.T.C. 2339 (TCC). In VD AC59275, the CRA notes:

> If payments made to charitable organizations can be shown to have been made to encourage or maintain business which would otherwise be lost, such payments may in certain circumstances be deducted from income as a business expense under paragraph 18(1)(a) of the Act. A gift made for such purposes has been ruled not to be a gift within the meaning of paragraph 110.1(1)(a) and is therefore not subject to the 20% maximum provided therein.

A capital gain may be realized if capital property is donated; however, the income inclusion rate is nil in respect of donations of publicly-traded securities to a qualified donee (see ¶4130).

Donations that are not deducted in a taxation year can be carried forward for 5 years. Donations cannot be used to increase a non-capital loss incurred in a taxation year; see ¶3205.

See also ¶2162 (Customer or Client Christmas Gifts) and ¶2585 (Political Donations).

SAMPLE

ITA 9(1), 18(1)(a), 67, *Olympia Floor & Wall Tile Ltd*, [1970] C.T.C. 99 (Exch), *Impenco Ltd*, [1988] 1 C.T.C. 2339 (TCC)

Tax Provision Note: The balance of donations available for carryforward (Sch. 2) at the end of the year is a deductible temporary difference (see ¶15220). A rate reconciliation adjustment will be required if the deductible temporary difference with respect to the carryforward donations is offset by a valuation allowance that increases the effective tax rate of the corporation (see ¶15233, 15420).

¶2335 Eligible Capital Property (Gain on Sale) (Sch. 1: Line 108; Sch. 10)

The taxation of gains on dispositions of eligible capital property is discussed under ¶5310. Generally, upon a sale of eligible capital property, 75% of the proceeds of disposition are credited to the cumulative eligible capital pool (Sch. 10). If credit brings the pool to a negative balance, previously claimed tax amortization is recaptured and included in income for tax purposes. Additionally, 50% of any excess gain is included in income for tax purposes. Income recognized on a disposition of eligible capital property, which should be reported on Line 108 of Schedule 1, is business income rather than a capital gain. However, in certain circumstances, ITA 14(1.01) permits a corporation to elect to report a capital gain on the disposition of an eligible capital property where the corporation can identify the cost of the particular property disposed of. Effectively, ITA 14(1.01) allows a corporation to elect to remove a particular asset from the cumulative eligible capital pool and to recognize a capital gain as if the asset were ordinary non-depreciable capital property.

ITA 14(1), IT-123R6, IT-143R3, IT-99R5, IT-291R3, IT-341R4, IT-187, ITTN-38

Tax Provision Note: The 50% non-taxable portion of a gain realized on a disposition of eligible capital property is a permanent difference that reduces the effective tax rate of the corporation. Normally, such a disposition will otherwise reverse existing temporary differences (see ¶15202, ¶15310, ¶15500: Example Note 2).

¶2340 Employee Profit Sharing Plan (EPSP) Contributions

See under ¶2575 (Pension and Profit Sharing Plan Contributions).

¶2345 Equity Investments (Book Income or Loss) (Sch. 1: Lines 110, 306)

Losses recognized during the year for book purposes in accordance with the equity method of accounting (i.e., Dr Loss, Cr Investment account) should be added to income for tax purposes on Line 110 of Schedule 1. Similarly, income recognized during the year for book purposes in accordance with the equity method (i.e., Dr Investment account, Cr Income) should be deducted from income for tax purposes on Line 306 of Schedule 1. Equity investments are normally those in which the corporation has a 20% to 50% interest. Where the equity method of accounting is used, a proportionate share of net income and losses of the investee during the year are accrued and recognized by the investor and an equivalent increase or decrease is made to the carrying amount of the investment account.

The equity method of accounting does not apply for tax purposes.

Income and losses are not accrued for book purposes in respect of investments accounted for using the cost method of accounting (portfolio investments, for example, are accounted for using this method). Thus, except in the case were the cost amount of an investment is written down for book purposes, Schedule 1 adjustments are normally not required in respect of investments accounted for using the cost method.

SAMPLE

ITA 9(1), IAS 28

Tax Provision Note: An exception normally applies such that deferred taxes are not recognized in respect of outside basis differences related to investments in subsidiaries (see ¶15110 and ¶15315). In non-consolidated financial statements, equity income deducted from income for tax purposes would normally decrease the effective tax rate of the corporation.

¶2347 Exchangeable Debentures

See under ¶2468.

¶2350 Exempt Income (Sch. 1: Line 307)

"Exempt income" included in book income should be deducted from income for tax purposes on Line 307 of Schedule 1. "Exempt income" includes income exempt from taxation in Canada by virtue of a provision contained in a tax treaty.

Expenses incurred to earn "exempt income" (i.e., income that is not subject to taxation) are not deductible and should be added to income for tax purposes. Whether an expense is related to exempt income is a question of fact.

ITA 81(1)(a), 18(1)(c), ITA 248(1)"exempt income", IT-397R, VD 2003-0007967, 2000-0053445

Tax Provision Note: Exempt income deducted from income for tax purposes is a permanent difference that decreases the effective tax rate of the corporation (see ¶15110, ¶15420).

¶2355 Exploration Expenses

Exploration and development expenses incurred in exploring and drilling for oil, gas, and minerals are deductible within the limits provided by ITA 66–66.7; see ¶2650 (Resource Deductions) and ¶5400 (Resource Pools),

¶2360 Farmers and Fishermen (Sch. 1: Lines 201–203, 224, 229, 233, 300–302, 309, 313)

As an exception to normal rules, farmers and fishermen (other than fish packers or canners, or manufacturers of fish products) are permitted to compute their income for tax purposes according to the "cash method". When the cash method is used, income is computed without taking into account uncollected sales invoices, unpaid amounts owing for supplies, unsold inventories of farm products or livestock, etc. The ability to file on the cash method permits farmers and fishermen to postpone their tax until their product is converted into cash and also provides relief from the necessity to maintain more complex accounting records. The meaning of "farming", including interpretation of relevant case law, is discussed in paragraphs 8 and 9 of IT-433R, IT-156R (archived), and VD 2004-0086271E5.

Where the cash method is used for tax purposes but the accrual method is used for book purposes, accruals need to be reversed on Schedule 1 to compute income for tax purposes.

Other considerations with respect to farming businesses include:

- The CRA will generally consider income from a certain activity (such as rental income) that, by itself would be a non-farming activity, to be income from a farming business if the activity is incidental to

SAMPLE

the corporation's farming operations and the income generated by the activity is not substantial in relation to the corporation's farming revenue (VD 2010-0385151E5, 2007-0254211E5);

- Members of a farmer's family may work for the family farming corporation. Provided the wages paid are reasonable for the services performed, the farmer may normally claim these wages as a deduction from taxable income (¶2160));

- The granting of an easement or right of way by a landowner is considered to be a disposition of a part of the property in respect of which it is granted (¶4000, VD 2009-0312701E5);

- Generally, sales of agricultural land on a share crop basis extending over a period of years are not considered to give rise to taxable income in the hands of the seller unless the selling of agricultural lands is part of the business of the corporation. The CRA generally gives a restrictive meaning to “agricultural land” by excluding therefrom farm buildings, equipment, livestock and crops (ITA 12(1)(g), IT-462);

- A deduction is allowed for expenditures made for clearing or levelling farm land, or for installing a land drainage system, in computing income for tax purposes from a farming business (ITA 30);

- Generally, payments received by a landowner as compensation for damage to crops and compensation for additional costs and losses of a property owner who carries on farming operations around structures situated on the owner's property should be included in computing the property owner's income from farming operations (VD 2008-0297051E5);

- All small tools such as forks, spades, picks, shovels, etc. costing less than $500 may be deducted as an expense and need not be included with depreciable assets (¶5000, Cl. 12);

- An individual taxpayer can claim the $750,000 capital gains exemption in respect of a disposition of qualifying farming or fishing property (ITA 110.6). The capital gains deduction is not available to a corporation.

- The value of goods produced by a farming corporation and consumed by the farmer or a member of the farmer's family should be added to the income derived from the farm if the costs of producing such items were deducted as expenses. The value placed on these goods should represent the farmer's cost of raising or producing them.

The CRA is not involved in administering the Agristability and AgriInvest programs, which are important for many farmers. For information on these programs, visit: *agr.gc.ca/agristability* and *agr.gc.ca/agriinvest*. Also, refer to CRA Guides RC4060: *Farming Income and the AgriStability and AgriInvest Programs Guide* and RC4408: *Farming Income and the AgriStability and AgriInvest Programs Harmonized Guide.*

ITA 28, IT-433R: *Farming or Fishing — Use of Cash Method;* IT-373R2*: Woodlots*, IT-200: *Surface Rentals and Farming Operations,* IT-425: *Miscellaneous Farm Income,* CRA Guides T4003: *Farming Income*; T4004: *Fishing Income*, *Tinhorn Creek Vineyards Ltd.,* [2006] 1 C.T.C. 2096 (TCC) (wine business was farming), *Levy*, [1990] 2 C.T.C. 83 (FCTD) (member of syndicate that bred and raced horses held to be in farming business despite not actively participating); John F Oakey, CA, “Tax Developments in the Fishing and Farming Industry,” *2007 Atlantic Provinces Tax Conference*, (Halifax: Canadian Tax Foundation, 2007), 3A:1-23.

Tax Provision Note: If the accrual method is employed for book purposes and the cash method for tax purposes, the timing differences outlined below will not affect the effective tax rate of the corporation.

The balance of amounts required to be added to income for tax purposes in the following year are taxable temporary differences and the balance of amounts to be deducted from income for tax purposes in the following year are deductible temporary differences. See the example of deferred taxes recorded in respect of reserves under ¶2630.

Accounts Payable and Accruals *(Sch. 1: Line 201, 300)*

Expenses in respect of accounts payable should be added to income for tax purposes on Line 201 of Schedule 1 when the cash method is employed. Under the cash method, an expense is not deductible until paid. An amount added to income for tax purposes on Schedule 1 in the prior year in respect of accounts payable and accruals should be deducted from income for tax purposes on Line 300 of Schedule 1 in the subsequent year as the expenses have not yet been recognized for tax purposes.

ITA 20(7) denies a reserve under ITA 20(1)(m) in respect of undischarged commitments for goods not yet delivered or services not yet rendered for cash-basis corporations.

ITA 12(1)(b), 20(7), 28(1), VD 2008-0302631I7

Accounts Receivable and Prepaids *(Sch. 1: Lines 202, 301)*

Income is not recognized until an amount is received when the cash method is employed. As such, if this method is used to compute income for tax purposes, income recorded for book purposes in respect of accounts receivable should be deducted from income for tax purposes on Line 301 of Schedule 1. Similarly, the balance of prepaid expenses at the end of the year for book purposes should be deducted from income for tax purposes on Line 301 of Schedule 1 as the expenses have been paid.

An amount deducted in computing income for tax purposes in the prior year in respect of accounts receivable should be added to income for tax purposes in the subsequent year on Line 202 of Schedule 1 as the income has not yet been recognized for tax purposes. Similarly, an amount deducted in computing income for tax purposes in the prior year in respect of prepaid expenses should be added to income for tax purposes on Line 202 of Schedule 1 in the subsequent year as the expense has already been deducted for tax purposes.

ITA 28(1), 12(1)(b)

Accrual Inventory *(Sch. 1: Line 302)*

Expenses are deducted when paid when the cash method is employed. As such, when this method is used, the balance of inventory for book purposes at the end of the year should be deducted from income for tax purposes on Line 302 of Schedule 1 as the inventory has been paid for (or the related accounts payable has been added to income for tax purposes as described above). An amount deducted in computing taxable income in the prior year in respect of the balance of inventory on hand at the end of the year should be added to income for tax purposes in the subsequent year on Line 203 of Schedule 1 as the expense has already been deducted for tax purposes. Only a corporation using the cash method should complete Lines 203 and 302 of Schedule 1.

Farming corporations that report on the accrual method of accounting are required to make an inventory valuation of their livestock annually, as required by ITA 10. However, this task may be greatly simplified by the adoption of a fixed unit price method as permitted under the ITRs.

SAMPLE

ITR 1802 allows a farming corporation to elect to value each animal of a particular species (except a registered animal, an animal purchased for feedlot or similar operations, or an animal purchased by a drover or like person for resale) included in inventory at a unit price determined in accordance with the rules in the ITR; see Form T2034: *Election to establish inventory unit prices for animals*. Under ITR 1802, the unit price is defined as the value obtained by dividing the inventory valuation for the previous year-end by the number of animals then on hand, class by class. Once this unit price is determined, it is employed for the particular class to which it pertains, unchanged thereafter, or until it can be demonstrated that the market value in a particular year has fallen below the unit price valuation, or until the farmer notifies the CRA in writing of wishing to revoke the election (see ITR 1802(2)). In respect of a farming corporation that has been filing in accordance with the cash method (and therefore has no previous inventory valuation to use as a starting point) and that desires to change over to the accrual method, the CRA is empowered to determine the unit price having regard to other unit prices already established in the same district.

The election under ITR 1802 is not available to drovers and feedlot operators who have rapid turnovers. Also, the election is denied in the case of registered animals for which identification of animals on hand with their respective costs does not present an administrative problem.

ITA 10, 28(1), Part XVIII of the ITRs, Guide T4003 (see under the headings "Reporting methods" and "Valuing your purchased inventory")

Mandatory Inventory Adjustment *(Sch. 1: Lines 224, 309)*

By virtue of ITA 28(1)(c), when a corporation that employs the cash method incurs a loss in any fiscal year from the business of farming, the farming loss incurred for the period is required to be reduced or eliminated by the value of inventory on hand at the end of the year that the corporation had purchased in connection with the business. ITA 28(1)(c) applies in loss years only and is a mandatory adjustment. When applicable, the amount of the adjustment should be added to income for tax purposes on Line 224 of Schedule 1.

A mandatory inventory adjustment included in computing income for tax purposes in the prior taxation year should be deducted on Line 309 of Schedule 1 in the subsequent year as a deduction has not yet been claimed for tax purposes in respect of the cost of the inventory.

ITA 28(1)(c), (f), IT-526, IT-427R, CRA Guide T4003

Optional Value of Inventory Adjustment *(Sch. 1: Lines 229, 313)*

A farming corporation is permitted to add to its income for tax purposes for a year an elected amount not exceeding the fair market value of livestock on hand at the end of the year, with a deduction of an equivalent amount required to be made in computing income for tax purposes in the following year. Such an amount should be added to income for tax purposes on Line 229 of Schedule 1. The deduction of the elected amount in the subsequent year should be reported on Line 313 of Schedule 1.

ITA 28(1)(b)

Restricted Farm Losses *(Sch. 1: Line 233; Sch. 4)*

Where neither farming alone, nor a combination of farming and some other source of income, is the "chief source" of a corporation's income, there is a limit to the amount of a farming loss sustained in a given taxation year that may be deducted in computing the corporation's income for that year; see Chapter 4 under ¶3215.

SAMPLE

Generally, when farming is a secondary source of income for a corporation, the amount which may be deducted in respect of farming losses is limited to $8,750, made up of the first $2,500 of the loss, in full, plus one-half of any further loss between $2,500 and $15,000.

ITA 31(1), IT-322R, IT-232R3, *Craig*, 2009 CarswellNat 4372

¶2365 Financing Fees (Sch. 1: Line 216)

An amount deducted from book income in respect of financing fees in the nature of those described below should be added to income for tax purposes on Line 216 of Schedule 1. For tax purposes, ITA 20(1)(e) permits the amortization over a five-year period of financing fees relating to the issue or sale of shares, units of unit trusts, or partnership or syndicate interests, or relating to the borrowing of money.

Costs of collection, discounts, drafts and the like in connection with a business are deductible.

See also ¶2675 (Share Issue Expenses).

ITA 18(1)(b), 20(1)(e)

Tax Provision Note: Financing fees deducted from income for tax purposes in the year relate to a timing difference and do not decrease the effective tax rate of the corporation. The balance of unamortized financing fees available at the end of the year is a deductible temporary difference. See the example under ¶2275.

¶2366 Amortization of Financing Fees for Tax Purposes

Financing fees incurred by a corporation in the course of issuing shares of its capital stock or in the course of borrowing money used by the corporation for the purpose of earning income from a business or property are deductible in equal annual amounts over five years for tax purposes (the deduction is pro-rated for a short taxation year) by virtue of ITA 20(1)(e).

As financing fees in the course of issuing shares or borrowing money would otherwise be non-deductible capital outlays, ITA 20(1)(e) is required to permit a deduction of the expenditures for tax purposes.

The following examples of share issue expenses deductible under ITA 20(1)(e) are provided in paragraph 16 of IT-341R4: *Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate and Expenses of Borrowing Money*: legal fees in connection with the preparation and approval of a prospectus pertinent to the issuance or sale of shares, units, or interests; accounting or auditing fees in connection with the preparation of reports on financial statements and statistical data for inclusion in, or for presentation with, the prospectus; the cost of printing the prospectus, new share, unit, or interest certificates, etc; registrars' or transfer agents' fees; and filing fees charged by any public regulatory body which requires the filing of a prospectus for acceptance.

The following examples of borrowing costs deductible under ITA 20(1)(e) are provided in paragraph 17 of IT-341R4: legal fees in connection with the preparation and approval of a prospectus when the money is to be borrowed by means of an issue of bonds or debentures; the cost of printing the prospectus, bonds, or debentures, etc; a commitment fee paid to a lender pursuant to an agreement between the borrower and the lender whereby the lender is committed to make a specified amount of money available to the borrower from time to time as, and when, the borrower requests; an amount paid to the guarantor of a loan either on a periodic basis during the continuance of the loan, or as a one-time payment at the commencement of the loan; certain “soft costs” an investor incurs in the course of financing the

SAMPLE

construction of a building to be used for the purpose of earning income from property in which the investor has the beneficial ownership at the time such costs are incurred (frequently encountered soft costs (i.e., costs not related to the acquisition of the land, buildings, and equipment) that an investor pays which are deductible under ITA 20(1)(e) include mortgage application, mortgage appraisal, mortgage processing, and mortgage insurance fees, mortgage guarantee fees, mortgage brokerage (placement) and finder's fees, and legal fees related to mortgage financing); promoter's service fees related to those soft cost expenses that are deductible under ITA 20(1)(e); certification fees and certain other expenses incurred, such as commissions charged by a bank, in connection with the sale of bankers' acceptances; and accounting or auditing fees in connection with the preparation of reports on financial statements and statistical data for inclusion in, or for presentation with, a prospectus, registrars' or transfer agents' fees, and filing fees charged by any public regulatory body which requires the filing of a prospectus for acceptance if the latter expenses are incurred in the course of borrowing money and not otherwise deductible under ITA 20(1)(e.1).

Amounts that cannot be deducted under ITA 20(1)(e) include amounts paid on account of the principal or interest of a debt obligation, amounts dependent or contingent upon the use of or production from property, or an amount computed by reference to revenue, profit (i.e., a profit participation payment), cash flow, commodity price or similar criterion, or by reference to dividends paid on any class of shares.

Where the expense incurred is a standby charge, guarantee fee, registrar fee, transfer agent fee, filing fee, service fee or any similar fee, the expense is fully deductible in the year incurred by virtue of ITA 20(1)(e.1) provided the expense can reasonably be considered to relate solely to the year it is incurred.

If a particular expense relates to a year other than the year in which it is payable, the expense will be deductible in accordance with ITA 20(1)(e) rather than ITA 20(1)(e.1). ITA 20(1)(e.1) would not apply, for example, to a guarantee fee paid in respect of the term of a loan rather than with respect to the year in which it is paid. ITA 20(1)(e.1) applies equally to such expenses that relate to amounts payable for property acquired to earn business income or to expenses related to debt rescheduling, restructuring or assumption.

If the relevant borrowings in respect of which financing fees deductible under ITA 20(1)(e) were incurred are repaid, any balance of borrowing expenses not yet deducted are deductible in the year of repayment unless the repayment was made in the course of a refinancing.

Where expenses were incurred by a corporation that is wound up or amalgamated, the parent or successor may deduct the expenses of the remaining amortization period. Where financing fees were incurred by a partnership that is dissolved, the partners may deduct the remaining undeducted balance with a corresponding reduction in the ACB of their partnership interest (see ¶4113).

Expenses incurred in restructuring or rescheduling debt or in assuming debt, either where the borrowings are used to earn business income or to pay for income earning property, are deductible by virtue of ITA 20(1)(e)(ii.2). The restructuring or rescheduling is required to either be a change in the terms and conditions of the debt, or a conversion or substitution of debt to shares or to another debt obligation.

Where a corporation issues shares in the course of a takeover and related investment banker fees are incurred, the CRA normally considers such fees to form part of the ACB of the shares acquired (IT-341R4 (para. 20), VD 2004-0087011C6). In VD 2002-0150835, the CRA states:

SAMPLE

> [T]here are in effect two tests that have to be met [under subparagraph 20(1)(e)(i)]. The first one is that the expenses must be "in the course of an issuance . . . of shares of the capital stock of the taxpayer".
>
> In the second test, the expenses must meet the preamble to subsection 20(1) . . . As such, the expenses incurred must be wholly applicable to the issuance of the shares and not be only consequential or resulting from the issuance of the shares. It is a question of fact whether fees payable to investment bankers are wholly applicable to the issue of shares of the capital stock of a corporation. Generally, investment bankers recommend and execute strategies for takeovers and mergers of corporations and accordingly, the fees would not, in our view, be wholly applicable to the issuance of shares for purposes of subparagraph 20(1)(e)(i) . . . The [CRA] generally takes the view that costs incurred by the Purchaser in the course of a take-over will be capital expenditures that should be added to the cost of the shares so acquired.

ITA 20(1)(e)(i) refers to "an expense incurred in the year or a preceding taxation year in the course of an issuance or sale of... shares of the capital stock of the taxpayer. The CRA has suggested that for expenses to be deductible under ITA 20(1)(e)(i), shares must be issued from treasury. This interpretation is not, however, supported by the Courts. The phrase "in the course of" was broadly interpreted by Mr Justice Thurlow as meaning "incidental to" or "in connection with" in *Yonge-Eglinton Building Ltd*, [1974] C.T.C. 209 (FCA) and in *International Colin Energy Corp.*, [2003] 1 C.T.C. 2406 (TCC), the Court stated (paras. 58, 59):

> The question is however whether "in the course of the sale ... of the shares of the capital stock of the taxpayer..." is to be restricted to a sale by the corporation of its own shares.
>
> There are respectable arguments on either side. It is arguable that "sale" by its juxtaposition with "issuance" means a sale by the company of its own shares and not a sale by shareholders of their shares. It is equally arguable that "issuance" by itself is quite broad enough to cover a sale by a company of its own shares and that there was no need to add the word sale if all that was meant was a sale by the company. Therefore "sale" must imply something else and the only thing it can refer to is a sale by the shareholders in the course of a corporate transaction of the type involved here where the interests of the corporation are affected. I find the argument attractive not only because it makes sense commercially but because the more restrictive interpretation requires reading into the statute words that are not there.

See also *BJ Services*, [2004] 2 C.T.C. 2169 (TCC) and the commentary under ¶2512.

Arguably, expenses do not necessarily have to be wholly applicable to the issuance of shares to be deductible under ITA 20(1)(e)(i) (see for example VD 2004-0087011C6).

In *MacMillan Bloedel Limited*, [1990] 1 C.T.C. 468 (FCTD), the Court held that losses under certain foreign exchange hedging transactions were deductible under ITA 20(1)(e)(ii) as expenses incurred in the course of borrowing money. In the case, the corporation arranged to borrow US dollars and, to ensure that specific amounts of Canadian dollars would be available on closing, entered into forward hedging contracts with certain banks for delivery of US dollars in the future for Canadian dollars based upon specified exchange rates. The CRA considers the decision in *MacMillan* to be limited to the particular facts of that case and is not prepared to adopt as a general position that foreign currency gains or losses that arise as the consequence of the sale of a currency pursuant to the exercise of a forward contract to be an expense incurred in the year in the course of borrowing money for purposes of ITA 20(1)(e) (see VD 2008-0272441I7).

SAMPLE

The CRA's position is that if expenses are paid by a parent company on behalf of its subsidiary in connection with the issuance of shares by its subsidiary, they are not deductible by the parent company under ITA 20(1)(e); however, if such expenses are reimbursed by the subsidiary to the parent, and are reasonable in the circumstances, they should be deductible by the subsidiary (VD 2009-0328671I7).

In *Merban Capital Corporation Limited*, [1989] 2 C.T.C. 246 (FCA), the Court held that payments made by a corporation when its subsidiary was in default on a bank loan were not deductible under ITA 20(1)(e) (as it then read) as expenses incurred in the course of borrowing money, on the basis that the taxpayer did not itself borrow the money to which the expenses related.

The CRA does not consider costs incurred related to the acquisition of shares in the course of a reorganization to be deductible under ITA 20(1)(e). In VD 2009-0328671I7, the CRA states:

> In our view, the purpose of paragraph 20(1)(e) is to allow the deduction of financing expenses. Subparagraph 20(1)(e)(ii) permits the deduction of expenses incurred in the course of a borrowing of money. Subparagraph 20(1)(e)(ii.1) allows for the deduction of expenses incurred in the course of becoming indebted by reason of an amount having become payable by the taxpayer for property acquired to earn income. Finally, subparagraph 20(1)(e)(ii.2) allows for the deduction of expenses incurred in the course of a rescheduling or restructuring of a debt obligation or an assumption of a debt obligation.
>
> Based on the above, and considering the scope of subparagraphs 20(1)(e)(ii), (ii.1) and (ii.2), it can be argued that subparagraph 20(1)(e)(i) should be interpreted as allowing a deduction in respect of expenses incurred in the course of an issuance or sale of shares, only if such issuance of shares results in the raising of money for the corporation. In the absence of any indication of financing, no deduction may be permitted under subparagraph 20(1)(e)(i).
>
> Further, as explained in paragraph 10 of the Interpretation Bulletin IT-341R4, entitled "Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate, and Expenses of Borrowing Money", the deduction permitted by paragraph 20(1)(e) or (e.1) is restricted to the taxpayer who enters into a transaction described within these paragraphs. For instance, a taxpayer can deduct expenses incurred in the course of: an issuance of shares of the taxpayer by the taxpayer; a borrowing of money used by the taxpayer for the purpose of earning income from a business or non-exempt income from property; an assumption of a debt obligation by the taxpayer in respect of such a borrowing; etc. Accordingly, if expenses are paid by a parent company on behalf of its subsidiary in connection with the issuance of shares by its subsidiary, they are not deductible by the parent company under paragraph 20(1)(e). However, if such expenses are reimbursed by the subsidiary to the parent, and are reasonable in the circumstances, they should be deductible by the subsidiary.
>
> It should be noted that in any particular situation it would need to be determined whether we are dealing with the issuance of a share, such that the provisions of subparagraph 20(1)(e)(i) are applicable, or whether we are dealing with a restructuring or rescheduling of a debt obligation, which had originally been issued in the course of a borrowing noted under subparagraph 20(1)(e)(ii) or incurring indebtedness noted under subparagraph 20(1)(e)(ii.1), and such restructuring or rescheduling involves the conversion or substitution of the debt obligation to or with a share, such that the provisions of subparagraph 20(1)(e)(ii.2) are applicable.

See also under ¶2512 (Merger and Acquisition Fees).

A discount of a debt obligation is not deductible under ITA 20(1)(e); see under ¶2468. In *The Queen v Royal Trust Corporation of Canada*, [1983] C.T.C. 159 (FCA), a payment to an underwriter was held to

SAMPLE

be a commission rather than a discount or rebate on the sale price of the shares to the underwriter as contended by the CRA. Even though title in the shares in question was transferred to the underwriter, the amount agreed upon as a commission (which was paid to the underwriter by way of separate cheque and not, for example, reflected as a reduction in the price paid to the plaintiff for the shares by the underwriter) was for the entire range of services provided by the underwriter in the course of the latter's distributing the shares to the public (agreeing to attempt to ensure a broad public distribution, analysis of share price and market possibilities, etc.).

Other considerations in respect of financing fees deduction under ITA 20(1)(e) include:

- A deduction cannot be claimed under ITA 20(1)(e) if the relevant property were to produce exempt income or the property acquired is a life insurance policy.

- The fact that a plan for a transaction is abandoned would not result in a disallowance of expenses relating to that plan if the transaction is actually carried out pursuant to a new transaction plan that is substituted for the original one. It is a question of fact whether a new transaction plan has been substituted for an original one (*BACM industries Ltd*, [1973] C.T.C. 2093, VD 2009-0340251I7 and para. 12 of former IT-341R3);

- Borrowed money is defined to include funds raised on the sale of a banker's acceptance. Accordingly, certification fees and other expenses incurred in connection with the sale of acceptances are deductible for tax purposes.

- The CRA's position is that financing costs are deductible under ITA 20(1)(e) where the indirect use of funds interest deductibility test outlined paragraphs 22–26 of IT-533 is met (VD 2005-0161661E5);

- The CRA does not consider a derivative termination payment related to a so-called gilt lock derivative used to secure current market rates for future fixed-rate funding to be deductible under ITA 20(1)(e). Rather, the CRA's view is that hedge costs or hedge premiums should be factored into any gain or loss on the derivative contract (VD 2008-0272441I7);

- Foreign currency gains or losses that arise on the realization of an exchange conversion would not be deductible under ITA 20(1)(e) (see ¶4425).

ITA 20(1)(e), ITA 248(1)"borrowed money", *ACM industries Ltd*, [1973] C.T.C. 2093 (TRB), *Trans-Prairie Pipelines Ltd*. [1970] C.T.C. 537 (Exct), IT-341R4, IT-119R4, IT-99R5, IT-533, ITTN-16, VDs 2009-0340251I7, 2009-0328671I7, 2008-0272441I7, 2005-0161661E5, 2002-0142745, September 1990-101

¶2370 Fines and Penalties (Sch. 1: Line 128)

Prior to *65302 British Columbia Limited*, the CRA took the position that fines or penalties could be denied as a business deduction if the event that resulted in the fine or penalty being imposed was avoidable or contrary to public policy. In *65302 British Columbia Limited*, the Court concluded that, in the absence of a specific provision in the ITA indicating otherwise, the CRA's position had no legal basis, and that a penalty or fine was deductible in computing income from a business where a corporation could establish that the penalty or fine was incurred for the purpose of gaining or producing income from that business (except in limited cases where an act is so egregious or repulsive that the fine or penalty cannot be justified as being incurred for an income earning purpose). However, after March 22, 2004, ITA 67.6 was enacted to partially override the decision in *65302 British Columbia Ltd*. By virtue of ITA 67.6, an expense incurred in respect of a fine or penalty imposed under the law of a country, state, province or

SAMPLE

territory by any person or public body is not deductible for tax purposes (other than an amount prescribed by draft ITR 7309).

ITA 67.6 does not preclude the deduction of legal fees to defend against prosecutions which can lead to fines if the legal fees are otherwise deductible. Also, the provision does not apply to interest, including interest on penalties on provincial capital tax.

If the relevant expenditure is not characterized as a fine or penalty and is incurred for the purpose of earning income, it may be deductible.

ITA 67.6 would not apply to prohibit the deduction of penalties or damages under a private contract.

See also ¶2460 (Interest and Penalties on Taxes).

ITA 67.6, Reg 7309, ITTN-38, IT-467R2, IT-365R2, 2008-0271801I7, 2008-0294701E5, 2004-0103901E5, 2009-0326941I7, Joel A. Weinstein, QC, "Damages, Fines, and Penalties: An Update," *Report of Proceedings of Fifty-Second Tax Conference*, 2000 Tax Conference (Toronto: Canadian Tax Foundation, 2001), 7:1-29

Tax Provision Note: Non-deductible fines and penalties added to income for tax purposes are a permanent difference that increases the effective tax rate of the corporation (see ¶15110, ¶15420).

¶2375 Flow-Through Share Tax

A corporation can deduct any tax paid by it for the year under Part XII.6 of the ITA in respect of an amount renounced under the flow-through share "look-back rules" (see ¶5437). The flow-through share rules allow a corporation to issue shares that transfer the tax deductibility of qualifying resource expenditures (i.e. Canadian exploration expenses) to investors on a potentially accelerated basis.

ITA 20(1)(nn), Form T101C, Ron Mar et al., "Basic Issues in Resource Taxation," Report of Proceedings of Sixtieth Tax Conference, 2008 Tax Conference (Toronto: Canadian Tax Foundation, 2009), 10:1-29

Tax Provision Note: See under ¶15226.

¶2380 Foreign Accrual Property Income (FAPI) (Sch. 1: Line 217)

FAPI of a "controlled foreign affiliate" (CFA) (see ¶7210) of a Canadian resident corporation is imputed to the Canadian corporation on an accrual basis. The imputation is made at the end of each taxation year of a CFA.

The FAPI rules are generally intended to thwart the use of so-called tax havens to avoid Canadian tax on passive/investment income earned by certain CFAs. FAPI generally includes income for the year from property or from a business other than an active business and taxable capital gains arising from the disposition of property that is not used in an active business.

ITA 95 contains detailed rules setting out certain specific types of income which are included in FAPI, and certain types of property that are "excluded property". ITA 91 contains the rules that impute FAPI to a corporation resident in Canada and the rules that provide recognition for foreign taxes already imposed on FAPI, generally ensuring that FAPI is not taxed a second time when it is distributed to the Canadian corporation. The definition of FAPI is discussed in detail under ¶7225.

SAMPLE

Generally, where a foreign affiliate (FA) (see ¶7205) carries on an active business (such as a manufacturing operation) or a qualified business (such as a financial institution), the income earned by the FA will not be FAPI and is only taxed when repatriated to Canada. If the income is earned in a country with which Canada has a tax treaty, any dividends received are generally free from Canadian tax (see ¶7250). These non-taxable earnings are referred to as exempt surplus and the dividends are referred to as exempt surplus dividends. Dividends paid from an FA resident in a non-treaty country out of taxable surplus may also be received free of Canadian tax depending on the amount of underlying foreign tax paid by the FA in respect of the earnings from which the dividend is paid.

The imputation of FAPI is made in a series of steps and calculations. First, the corporation is required to identify its CFAs. As discussed under ¶7210, the relevant rules can be complex. Many FAs of a Canadian corporation are not CFAs, and some foreign corporations that are controlled by a Canadian corporation are not FAs, and hence cannot be CFAs. The FAPI of each CFA is required to be calculated separately from that of others, as must the "foreign accrual tax" (FAT), if any, that is applicable to the FAPI. Finally, the participating percentage of each share owned directly by the Canadian corporation in a CFA must be determined, as this percentage is used to determine the amount of FAPI imputed to the Canadian corporation. This participating percentage is in respect of both the CFA itself, and any subsidiary CFAs. The participating percentage calculation is made on a per share basis and is ascertained at the end of the relevant taxation year of the CFA notwithstanding any changes in shareholdings that might have taken place during the course of that year. Participating percentage is not synonymous with the concept of "equity percentage" discussed under ¶7205 which is relevant in determining whether a non-resident corporation is an FA.

The imputation of the FAPI, if any, of a CFA is made at the end of a CFA's taxation year. As such, if a corporation is not a CFA at the time of its taxation year-end, a FAPI imputation will not occur. Conversely, if the corporation is a CFA at that particular time, its entire earnings for the year are within the scope of the FAPI imputation rules even if the corporation became a CFA during the course of the year. Where the FAPI of an FA in a year is $5,000 or less, no imputation arises.

Where a CFA has only one class of issued shares at the end of its taxation year, the participating percentage will be the Canadian corporation's equity percentage in the CFA reduced to a per share basis. For example, if a Canadian corporation holds all 1,000 issued common shares of a CFA, the corporation's equity percentage in the CRA is 100%, and the participating percentage per share is .1%. Where the calculation involves more than one non-resident corporation, but each of them has only one class of issued shares outstanding at the relevant time, the calculation is generally the same.

FAPI imputation only applies where the particular Canadian resident corporation owns shares of a particular CFA directly; however, the participating percentage rules also provide for the imputation of FAPI of lower-tier CFAs through the shares of a top-tier CFA (i.e., the imputation applies to include an amount in computing income in respect of each share owned by the Canadian corporation of the capital stock of a CFA (i.e., the top-tier CFA) of the corporation). The amount included in income in respect of the shares of a lower-tier CFA is based on the participating percentage of the top-tier CFA in the lower-tier CFA.

In cases where one or more of the corporations involved in the participating percentage computation has issued more than one class of shares, the participating percentage is determined in accordance with a special set of rules contained in ITR 5904.

ITA 91(4) provides relief for any foreign taxes borne by FAPI that have been imputed to a Canadian corporation. The relief is granted either in the year of imputation or in any of the subsequent 5 taxation

SAMPLE

years, so as to allow for different accounting or taxation procedures in the foreign country. The relief applies only to the FAT borne in respect of the FAPI imputed to the Canadian corporation.

When a corporation resident in Canada incurs a foreign withholding tax on dividends received out of FAPI, it is also entitled to a deduction of the amount of that tax multiplied by its “relevant tax factor” (RTF) under ITA 113(1)(c). A corporation's relevant tax factor where the corporation's taxation year coincides with the calendar year is as follows: year / RTF; 2000-2001 / 2.63; 2002 / 2.86; 2003 / 3.03; 2004-2007 / 3.23; 2008 / 3.39; 2009 / 3.45; 2010 / 3.57; 2011 / 3.77; 2014 / 4.00.

ITA 91(5) exempts from tax dividends paid out of previously taxed FAPI. Also, ITA 92(1) increases the ACB of a share in an FA by the net amount of imputed FAPI in respect of that share. In more general terms, once FAPI has been imputed and subjected to Canadian tax, inasmuch as the assets or value embodying the FAPI remain in the FA, double taxation is prevented in the event that the shares of the FA are disposed of or in the event that a dividend is paid by the FA. To ensure that an exemption is not granted twice, any amount deductible under ITA 91(5) reduces the ACB of the shares of the FA held by the Canadian corporation.

ITA 91(5) applies only to an FA in which the Canadian corporation holds shares directly. If a Canadian corporation (Canco) holds all of the shares of a CFA (CFA1) that in turn holds all of the shares of another CFA (CFA2), CFA2's FAPI is imputed in respect of the shares held by Canco in CFA1 and it is the shares of CFA1 whose ACB is increased when FAPI is imputed. Additionally, for ITA 91(5) to apply, the corporation paying the dividend is required to have been at some time a CFA of Canco and must be an FA of Canco at the time of the payment of the dividend; otherwise, no portion of the dividend will be prescribed to have been paid out of the taxable surplus of the corporation (ITR 5900(1) only applies where, at any time, a corporation resident in Canada, or an FA of the corporation, receives a dividend on a share of any class of an FA of the corporation). The deduction under ITA 91(5) is limited to the lesser of: 1) the portion of the dividend that is paid out of taxable surplus, less the amount deductible in respect of underlying foreign tax under ITA 113(1)(b) (see ¶7253), and 2) the amount by which all additions to the ACB of the relevant shares in respect of FAPI exceed all such deductions.

For example, in year 1, CFA1 earns $100,000 of FAPI and pays a local tax thereon of 20%. The amount of imputed FAPI to Canco is $100,000; Canco owns all the shares of CFA1. Canco deducts an amount equal to the $20,000 of FAT multiplied by the RTF for the year. The taxation year in question is the 2008 taxation year, such that the deduction available is $67,797. Canco has a net increment included in its income of $32,203 ($100,000 – $67,797) and pays $9,500 Canadian tax thereon. At the same time, the ACB of its shares in CFA1 increases by $32,203.

In year 2, CFA1 pays a dividend of $80,000 and withholds foreign tax therefrom of 5% ($4,000). The entire amount of the dividend is prescribed to have been paid out of the taxable surplus of CFA1. The dividend is included in Canco's income. In respect of the dividend, a deduction in computing taxable income of $48,966 is available under ITA 113(1)(b), computed as: ((1/(.38 – .09)) – 1) × $20,000). In the latter calculation, the RTF is reduced by one in order to convert the foreign tax on the underlying taxable surplus into a taxable income deduction that, similar to the associated dividend payment, is net of such tax). Also, a deduction of $13,793 is available under ITA 113(1)(c), computing by multiplying the applicable foreign withholding tax by the RTF ($4,000 × (1/(0.38 – .09)). The deduction available under ITA 91(5) is equal to the lesser of: 1) the dividend less the deduction under ITA 113(1)(b), or $31,034 ($80,000 – $48,966 = $31,034) and 2) the net increase in the ACB of the shares in the previous year, or $32,203. The results are illustrated below:

Year 1

SAMPLE

Imputed FAPI (foreign tax of $20,000 was paid)	$ 100,000
Deduction for foreign tax: ITA 91(4)	67,797
Income and taxable income	32,203
Canadian tax at 29.5%	9,500

Year 2

Dividend (foreign tax withheld was $4,000)		$ 80,000
Less previously taxed FAPI: 91(5)		31,034
Income		48,966
Less: deduction for applicable foreign tax: 113(1)(b)	$ 48,966	
deduction for foreign withholding tax: 113(1)(c)	13,793	62,759
Taxable income (loss)		(14,063)
Canadian tax reduction in respect of loss carry-over:		(4,078)

The total tax paid is $33,500 ($20,000 in foreign income tax, $4,000 in foreign withholding tax, and $9,500 in Canadian tax). However, when the value of the Canadian tax loss carry-over is considered, the net Canadian tax is $5,422 ($9,500 – $4,078), and the total tax is $29,422. Thus, the result is generally the same as would have obtained had the Canadian corporation earned the foreign income directly and paid tax thereon at a rate of 29.5% (the result would have been exactly the same except for the fact that RTF increased from 2008 to 2009).

FAT has three major components. First, it includes any income or profits tax paid by the CFA, including withholding tax borne by dividends, interest, royalties, or other such types of income, as well as ordinary income or profits tax. There is no limitation with respect to the jurisdiction levying the tax, and the country can be any country in the world (including Canada), regardless of whether or not the CFA is resident or carrying on business in that country or any political subdivision thereof. The meaning of the term "income or profits tax" is discussed under ¶10312. Second, FAT includes any income or profits tax paid by another FA of the Canadian corporation in respect of a dividend received from the CFA. Again, this may include both withholding tax and ordinary income or profits tax. This rule recognizes that inter-affiliate dividends are not included in FAPI.

If a Canadian corporation holds a CFA through a foreign holding company and the CFA pays a dividend to the foreign holding company, a deduction is available in respect of any FAT paid by either the CFA or the foreign holding company.

FAT also includes amounts applicable in cases where FAs file on a "consolidated basis" or are entitled to "group relief" in respect of losses. Specifically, ITR 5907(1.3)(a) provides that where an FA of a Canadian corporation and other corporations resident in the same country file consolidated returns (for example, the US), reimbursements made by the FA to any of the other corporations for taxes otherwise payable by the affiliate in respect of income that constitutes FAPI of the Canadian corporation is FAT in respect of the affiliate applicable to the FAPI.

ITR 5907(1.3)(b) provides that where the tax of an FA of a Canadian corporation is reduced by losses of another corporation resident in the same country under "group relief" provisions (for example, the UK), a compensation payment made by the affiliate to the other corporation for the use of its losses is included in the FAT in respect of the affiliate if the compensation payment is for taxes otherwise payable in respect of

SAMPLE

income that constitutes FAPI of the Canadian corporation. There is no requirement that the tax be paid in the year in which the FAPI was earned.

The FAT definition refers to taxes "that may reasonably be regarded as applicable to" FAPI included in income. In VD 2002-0134201I7, the following example was provided to illustrate the CRA's position with respect to the FAT definition:

> Assume in year 1 a particular affiliate has $100 FAPI income and a $50 active business loss (paying tax on $50 taxable income). In year 2 the affiliate has $100 FAPI income and $130 active business loss (paying no tax for the year) and having a $30 loss carry forward. In year 3 the affiliate has $100 FAPI income and $500 active business income (paying tax on $570 taxable income after using the $30 loss carried forward). This was the fact pattern described in Rulings document 971905 dated October 29, 1997. In that interpretation we considered it reasonable to look at the three-year period in determining what portion of the tax paid in year 3 reasonably related to an amount included in FAPI. Over the three-year period the total FAPI income was $300 and the total active business income was $320. It was our conclusion that the total tax paid for the three years that should be considered FAT would be 300/620 of the total tax. The tax paid in year 1 clearly related to FAPI and would be considered FAT. Accordingly, a deduction could be computed under subsection 91(4) in respect the tax paid by the affiliate in year 1 and deducted in the taxation year of the taxpayer in which taxation year 1 of the affiliate ended. The balance of the FAT would be recognized in year 3 and would be available for the computation of a deduction under subsection 91(4) in the taxation year of the taxpayer in which taxation year 3 of the affiliate ends. Some of such FAT in year 3 is pertains to the FAPI included in the taxpayer's income in respect of the each of the affiliate's three taxation years.

Generally, FAT in respect of a capital gain may reasonably be regarded applicable to an amount of imputed FAPI to the extent that such foreign tax is required to eliminate the Canadian income tax that would otherwise be payable in respect of the gain under the FAPI rules or through the repatriation of the taxable surplus resulting from the gain. ITA 91(4) is generally intended to ensure that FAPI is not subject to additional Canadian tax if the effective rate of foreign tax on underlying FAPI is equal to or greater than the Canadian effective tax rate which would have applied had the FAPI been earned directly by a Canadian corporation.

As mentioned above, relief under ITA 91(4) is granted either in the year of imputation or in any of the subsequent 5 taxation years. The relief applies only to the FAT borne in respect of the FAPI imputed to the Canadian corporation. An amount is not recognized as FAT until it is paid; however, there is no requirement that the tax be paid in the year in which the FAPI was earned. In this respect, in VD 2002-0134201I7, the CRA states:

> In our view, the deduction under subsection 91(4) is available in the taxation year of the taxpayer in which the taxation year of the affiliate for which the amount in respect of foreign tax is paid ends. The amount must be payable for the year of the affiliate for which the FAPI is included in the taxpayer's income under 91(1), or the 5 immediately succeeding years. In those rare situations where the amount pertains to a taxation year preceding the year in which the FAPI is reported (this could be due to timing differences in how FAPI is computed under Canadian rules versus how the income is computed under the foreign law), the deduction may be made in the taxation year of the taxpayer in which the FAPI is reported.
>
> In applying subsection 91(4), some meaning has to be given to the phrase "or for any of the 5 immediately preceding years" in the preamble to the subsection, as well as the phrase "the portion of

SAMPLE

the foreign accrual tax applicable to the income amount that was not deductible under this subsection in any previous year" found in subparagraph 91(4)(a)(i).

Under this interpretation, there are a number of situations in which this could be relevant.

First, where foreign tax has been paid in an earlier year, but the income that it related to was not recognized as FAPI until a later year, such tax would become FAT in the year the FAPI was reported and the deduction would be taken in that year. It would not have been deductible in any previous year notwithstanding that the tax had been paid in a previous year.

Second, FAT that is applicable to an amount that has been included in FAPI in a previous year can occur in a number of situations where the foreign tax liability arises in a year subsequent to the year the FAPI was included in income under 91(1). For example, withholding tax in respect of a dividend paid out of income that was included in FAPI will only be recognized as FAT at the time the withholding tax liability arises. Such tax is treated FAT at that time and such FAT was not deductible in a previous year (there having been no obligation under the foreign tax law to pay such FAT). In another example, where FAPI is included under 91(1) in a particular year, but the income for foreign purposes is recognized over a period of years because of a reserve allowed under the foreign tax law, so long as it was eventually paid the FAT would be deductible in respect of the year the affiliate became obligated to pay it.

Because the deduction cannot exceed the amount included in income, the reference to the previous 5 years in 91(4)(b) has relevance. For example, if the deduction in respect of the withholding tax on the dividend out of FAPI (when combined with deduction taken earlier in respect of tax paid by the affiliate that earned the FAPI) exceeds the income included in FAPI, the deduction in respect of the withholding tax will be restricted.

The CRA's general position is that an FA that derives a particular amount of FAPI that is imputed to a particular Canadian corporation in a taxation year is required to be the same FA that pays the foreign tax for an amount to be deductible in respect of FAT (VDs 9822835 and 2007-0247551E5). It is unclear whether the CRA's position is supported by the language of the relevant provisions.

FAPI is "foreign investment income" for the purposes of calculating a CCPC's RDTOH (see ¶8235). Thus, where FAPI has been imputed to such a corporation, it will be subject to tax at the full corporate rate, but a portion of the tax may be refunded to the corporation if it pays a taxable dividend.

For a comprehensive analysis and explanation of all of the complex foreign affiliate rules, order a copy of the *Canada Tax Service Foreign Affiliates Guide*, available on Carswell.com (November 2010, ISBN/ISSN: 978-0-7798-3458-7, $85). The Foreign Affiliate Guide includes an authoritative section-by-section analysis, researched and prepared by leading tax experts, of the core provisions contained in the ITA and ITRs related to the taxation of foreign affiliates (including the surplus rules). The analysis includes examples, discussions of leading cases, and references to relevant CRA publications.

ITA 91, 95, 113(1), VDs 2004-0078921E5, 1999-0010175, 2002-0134201I7, September 1991-231, 5-1511, 2004-0078921E5

Tax Provision Note: Normally, FAPI included in income for tax purposes is a permanent difference as an exception normally applies from recognizing deferred taxes in respect of outside basis differences related to investments in subsidiaries (see ¶15110 and ¶15315).

SAMPLE