# Source of Canadian Tax Law and Tax Logic

Sources of Tax Law in Canada: Statute, Regulations, CRA Interpretive Bulletins, Other CRA Internal Memoranda, the Marketplace and Administrative Practice

The most frequently litigated issues include:

1. Whether a person is a resident of Canada
2. Whether income is from employment or a business
3. Whether a profit from a sale of property is an income from a business or capital gain
4. Whether certain types of expenses are deductible from income
5. Whether losses from unprofitable ventures are fully deductible from income
6. Whether GAAP principles apply to computing income from a business
7. Whether an interest expense is currently deductible
8. Whether anti-avoidance rules are applicable

**Haig-Simons Definition of Income:** The income of a person during a particular period equals (i) the monetary value of actual consumption the person engaged in, plus (ii) the change in net wealth of the person, both during that period.

**Ability to Pay Principle**: equity or fairness should be the major objective of the income tax system and based on the ability to pay and determined by amount of discretionary income

* Horizontal equity: those in similar circumstances bear the same taxes
* Vertical equity: those in different circumstances bear appropriately different taxes

# Income from a Source

**ITA 2** The taxable income of a taxpayer for a taxation year is the taxpayer’s income for the year plus the additions and minus the deductions permitted by Division C.

**ITA 3 Income -** The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer’s income for the year determined by the following rules:

**(a)** determine the total of all amounts each of which is the taxpayer’s income for the year (other than a taxable capital gain from the disposition of a property) **from a source** inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer’s income for the year from each **office, employment, business** and **property**…

* The existence of a source determines whether income is taxable or not
* While the 4 enumerated sources in 3(a) are non-exhaustive, the Courts have been very reluctant to deem any income that does not fall into those categories as taxable and leaves it to Parliament to specifically include it **Schwartz**
* **Capital gains** are considered income under **(b)** though not from a source in the traditional sense, but instead from the disposition of a source (currently taxed at 50%)

**ITA 4** Income must come from a source. Deductions from income from a source must be reasonably attributed to that specific source.

* For example, you can’t deduct business expenses from employment income

**ITA 117(2)** lists the marginal tax brackets applicable in Canada as of 2008

# Income from Office or Employment

**ITA 5(1)** Subject to this Part, a taxpayer’s income for a taxation year from an office or employment is the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year.

**ITA 5(2)** A taxpayer’s loss from employment are the losses from the year from that source after applying the appropriate parts of the Act

## Section 6 Inclusions in Employment Income

**ITA 6** is a deeming section which will bring amounts received that are clearly related to employment but don’t necessarily fit into **5(1)** to be employment income for the purposes of the Act

**ITA 6(1)(a) Benefits -** the value of board, lodging, or benefits of any kind whatsoever received by the taxpayer (or someone not at arm’s length) in connection with their employment are deemed to be employment income

* Exceptions from **i-vi** for benefits such as retirement compensation agreements, use of an automobile, amounts to further the taxpayers education so long as its reasonably regarded as a substitute for salary, employer contributions to pension plans etc.

**ITA 6(3) Other Payments -** deems any amounts received **(a)** by a person while under the employment of another, or **(b)** on account of, in lieu of payment, or in satisfaction of an agreement or obligation arising immediately prior or after being under employment to be employment income for the purpose of **5(1)**

Except when it cannot be reasonably regarded as being for **(c)** consideration or partial consideration for accepting the position, or **(d)** remuneration or partial remuneration for services rendered under the employment contract, or **(e)** consideration or partial consideration for a covenant of the employee to do, or not do, something before/after employment

* The Courts have used modern statutory interpretation to deem certain amounts to be employment income when intuition suggests that it clearly is, even when it does not fit into **6(3)** or **5(1)** **Curran,**
	+ **Fries** strike pay case - the FCA **Fries** decision was overturned by the SCC as having no source, but this was before modern statutory interpretation – the FCA decision would likely prevail today
* Both **(c)** and **(d)** were satisfied in **Moss**, which also anticipated the idea of taxation of stock options as employment income (now covered by statute
* Amounts given for a severance package in lieu of notice for termination were found to be in satisfaction of an obligation (to give reasonable notice) under **(b)** in **Quance**

## Gifts and Personal Injury Damages

**Gifts**

* Proper tax policy should have symmetrical treatment by the donor and donee with a deduction and inclusion, or non-deduction and non-inclusion
* Personal gifts are not deductible by the donor, and not included in income by the donee
	+ When the gift is property, it is deemed to have been disposed of at FMV and any capital gains on the property are deemed to have been realized by the donee
* A gift made in connection with employment is a taxable benefit under **6(1)(a)**
	+ A “gift” of cash given to a board chair after his service was taxable despite it being voluntary and there being no guarantee of remuneration of any kind **Goldman**
	+ Prizes given to an employee by her company for voluntarily completing educational courses were considered to be taxable benefits (though were exempted under **56(n)** for scholarships) **Savage**

**Surrogatum Principle:** the tax consequences of a damage or settlement payment depend on the tax treatment of the item for which the payment is intended to substitute

* Damages for lost income are treated as income; damages for the deterioration of capital are treated as capital

**Personal Injury**

* The source for damages in tort is the right not to be injured by another which is not a recognizable source under **3(a)**
	+ Compensation for the loss of well-being should not be taxable
* Special damages awarded to an injured welder were treated as being a loss of human capital (unable to work in the future) and not a loss of income (no work was done) **Cirella**
	+ Deterioration of human capital is treated differently than business capital by the tax system in that it can’t normally be deducted against income obtained from its deployment
	+ This brings up the question of how to treat sale of blood, plasma, organs etc. once they have been detached – they appear to be property. Can they be regarded as capital? What is their cost basis?
* Punitive damages have been analogized as both windfalls and gifts and are not taxable

## Employee Benefits and Allowances

**3 main questions are posed as a result of ITA 6(1)(a):**

1. What is a benefit?
2. Is there a relationship between the benefit and employment?
3. What is the value of the benefit?

**What is a benefit?**

* In **Savage** benefit was interpreted to mean an economic advantage or material acquisition and it is defined very broadly
* Whether this benefit is taxable under **6(1)(a)** depends on the underlying nature of the expense covered
	+ Personal expenses or living expenses are taxable benefits
	+ Expenses carried out in the course of employment are not (e.g. reimbursement for office supplies)
* Current test is whether the economic benefit was primarily for the taxpayer or for the employer **Lowe**
	+ Lowe was sent on a trip to New Orleans where he was primarily expected to perform duties as an account executive and any personal pleasure derived was merely incidental to this purpose – not a taxable benefit under **6(1)(a)**
	+ If EE’s subjective valuation << FMV, there is a strong argument for primarily ER benefit

**Is there a relationship between the benefit and employment?**

* Benefits do not need to be received in exchange for services provided **Savage**
	+ A loose connection to employment is all that is needed (improving employment skills)
* **Savage** creates a presumption that any benefit from an employer is in respect of employment
	+ Rebuttable only if employee can show they were received in a personal capacity (eg birthday present from employer)

**What is the value of the benefit?**

* Valuation methods: Fair Market Value, Zero (non-inclusion), ER’s cost, EE’s other choices, EE’s subjective valuation
	+ Most common are FMV and ER’s cost
	+ Subjective valuation can be used to show little or no economic benefit obtained, thus non-taxable
	+ FMV test is “the price a buyer who does not have to buy would pay to a seller who does not have to sell”
* Reasonable apportionments are allowed when the benefit is a mix of taxable and non-taxable (though the main test is whether the benefit is “primarily” for the employer)
	+ Excess luxury can increase apportionment to taxable benefits
* Free tuition to children of EE’s at private schools are taxable benefits **Detchon, Spence**
	+ **Detchon** used the valuation of the ER’s average cost to educate a student (without overhead or profit)
	+ **Spence** overruled **Detchon** finding that the FMV test was most in line with the principle of fairness
	+ Both partially overruled by **6(1)(a)(vi)** exception for benefits enjoyed by an individual other than the taxpayer under a program provided by the taxpayer’s employer that is designed to assist individuals further their education – if it is reasonable to conclude that the benefit is not a substitute for salary/wages of the taxpayer
* **IT-470R** Where an educational institution which charges tuition fees provides tuition free of charge or at a reduced amount to an employee of the institution, or to the spouse or children of the employee, the fair market value of the benefit will be included in the employee's income. This applies to the extent it is not exempted by **6(1)(a)(vi)**.

**ITA 6(1)(b)** includes all **allowances** for personal or living expenses or other purposes as income

* Some are exempted under **6(1)(b)** such as reasonable allowances for travel or motor vehicles in certain situations
* Allowance is not defined in the Act but the CRA defines it as any periodic payment received by an EE from their ER in addition to salary or wages without having to account for its use
	+ Purpose is to compensate for expenses likely to be incurred in the course of employment
* Main difference between an **allowance** under **6(1)(b)** and a **reimbursement** under **6(1)(a)** is that an allowance doesn’t have account for the expenditure of funds

**ITA 6(1)(f) EI Benefits -** includes in income any periodic payments from employment insurance benefits resulting from loss of income

## Low or No-Interest Loans

**ITA 6(9)** any amount received by a taxpayer deemed under **80.4(1)** to be a benefit shall be included in income

**ITA 80.4(1) Employer** **Low/No-Interest Loan -** a benefit is received when a person incurs a debt as a result of past/current/future employment and the computed interest at the prescribed rate on that debt is paid by the employer in excess of the amount paid by the taxpayer

* **Prescribed Rate:** The risk-free rate of Canadian Gov’t T-Bills (currently around 1%)
* Taxpayer benefit is equal to amount of interest paid/payable by the ER in excess of the EE up to the prescribed rate
	+ E.G. $10K loan from ER, 10% prescribed rate, ER charges $600 interest during the year – EE must declare $400 benefit
* **(b)** and **(c)** just determined the difference between what is paid and what is payable (ERs are businesses on the accrual method who can deduct in year 1, so the EE should be including something in year 1 as well)
* The prescribed rate is currently unrealistically favorable to borrowers, and it doesn’t seem justifiable (policy-wise) for ER’s to be able to give interest free loans to EE’s with such a small benefit included as income

**ITA 80.4(1.1)** A loan or debt is deemed to have been received or incurred because of an individual’s office or employment…if it is reasonable to conclude that, but for an individual’s previous, current or intended office or employment…

**(a)** the terms of the loan or debt would have been different; or

**(b)** the loan would not have been received or the debt would not have been incurred

**ITA 80.4(3) 80.4(1)** doesn’t apply if the rate would have reasonably been the same if agreed upon by parties who were not in an EE/ER relationship AND the lending party is ordinarily in the business of lending money

**ITA 110(1)(j)** if the benefit received under **80.4(1)** was in respect of a **home relocation loan**, it may be deducted from income

* Maximum deductible limited by assuming the calculation based on a loan of up to $25,000 for a max of 5 years

**Home Relocation Loan:** an amount received by an individual or their CL partner/spouse where their new employment required them to move at least 40km within Canada, and the loan proceeds are used to acquire a new dwelling for them to live

**ITA 6(23)** **Employer Housing Assistance -** the amount paid or value of assistance provided by an ER to an EE in respect of the cost, financing, use, or right to use of a residence is a benefit received because of office or employment – introduced as a partial response to **Hoefele**

* In **Hoefele**, the ER Petro Canada paid the increase on mortgage interest payments of EE’s they required to move from Calgary to (costlier) Toronto. No equity was provided and no principal payments were made. Court surprisingly ruled there was no economic benefit under **6(1)(a)** as their equity remained unchanged, and the amount received was not *because of their employment* under **80.4(1)** because they already owned homes and the employment did not change this.
* Court seemed to ignore that there was no immediate economic benefit, but they would over time gain more equity in a more valuable asset at a lower cost to themselves

**ITA 6(15)** **Debt Forgiveness -** a benefit is received under **6(1)(a)** when a debt is forgiven, and it Is deemed to be valued at the **forgiven amount** at the time the debt was extinguished

* **Forgiven Amount:** Reading **6(15.1)** and **80(1)** together, the forgiven amount is deemed to be the lesser of the principal outstanding at the time the loan is extinguished, and the total loan proceeds

## Eligible Housing Loss SS. 6(19)-(22)

**ITA 6(19)** the amount paid by an ER to an EE for a housing loss (other than an **eligible housing loss**) because of their employment is a taxable benefit under **6(1)(a)**

**ITA 6(20)** the amount exceeding $15K paid by an ER to an EE for an **eligible housing loss** because of their employment is a taxable benefit under **6(1)(a)** with the benefit calculated at **50% of the excess**

* Amounts less than $15K given for an eligible housing loss are not taxable benefits
* **Housing loss** under **6(21)** is the amount received on disposition by which the ACB exceeded the FMV
* **Eligible Housing Loss** under **6(22)**  is a housing loss by a taxpayer in respect of an **eligible relocation,** and no more than one residence may be designated for eligible relocation
* **Eligible Relocation** under **248(1)** means that it enables the taxpayer to carry on employment or full-time post-secondary studies, they ordinarily resided in a residence before and will do so after, and the distance between the locations is at least 40km

## Employee Stock Options S. 7 – all require arms-length ER

**Stock Option:** Defined as a right conferred upon an EE to purchase a specified number of shares of the company at a fixed price during a certain period of time

* Benefit arises if the option is exercised and the strike price is < FMV, or alternatively if the option is disposed of for a gain

**ITA 7(1)(a) Value of Benefit : -** The value of the benefit to an EE if they acquire securities under an agreement with their ER is the FMV of the securities minus any amounts paid by the EE for the securities AND any amounts paid for the option (subject to **7(1.1)**), and is recognized in the year of exercise of the option

**ITA 7(1)(b) Disposition of Options** - The value of the benefit to an EE if they dispose of an option to purchase securities to an arms-length party is the amount of the disposition less any amounts paid to acquire the option

**ITA 53(1)(j)** The amount of any benefit deemed under **s.7** is to be added to the ACB of the security

* For the purposes of computing capital gains on disposition, the ACB is the cost paid + amount of benefit received (total equal to FMV at time of exercise of the option)

**ITA 7(3)** if an ER agrees to sell/issue shares of itself or of its subsidiary to an EE

* **(a)** the EE is not deemed to have received a benefit except if expressly provided in **s.7**
* **(b)** the ER may not deduct the value of the benefit when agreeing to grant stock options
	+ Ensures the grant of a mere option is not a benefit to EE unless it is exercised
	+ Not favorable to ERs as salary paid would be deductible
	+ Court ruled a deduction by ER of the FMV of shares issued to EE’s as bonuses was not barred by **7(3)(b)** when it was completely voluntary and determined to be a discretionary bonus in respect of past uncompensated services - **TransAlta**

**Canadian Controlled Private Corporations** – non-public company for our purposes

**ITA 7(1.1)** Special favorable rule for **CCPCs**: in applying **(1)(a)** in respect of the EE’s acquisition of the share, the reference in that paragraph to “the taxation year in which the employee acquired the securities” shall be read as a reference to “the taxation year in which the employee disposed of or exchanged the securities”.

* Benefit is not realized until the EE disposes of the securities – tax deferral
* Purpose is to promote the EE ownership of CCPCs and give the ER incentive to offer this
* CCPC status is determined by reference to the year the options were granted (CRA bulletin)

**Deductions**

**ITA 110(1)(d)** a deduction is permitted by the EE equal to half the benefit deemed under **7(1)** if the exercise price at the time the option was granted was at least the FMV, and the EE must be dealing at arm’s length with the grantor

**ITA 110(1)(d.01)** a deduction is permitted by the EE equal to half the benefit deemed under **7(1)** if the EE disposes of the security by means of a charitable donation

**ITA 110(1)(d.1)** a deduction is permitted by the EE equal to half the benefit deemed under **7(1)** if the share is in a CCPC, the EE holds it for at least two years, and they have not made a deduction under **110(1)(d)**

## Retiring Allowances

**ITA 248(1)** – “**retiring allowance** means an amount received

**(a)** on or after retirement of a taxpayer from an office or employment in recognition of the taxpayer’s long service, or

**(b)** in respect of a loss of an office or employment of a taxpayer

**ITA 56(1)** 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 as, on account or in lieu of payment of, or in satisfaction of,

**(ii)** a **retiring allowance**, other than an amount received out of or under an employee benefit plan, a retirement compensation arrangement or a salary deferral arrangement

* No benefit was found for an award made to a person who had a K for a job but never started because his services were not needed – not a retiring allowance because income from office/employment cannot be lost if it hasn’t started. It does not start until there is an obligation to perform services **Schwartz**

## Employee Expenses and Allowances

**General Comments**

* Unreimbursed employee expenses are relatively uncommon compared to business expenses because EEs (as compared to independent contractors) are rarely expected to provide the factors of production
* Although EEs typically have more expenses than unemployed persons (clothes, car, food, etc.) these are generally considered to be personal expenses
* Since allowances are meant to be (imprecise) reimbursements for expenses, whether or not the allowance is included in income should be based on whether or not the corresponding expense would be deductible
	+ To do otherwise would create a tax preference
* Distinguishing between work travel expenses and commuter expenses can be very difficult

**ITA 8(2)** Except as permitted by this section, no deductions shall be made in computing income for a taxation year from office or employment.

**ITA 8(1)** The following deductions attributable in whole or in part to office or employment are permissible:

 **(b)** Legal fee expenditures used to collect or establish a right to amounts that would be included as employment income

**(f)** Sales expenses where the taxpayer was employed in the year in connection with the selling of property or negotiating of contracts for the taxpayer’s employer

**(h)-(h.1)** – travel and motor vehicle expenses (see below)

**(i)** Amounts paid by the taxpayer (or included as a benefit) for statutorily required professional membership dues, union dues, office rent/assistant salaries (if required by employment K), cost of office supplies directly used in performance (if required by employment K)

**Travel and Motor Vehicle Expenses**

* Commuting expenses often reflect personal consumption choices and therefore are usually not deductible
* In determining whether a travel expense is deductible, the question can often be reframed to ask if an allowance for that expense would have been excludable from income

**ITA 8(1)(h) Travel Expense Deduction**: An EE may deduct travel expenses (non-motor vehicle) where the EE was ordinarily required to carry on duties away from the ERs place of business and was required by the employment K to pay for these expenses EXCEPT when an allowance was received but not included by **6(1)(b)(v-vii)** or already claimed a deduction under **8(1)(e), (f)**  or **(g)**

**6(1)(b)(vii) Travel Allowance Exclusion**: reasonable allowances for travel expenses received by an EE from the ER for travelling away from

**(a)** the municipality where the ER’s establishment at which the EE ordinarily worked or to which the EE ordinarily reported was located, AND

**(b)** the metropolitan area, if there is one, where that establishment was located

* Note: more strict than **8(1)(h)** by adding the travel away from municipality/metro requirement

**ITA 8(1)(h.1) Motor Vehicle Expense Deduction**: An EE may deduct motor vehicle expenses where the EE was ordinarily required to carry on duties away from the ERs place of business and was required by the employment K to pay for these expenses EXCEPT when an allowance was received but not included by **6(1)(b)(vii.1)** or already claimed a deduction under **8(1)(f)**

**6(1)(b)(vii.1) Motor Vehicle Allowance Exclusion**: reasonable allowances for the use of a motor vehicle received by an EE (other than an EE employed in connection with the selling of property or the negotiating of contracts for the ER) from the ER for travelling in the performance of the duties of the office or employment

* Note: most liberal in that it only requires traveling in the performance of duties, not even away from the ER’s place of business

**ITA 8(4)** **Meal Deduction:** Amounts for EE meals cannot be deducted under **8(1)(h)** unless the meal was consumed while EE was required to be away for at least 12 hours from the municipality where the ER’s establishment to which the taxpayer ordinarily reported for work was located AND away from the metropolitan area, if there is one, where it was located.

**IT-522R Employer’s Establishment** – for the purposes of **8(4)** meal deductions, the ER establishment is the one where the EE ordinarily reports to work. If there is more than one, it is the one the EE reports to most frequently. If there is more than one in the same municipality/metro area, they shall be considered the same place of business for these purposes.

**ITA 8(10) Required Certificate -** In order to claim deductions under **8(1)(h) and (h.1)**, the EE must submit a certificate signed by the ER that the required conditions have been met (i.e. they were required by K to travel to these places and pay their own expenses)

Ranking from most favorable to least favorable to the taxpayer:

* Motor vehicle expense allowances under **6(1)(b)(vii.1)**
* Travel expense deductions under **8(1)(h**) and **8(1)(h.1)**
* Non-motor vehicle expense travel allowance under **6(1)(b)(vii)**
* Meal expense deductions under **8(4)**

**ITA 6(6) Special Worksite Allowance** – despite **6(1),** taxpayer may exclude amount received for the value of or a reasonable allowance for

 **(a)** board and lodging for a period at

**(i)** a special worksite where the EE performed temporary duties while maintaining a self-contained domestic establishment elsewhere as their principle residence which was **(A)** available/not rented out and **(B)** it was not reasonable to return daily and the EE was required to be gone more than 36 hours

 **(b)** transportation between the principle residence and this special worksite

* Case law has found temporary to be up to 2 years in some circumstances

**Office Rent and Home Workspaces**

**8(1)(i)(ii) Office Rent -** taxpayers may deduct amounts paid as office rent, the payment of which by the EE was required by the employment K

* The TCC has been confused in the jurisprudence as to whether employment (not business) deductions can be made for people who work at home
* The likely correct answer in most cases is “no” because there is no imputed rental income included so you cannot make deductions against that
* Clarified in **8(13)**

**8(13)(a) Home Workspace -** despite **8(1)(f)** and **8(1)(i)**, no amount is deductible for work spaces in the home EXCEPT if **i)** the space is the principal place of employment or **ii)** there is another workplace, but during the period in question, this space continuously is used exclusively for work AND you regularly meet clients there.

**8(13)(b)** the deduction made under this part cannot be more than income from employment

* Note: similar provision under **18(12)** limiting home office deductions for income from business

**IT-352R2**

* If an EE owns or rents a home workspace, the amounts normally deducted as supplies under **8(1)(i)(iii)** are to consist of a reasonable proportion of expenses paid by the EE for maintenance of the home (cleaning, light bulbs, electricity, etc.).
* If the EE rents the home, they may deduct a reasonable proportion of the rent paid for the workspace.
* If the EE owns the home, they may not deduct an amount for the rental value of the workspace.

## Receipt Under the Cash Method

* **Constructive Receipt:** doctrine holds he word “receive” means to get or derive benefit from something, to enjoy its advantages without necessarily having it in one’s hands. Cash is deemed to have been received by the taxpayer at the time it is made available to them, not when they decide to pick it up. **Morin**
	+ In **Morin,** taxpayer didn’t declare on federal return $1600 withheld by employer to be paid for provincial income taxes claiming it was “deducted at the source,” thus never received. Court rules he received its benefits
* Special treatment – employee/shareholder loans: employees who are also shareholders of a corporation chose to leave their salary in the corporation for working capital. CRA said they must declare income. Court rules constructive receipt does not apply here as nothing was credited to the individuals’ accounts and the need to maintain the shareholder/corporation distinction.

**ITA 78(4)** when a ER who still owe amounts to EEs for wages/pension/retiring/other remuneration (except vacation pay or deferred salary arrangement) 180 days after the tax year the expense was incurred, the expense will be deemed not to have occurred in that year but rather in the year it is actually paid

* Artificially moves ER from accrual to cash method in order to match the ER deduction with the EE income receipt

**ITA 248(7)(a)** anything sent by first class mail or equivalent, is deemed received on the day it was mailed, except **(b)** amounts required by the Act to be withheld/deducted, or payable by a corporation are deemed to have been paid upon receipt by the Receiver General

# Income from Business and Property

## Characterization of Income “From a Business”

**ITA 9(1)** Subject to this Part, a taxpayer’s income for a taxation year from a business or property is the taxpayer’s profit from that business or property for the year.

**ITA 9(2)** Subject to **s.31** (restricted farming losses), loss from a business or property is the amount of the taxpayer’s loss, if any, for the taxation year from that source computed by applying the provisions of this Act

**ITA 9(3)** income and loss from property do not include capital gains or capital losses from disposition of that property

**ITA 248(1)**

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

* Whether something is a “business” is one of the most litigated issues in the ITA

**“property”** means property of any kind whatever whether real or personal, immovable or movable, tangible or intangible, or corporeal or incorporeal – includes a right of any kind, share, chose in action, money (unless contrary intention shown), WIP of a business that is a profession

The classification of whether something is a business is important because

* Due to **9(3)**, business gains/losses are taxed differently than capital gains/losses
	+ Taxpayers prefer to categorize gains as capital gains because they are taxed at 50%
	+ Taxpayers prefer to categorize losses as business losses because they are offset against income generally, while capital losses are offset only against capital gains
* Business activities need to be distinguished from personal activities as personal consumption choices should be taxed (not deductible)
* Income items that are not from a business may not have a source at all, and are thus non-taxable

**Adventure or Concern in the Nature of Trade (ACNT)** – activities that will be deemed to generate business income. There is no strict definition and regard must be given to the individual case and circumstances, but there are non-exhaustive factors which help determine **Taylor**

* These, if present, do NOT preclude the finding of an ACNT:
	+ A single or isolated transaction
	+ No organization needs to be set up to carry it into effect
	+ Nothing needs to be done to the material to make it saleable
	+ The activity is of an entirely different nature than the taxpayer’s normal business activities
	+ There absence of a profit motive (although its presence is highly suggestive of an ACNT)
		- So long as there are sufficient business indicators to override its nature (**Taylor**)
* These factors are suggestive of an ACNT:
	+ There is no personal enjoyment gained from the activity
	+ The transaction was of the same kind, and done in the same way, as a trader or dealer in that property matter normally would have done
	+ The nature and quantity of the subject matter may exclude the possibility that its sale was the realization of a capital investment or that it could have been disposed of other than as a trade transaction
		- e.g. couldn’t generate an income stream, no personal use, no holding value – “the commodity itself stamps the transaction as a trading venture”

**Gambling** – is it a business?

* Generally, gambling wins are not taxable unless it can be shown the gambling was undertaken as a business
	+ Despite incredible sustained winnings, 2 brothers found not to have operated a business because there was no evidence of a winning system, risk minimization, reliance on special skills, knowledge or insider information. A view to a profit was not determinative as all gamblers intend to profit **Leblanc**
* There is an argument that even if it were a professional business, losses should not be deductible as there are non-pecuniary benefits to the gambler meaning it reflects a consumption choice

**REOP Test** – “Reasonable Expectation of Profit”

* Proper use of REOP test: is an activity of a commercial or personal nature?
	+ If the activity is clearly commercial, there is no need to analyze the taxpayer’s business decisions – these activities necessarily involve pursuit of profit. **Stewart**
		- E.G. in **Stewart**, he gained no personal value in renting out properties and did it only for business reasons
	+ If there is a personal element, apply REOP to determine if the activity is sufficiently commercial.
* Improper use of the test: is an activity without REOP a possible source of income?
* REOP can currently be used to combat hobby losses, but not tax shelters such as in **Leblanc**
* “Profit” in the REOP context must be understood in layperson’s terms – expectation of capital gains is included

**Restricted Farming Loss** – a limitation on declaring business losses for hobby farms

**ITA 31(1)(a)** If a taxpayer’s primary income is not from farming or farming + a subordinate source, their loss, if any, from farming businesses is deemed to be the lesser of

 **(i)** their actual total farming loss, or

 **(ii)** $2500 plus the lesser of

 **(A)** half of the total farming loss that exceeds $2500, or

 **(B)** $15,000

* Hobby farming losses up to $2500 are included in full, additional losses between $2500 and $32,500K are included at 50%, and further losses over $30K are not included
* This provision is because farming as a secondary source of income is often much more reflective of a personal consumption choice and shouldn’t be eligible to be completely offset against other income

## The Surrogatum Principle (Business/Property Income Context) and Recovery of Capital

**Damages**

* Damages alone are considered neutral – their treatment as business income or a capital receipt is determined by the source of loss the money is intended to rectify
	+ Asymmetry may arise as the payor can deduct as a business expense and the payee has a capital receipt
* Personal injury damages in the business context would likely be excludable using the **Cirella** doctrine
* Damages for human rights violations, defamation, emotional suffering etc. are excludable from business income **Bellingham**
* A taxpayer who received damages for trademark infringement was required to include them as business income because the damages represented a loss of profits he would have otherwise received, not injury to capital property or goodwill **Donald Hart**
* The payment of damages may be deductible as business expenditures if it can be shown the amounts expended were necessarily incidental to the business operations **Imperial Oil**
	+ In **Imperial Oil**, $500K in damages settled as a result of a ship collision were found to be a business expense as the appellant’s marine operations were a normal part of its business, and despite the large loss, crew negligence and sea accidents are part of the ordinary risks incurred in marine operations
* If damages are determined to be a capital receipt, you must then determine how to treat the receipt
	+ If the asset was sold, destroyed or abandoned, it would be treated as a disposition and gain/loss is calculated
	+ If the asset was retained, the ACB must be reduced by the amount of the damages – treated as capital recovery
	+ If the damages do not correlate to a particular asset, the damages may be amortized as “eligible capital expenditures” under **s.14**

**Annuities**

**ITA 56(1)** “Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year…

**(d)** annuity payments -- any amount received by the taxpayer in the year as an annuity payment

**ITA 248(1) “annuity”** includes an amount payable on a periodic basis whether payable at intervals longer or shorter than a year and whether payable under a contract, will or trust or otherwise

A traditional annuity:

* Equal episodic payments commencing at a certain date and continuing throughout the annuitant’s life time
* A premium is paid for the annuity
* The premium depends on the annuitant’s life expectancy
* The number of payments is uncertain (it depends on when the annuitant dies)
* Any payment is in part return of capital and in part payment of interest
* **Short** is an example of the inconsistent use of the surrogatum principle – a taxpayer surrendered an annuity for a $37K gain when interest rates dropped and the amount was ruled to be a capital receipt. The annuity interest payments received would have been taxable as income from property under **56(1)(d)** had he elected to keep the annuity, and a lump sum payment to cancel or substitute for these interest payments should be as well according to the surrogatum principle.

**ITA 60(a)(i)** When a portion of an annuity can be identified as a recovery of capital, that amount is excluded from taxable income that would otherwise be included under **56(1)(d)**

**ITA 52(4)** Windfall Provision - deems property received in connection with a lottery to have been acquired at FMV

* In **Rumack,** $1000 monthly payments received from a “set for life” lottery were funded by an annuity. The entirety of the payments were not a windfall gain – the windfall was the underlying value of the annuity. The portion of each payment determined to be capital were excluded from income under **60(a)(i)** and the rest were taxable as income from an annuity property under **56(1)(d)**

**Reg S.300** – adopts the proportional/pro-rata approach to determining the capital recovery vs interest ratio in an annuity payment. The premium paid is divided into the total payout to determine the ratio.

* E.G. if a $30K premium annuity is to be paid out over 3 years in payments of $12K, then $10K of each payment is allocated to capital recovery
* This method will recover capital faster than economic reality (the accounting treatment reflects reality)

**IT-273R2** – Government assistance payments for the repair of capital property must be netted against the repair expense (prevents deductions). If an amount is used to replace capital property, the ACB is reduced by that amount (prevents realizing a capital loss on disposition).

## Interest Income

**12(1)(c)** Included in income: any amount received or receivable by the taxpayer in the year (depending on the method regularly followed by the taxpayer in computing the taxpayer’s income) as, on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer’s income for a preceding taxation year

* The taxpayer’s regular method of accounting determines when interest is included

**IT-396R** – Interest Income

* There must be a principal amount owed to another person in order for interest to accrue
* In the context of a damages award or out-of-court settlement, there is said to be an amount owing as of the date of injury. If the court or settlement states that a portion of the award is interest, then it will be deemed interest income for the purposes of the Act
	+ It is immaterial that the amount owed was not determined until a later date. Once a right to receive an award has been established, that right existed from the time of the injury
* When a property is sold for an agreed price, but payment is not made until a later date, any interest accrued between the date of execution and the date of payment is interest income in the hands of the vendor

**Contingent Liability**

Interest accruing on an indeterminate principle or a “contingent liability” is still interest income under the Act and the principle is said to come into existence retroactively once the conditions have been satisfied **Perini Estate**

* In **Perini Estate**, the taxpayer sold his company and part of the agreement included payments contingent on the after-tax profits of the company for the following 3 years with 7% interest included. He argued these do not meet the definition of interest because they are not based on a principle amount. Court found the principle amount is determined retroactively once profits were known.

**Financing Expense Deductions**

**ITA 20(1)(e)** taxpayers may deduct an amount not otherwise deductible incurred in the course of borrowing money for the purpose of earning income from a business or property

* The payments don’t have to be made in the specific year the money was borrowed
* Predecessor provision was applied in **Yonge-Eglington** where the appellant agreed to pay 9% interest as well as 1% of gross rental income of a building for 25 years in order to secure financing. It was agreed the 1% payments were not interest, but it was an amount incurred in the course of borrowing money to earn income from property – doesn’t matter that the payments occurred over 25 years and even when no principal was owing.

**Participatory Interest**

**Sherway Centre** expanded the definition of interest to reflect modern business realities and promote entrepreneurship. A profit-sharing scheme in lieu of interest on a debt can be included as an interest expense and therefore deductible

* **Sherway** agreed to a profit sharing scheme in exchange for below-market interest rates on bonds they issued because they would not have been able to afford the market rates. Court ruled that so long as the profit share payments had some kind of connection to a principal amount owing (they were to recapture the proper market interest rate on the principal), this was sufficient for them to be interest payments.

**Mixed Payment of Interest and Principal**

**ITA 16(1)(a)** when an amount paid can be reasonably regarded as being in part of an interest nature and in part of a capital nature, the amount that can be reasonably regarded as being of an interest nature will be deemed so, irrespective of what the parties or contract says

* Blended payments are to be unblended so the interest portion is included in income; the return of capital portion has no consequence

In **Groulx**, a taxpayer initially listing his property for $450K, after rejecting an offer of $350K, agreed to sell it for $395K payable in installments but stipulated no interest would accrue on these installments. The Minister assessed interest on the payments anyway by virtue of **16(1)(a)**. The Court ruled the evidence showed that the property was sold in excess of FMV in attempt to capitalize the interest payments, and allowed the assessment of interest.

* **16(1)(a)** tends to offer very poor guidance and is a weak rule in practice
* Courts may consider evidence of whether interest was discussed/waived, the FMV vs actual payment, discounts for prepayments, and similar practices
* There must be evidence of actual payment being greater than FMV to impute interest **Vanwest Logging**
	+ This isn’t very helpful in practice as it can often be argued the FMV of a particular asset is whatever the parties agreed on
	+ Using a prevailing market interest rate approach similar to **80.4** prescribed rate rather than FMV test would be much easier
* Nothing in the language of **16(1)(a)** requires there to be intention of the vendor to avoid taxes for application of the rule – should there be?

**IT-265R3** – cancelled bulletin, but contains the CRA position on **16(1)**

* When property is sold on a deferred or installment basis, it is a question of fact whether an interest/income element is included in the payments. Even though normal commercial practice is to charge interest in connection with a sale, a vendor/seller could agree not to
* **16(1)** does not apply unless there is sufficient evidence that selling price is greater than FMV.
* If found, the interest portion of the blend is not more than the lesser of the excess of selling price over FMV or an amount computed with reference to the prevailing market interest at the time of the transaction
* Interest likely should be imputed because the opportunity cost of funds is a fact of commercial reality, and any interest foregone almost certainly affects some other price in a commercial relationship

**Royalties** – income from intangible property

**Rents** – income from tangible property

**ITA 12(1)(g)** **Payments based on production or use** -- any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property, except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph

* Applies where property is sold, and the sale price is paid in instalments contingent on performance/production of the property
* This is very unfair to a taxpayer as the entire amount is deemed income and there is no capital recovery – advise clients against this!
	+ Courts will attempt to construe this rule as narrowly as possible

## Bond Discounts and Premia

**Original Issue Discount (OID):** A discount arises when a bond is initially sold for less than the par value to be received upon maturity. The OID represents the interest that would have accrued during the term of the bond

**Discount/(Premium):** A bond is sold for less/(greater) than the face value to be received on maturity. Often because stated coupon interest rate is greater/(lower) than prevailing interest rates.

**ITA 12(3)** Corporations/partnerships who are owed debt obligations (other than excluded ones) must include in their income, the interest that accrued to the obligation until the end of the year (to the extent it was not included in a previous year)

* Imposes accrual method when there is a “no-interest” obligation (otherwise use **12(1)(c)** for normal interest inclusion)

**ITA 12(4)** If a taxpayer other than one where **12(3)** applies holds an interest in an investment contract (debt obligation for our purposes), they must include in their income the interest that has accrued until the end of the anniversary day of the obligation in that year (to the extent it was not included in a previous year)

* **Anniversary day** is defined in **12(11)** as one year after the day before the contract was issued (and every following year), OR the day the contract was disposed of
	+ **Anniversary day** only applies to **12(4)**
* **12(3), (4)** make counter the tax deferral option through choice of accounting method in **12(1)(c)** unhelpful

**ITA 12(9)** For the purposes of subsections **(3), (4)** and **(11)** and **20(14)** and **20(21),** if a taxpayer acquires an interest in a debt obligation, an amount determined in prescribed manner is deemed to accrue to the taxpayer as interest on the obligation in each taxation year during which the taxpayer holds the interest or the right in the obligation.

* Goes beyond the cash method to impute interest in accordance with a prescribed rate on zero-coupon and other bonds that have no accrued interest over the year
* **Regulation 7000** outlines the prescribed manner
* The full amount of the OID deemed accrued to that point (end of tax year or anniversary date) is included in income as interest
	+ In absence of this provision, it would not be included until it was “paid or payable” on maturity when applying **16(1)**
* OID is included as interest, but any discount/premium due to market fluctuations is attributable to capital
	+ Not necessarily fair from a policy standpoint as coupon-bearing bonds may be purchased at a discount that reflects both higher prevailing market rates AND an anticipated larger return on maturity which would be attributable to capital, but a higher coupon rate bond could have been purchased without the discount but with the same overall return and the return would then be interest
	+ A “trader” in bonds would have to declare gains as income from business however

**Transfer of Debt Obligations**

* When a holder of a debt obligation transfers it before maturity, interest will have economically accrued up to that point and it will be reflected in the sale price
* The idea of ACB must also be applied so that interest income is not double taxed on redemption as a capital gain

**ITA 52(1)(d)** If an amount in respect of a property’s value was included in a taxpayer’s income for the year, an equal amount may be added to the ACB of the property

* Applicable when property is sold with accrued interest factored into the sale price AND included in income

**ITA 20(14)** If a debt instrument is transferred and the buyer then becomes entitled to interest that accrued before the transfer but not payable until sometime after, the proportion of the whole attributable to the seller

 **(a)** Shall be included in the income of the seller for the year

**(b)** May be deducted from the income of the buyer to the extent the amount was included under **s.12** (or paragraph **(a)** in the event of a second transfer in the year)

**ITA 53(2)(l)** If any amount in respect of a debt obligation was deductible under **20(14)**, that amount shall be deducted from the ACB

First Statutory Approach:

Seller

* **12(3)** and **(4)** require that accrued interest up to the time of sale must be included in the vendor’s income
* Accordingly, **52(1)(d)** allows accrued but unpaid interest that is included in the vendor’s income to be added to the ACB, thereby offsetting any capital gain from the sale attributed to the interest

Buyer

* Would **52(1)(d)** apply to include a loss in respect of income from accrued interest paid in the sale price, and a corresponding reduction in the ACB to prevent any capital loss on realization?

Second Statutory Approach:

Seller

* Includes a proportion of interest in income by virtue of **20(14)(a)**
* Add the amount from included in income to the ACB in accordance with **52(1)(d)**

Buyer

* May deduct the same amount included by the seller under **20(14)(a)** by virtue of **20(14)(b)**
	+ In **Antosko**, the Court didn’t require symmetrical inclusion by the seller (they were tax-exempt) in order for the buyer to be able to claim the deduction
* Make the corresponding deduction from ACB in accordance with **53(2)(l)**

**ITA 40(3)** deems a gain for the taxpayer when: the amounts deductible from ACB under **53(2)** exceed the actual cost PLUS amounts included in ACB by **52(1)**

* E.G. **Antosko** brothers have actual cost of essentially zero for their debt obligation and added nothing to ACB by virtue of **52(1)**. When they paid themselves $38K in interest and deducted it under **20(14)(b),** their ACB would become -$38K after applying **53(2)**. This amount of $38K in excess of the $0 base would be deemed a capital gain, and their windfall is reduced

## Introduction to Business Deductions

**ITA 18(1) Prohibited Deductions** - In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

**(a)** **General** – an outlay or expense except to the extent it was used for the purpose of gaining or producing income from business or property

**(b) Capital Outlays** – any outlay or loss in respect of capital, depreciation of capital

**(c) Exempt Income** – any expense made for the purpose of earning exempt income

**(h)** **Personal or living expenses** – except travel expenses occurred while away from home in the course of carrying on the taxpayer’s business

**Child Care Deductions**

**Symes** questioned whether a woman claiming child care expenses for a nanny so that she could carry on her business as a lawyer were deductible as business expenses or prohibited by **18(1)(h)** as personal expenses, or as not being for the purpose of producing income under **18(1)(a).** Traditional views of child care expenses is they were not used in the production of business income – they were to make the taxpayer available to the business, which is a personal expense. The majority did not rule on that issue of whether society has evolved such that child care could be a business deduction as it was already decided by **s.63** which outlines child care deductions otherwise.

**ITA 63** allows deductions from income for child care expenses to a maximum of $8K per child under 7, and $5K per child under 16. This typically must be claimed by the lower-earning of the supporting persons (exceptions for being attending school, medically unable to provide care etc.)

**Deductibility of Damages and Fines**

The majority in **65302 British Columbia** ruled that absent express wording to the contrary or a deliberate, morally culpable illegality, any fines incurred for the purpose of producing income would be deductible regardless of whether the intention was deterrent or compensatory.

* Policy argument of dissent is allowing the deductibility of deterrent fines would dilute their effect and frustrate Parliamentary purpose
* **67.6** was enacted in response overruling much of this case when it comes to government imposed fines
* Deductibility of damages (**Imperial Oil**), expenses of illegal businesses, and fines and penalties imposed under contract are still governed by case law principles

**ITA 67.5** No deduction shall be made for an expense incurred for the purposes of doing anything that is an offence under certain criminal code sections or other specified statutes.

**ITA 67.6** No deduction shall be made in respect of an amount that is a fine or penalty validly imposed under law

## Mixed Personal and Business Expenses

**General**

**ITA 18(1) Prohibited Deductions** - In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

 **(h)** **Personal or living expenses** except travel expenses occurred while away from home in the course of carrying on the taxpayer’s business

Generally, expenses that make the taxpayer available to work but not in the process of earning income are personal expenses

* Expenses for commuting to work, housekeeping, childcare are personal expenses

6 Common Law factors courts that may be relevant to distinguishing a business expense from a personal expense (none are conclusive)

1. Whether the expense is deductible according to accounting principles or practices such as GAAP – often concludes the matter
2. Whether the expense is normally incurred by other taxpayers carrying on a similar business
3. Whether, in absence of the business, the need to pursue the expense would still be there
4. Whether the taxpayer could have avoided the expense without affecting gross income
5. Whether the expense is “of the trader” or “of the trade” – if part of the business operation itself, it is an income-earning expense
6. Whether the expense was incurred to approach the income-producing circle (commuting, child care, clothing), or within the circle itself. This test is of limited assistance especially when the personal circle and income-producing circle overlaps.

**ITA 67** requires that any deductions made for any expenses must be reasonable in the circumstances

**Home Office**

**ITA 18(12)(a)** no amount is deductible for work spaces in the home EXCEPT if

 **i)** the space is the principal place of business or

**ii)** the space continuously is used exclusively for earning income from the business AND you regularly meet clients/customers there in respect of the business.

**ITA 18(12)(b)** the deduction made under this part cannot be more than income from business (but excess may be carried forward)

* Note: similar provision under **8(13)** limiting home office deductions for income from employment
* Courts have generally required a separate room devoted exclusively to this work space, and taxpayers may deduct expenses (heat, maintenance, property taxes, mortgage interest) based on proportion of floor space used

**Food, Beverage and Entertainment**

* Consumption of food is almost always a personal expense (exception made in **Scott** where an on-foot courier required additional food to perform his job analogized to gasoline for a car)
* Entertainment expenses which have a dominant business purpose are usually deductible
	+ **18(1)(l)** prohibits deductions for membership enrolment in social/recreational clubs even if for a dominant business purpose (though single use of club may still be deductible)
	+ **67.1** introduced to prevent 100% deduction of some of these dual-purpose expenses with a large personal enjoyment factor

**ITA 67.1(1)** amounts paid/payable in respect of human consumption of food, beverage, or entertainment are deemed to be 50% of the lesser of what was actually paid/payable or an amount reasonable in the circumstances

* Does not apply to **62/63** moving/child care expenses
* Means only half of food/bev/entertainment can be deducted as business expenses
* While generally meant to capture the personal portion, in **Stapley** a realtor was denied 100% deductions for food/entertainment vouchers he gave to clients (and did not consume himself) for purely marketing purposes because of the plain language of the statute and because it did not fall into one of the listed exceptions under **67.1(2)**

**ITA 67.1(2)** There are exceptions to subsection **(1)**

**(a)** Does not apply to businesses which ordinarily provide compensatory/promotional food, beverage or entertainment in the course of their business (E.G. free movies at theater, lunch at work training session)

**(b)** When it relates to a fund-raiser for the benefit of a registered charity

**(c)** When the amount is considered to be compensation, it is reasonable in the circumstances, and it is specified in writing (E.G. a law firm invoices lunch expenses to a client)

**(d)** The amount is a taxable benefit to an employee and required to be included in income under **s.6**

**(f)** The amount is for a maximum of 6 workplace holiday parties during the year for the benefit of the employees of the business

## Interest Expenses

**ITA 20(1)(c)** Despite the prohibited deductions under **18(1)(a)** – general prohibition, **(b)** – capital outlays, and **(h)** – personal expenses, a taxpayer may deduct amounts for an obligation to pay interest on

 **(i)** borrowed money used for the purposes of producing income from business or property

 **(ii)** an amount payable for property acquired for the purpose of producing income from business or property (deferred payment sale)

* Imposes a **purpose test** – must determine the purpose of the borrowed funds to apply the provision
* Limited to the lesser of the actual amount and a reasonable amount
* The characterization of a payment as interest is based on the contract between the lender and borrower – absent evidence of a sham, if a lending agreement characterizes a payment as interest, it shall be regarded as such, and there is no need to look at the economic realities **Shell Canada**
	+ The specific result in **Shell Canada** was overturned by **20(3)** though the general principle still governs

**ITA 20(3)** If borrowed money is used to refinance previously borrowed money, this new amount will be deemed to be for the same purpose as the original amount borrowed

**Interaction between 20(1)(c) and 18(b) – Current Expense or Capital Expense?**

* The current SCC position is interest expenses are almost always on account of capital and thus not deductible under **18(1)(b) Gifford**
	+ Only exception is when the proceeds add to the inventory of the borrower (such as a money lender)
	+ **20(1)(c)** is an incentive provision and statutory exception to **18(1)(b)** meant to encourage the accumulation of capital that produces taxable income
	+ HML rejects this position, stating that ordinary interest is not a capital expenditure as there is no enduring benefit, and treating it as capital is contrary to the general principles of accounting and timing – interest should be a current expense
	+ However, until SCC reverses its position, taxpayer must comply with **20(1)(c)** for interest to be deductible

**Interaction between 20(1)(c) and 18(a), (h) – Income Earning Purpose?**

* Recall from **9(3)** that capital gain/loss on disposition of property is not income from property
	+ If borrowed funds are used to earn capital gains, the interest is not deductible
* But what if a property can earn both income and capital gains? (E.G. stocks, rental properties)
	+ Ideally, the interest payments should be apportioned between the purposes, but in practice the CRA and the courts will consider the entire amounts deductible
* In cases of other dual-purpose expenses (personal and income-earning), courts have generally applied the dominant purpose test, but this was rejected by the SCC for interest expenses in **Ludco**
	+ In **Ludco**, it was held the proper test for determining the purpose was whether there was a reasonable expectation of **gross** income
	+ HML criticizes this decision as judicial rule-making, and also that it creates a different test for interest expense deductions and everything else which typically rely on a net expectation of profit

**Tracing**

* Since only interest on funds borrowed for the purpose of earning income is eligible for deduction, the purpose of any borrowed money must be determined
	+ Money is fungible, so there is no “correct” way to determine this with any certainty
* The courts have held the correct test is whether a direct link can be drawn between the borrowed money and an eligible use **Shell Canada**
	+ Requires the use of the borrowed funds be determined by factually “tracing” the use of the funds
	+ The current use and direct use of the borrowed funds governs eligibility
* The order of the transactions is crucial in the case of comingled funds because of fungibility
	+ E.G. taxpayer has $1000 savings, borrows $1000, buys $1000 shares (eligible), puts $1000 down payment on a car (ineligible) – the interest is deductible
	+ E.G. taxpayer has $1000 in savings, buys $1000 in shares (eligible), borrows $1000, puts $1000 down payment on a car (ineligible) – the interest is not deductible
* CRA: “In determining what borrowed money has been used for, the onus is on a taxpayer to trace or link the borrowed money to a specific eligible use, giving effect to the existing legal relationship”
* **Current Use**: If funds were originally used for an ineligible use (buying a cottage), and the use was converted to an eligible use (selling the cottage a buying income-earning shares), the interest would become deductible from the date of conversion to the eligible use
	+ The reverse also applies – E.G. taxpayer uses funds to buy a rental property (eligible) and the taxpayer decides to occupy the property himself (ineligible) – interest is not deductible from the time taxpayer moves in
* **Direct Use:** When classifying the use of borrowed funds, it is what the money is directly used for that governs **Bronfman**
	+ A taxpayer may not deduct interest on borrowed funds to buy a home (personal) even if the funds indirectly allowed the taxpayer to retain income-earning investments
	+ In **Bronfman** a trust was denied deducting interest on funds borrowed to make a capital payment to a trustee (doesn’t produce income). The funds were borrowed because they decided it was not the right time to sell the trust’s income-producing assets.
* The taxpayer has the right to use these rules and manipulate transactions in order to structure their affairs to reduce taxable income (subject to GAAR)
* Tracing Examples in Folio S3-F6-C1

## Inventory

There is no “matching principle” for inventory accounting in tax law, but accounting rules are a good starting point when there is no specific tax law stating otherwise

**ITA 12(1)(b)** A taxpayer must include in income any amounts receivable in respect of property sold or services rendered in a year, despite the fact that payment may not be due until a subsequent year

**ITA 248(1)** “**inventory**” means a description of property the cost or value of which is relevant to computing a taxpayer’s income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method.

* What assets constitute inventory depends on the nature of the business
* The cost of inventory expenses are generally deductible, but not until the goods are sold (matching principle)
	+ Under **10(1)** however, if unsold inventory declines in value, this can be deducted

**ITA 10(1)** For computing income from a business that is not an ACNT, inventory held at the end of the year will be valued at the lower of its cost and FMV (Lower of Market or Cost – LMC)

* Alternatively, **Reg 1801** allows taxpayers to value all inventory at FMV resulting in recognition of accrued losses or gains

**ITA 10(1.01)** For computing income from a business that is an ACNT, inventory held at the end of the year will be valued at cost

* This provision is a reaction to **Friesen** which Parliament found to be against the purpose of the LMC provision
* In **Friesen**, a taxpayer bought land for speculation which was an ACNT, and when the property declined in value, deducted the decline as a loss in inventory value under **10(1).** Majority held that a single piece of land in an ACNT could be considered inventory.

**Prepaid Expenses**

**ITA 18(9)(a)** no deduction shall be made in respect of an amount that can be reasonably regarded as

 **(i)** consideration for services to be rendered after the end of the year

 **(ii)** on account of/in lieu of payments to be made for interest, taxes, rents, royalties in respect of a period after the end of the year

**(b)** The portion of these payments that can be attributed to subsequent years will be deductible in those subsequent years

* **Canderel** holds there is a presumption this list is exhaustive

# Capital Expenditures

## Current vs Capital Expenditures

There are 2 main questions to ask when determining the deductibility of expenses

1. Was the expense incurred for the purpose of earning income from a business or property? (threshold purpose test)
	1. If no, it is a personal expense and not deductible
2. Once an income-earning purpose has been identified, what is the timing of the deduction? (determined by current vs capital)
	1. An eligible current expense is deductible immediately
	2. An eligible capital expense is added to the ACB of an asset and amortized over time
* It is advantageous to the taxpayer to have an item determined to be a current expenditure – offsets income
* If it is a capital expenditure, it is advantageous for the taxpayer to depreciate the cost as quickly as possible – offsets income

Capital assets are categorized by the manner in which their cost is recognized

* Depreciable Property: Capital Cost Allowance (CCA) system
* Intangible Property: Cumulative Eligible Capital Amount system (not covered in this course)
* Non-Depreciable Property (land, bonds, shares, etc.): Cost is recovered only when the property is sold
* Natural Resources: Depletion system (not covered in this course)
* Nothings: Never deductible in computing income or capital gains

There are several common law tests for distinguishing between current and capital expenditures; none are conclusive and some may not be helpful at all in certain situations

* **Enduring benefit test** – an expenditure is made with a view to bringing into existence an asset or advantage that will have a lasting benefit beyond the current period
* **Business structure vs. earning process test** – is the payment made for the establishment or expansion of the business structure that has an enduring benefit, or is it made “as part of the money-earning process?”
* **Recurring expenditure test** – one-time expenditures are more typically on account of capital, while recurring expenditures are generally current
* **Relative size of the expenditure** – smaller relative to income more likely to be current
* **Residual test** – Presumption in favor of taxpayer when applying the other tests is inconclusive

In the leading case of **Johns-Manville**, a mining company regularly acquired lands surrounding an open pit mine which they would “consume” as the mine got deeper in order to maintain an adequately safe slope. Tests applied pointed in both directions and were inconclusive. Court ruled in favour of taxpayer that these were current expenses based primarily on residual test – the taxpayer would have been able to recover virtually nothing if found to be a capital expenditure because the lands could not be amortized and would be worthless on disposition.

**Purpose to acquire an asset** – acquisition cost of a capital asset is the full cost to the taxpayer including engineering costs, legal etc., and would even require the capitalization of what would normally be current expenses used to build it such as construction workers’ wages

**Repairs vs Improvements of Assets**

* Repairs of tangible assets are current expenses, while improvements to tangible assets are on account of capital
* Factors considered when distinguishing between a repair and an improvement:
	+ A small cost relative to the value of an asset points to a repair
	+ Costs that are expected to regularly re-occur are typically repairs
	+ Purpose: the purpose of a repair is simply to restore the asset to its normal operating capacity
* It may be possible to treat protection of intangible assets (e.g. legal costs of trademark suit) as analogous to repairs
* In many cases, it is very difficult to determine and a court may easily find on either side
	+ **Canada Starch** held legal costs for a trademark dispute to be part of the earnings-process and therefore current
	+ **Dominion Natural Gas** found costs to defending a gas supply license to provide an enduring benefit

## Depreciating Capital Property

**ITA 20(1)(a)** despite **18(1)(b)**, capital costs of property to the taxpayer are permitted to be deducted as outlined by the regulations

**ITA 13(21) “depreciable property”** refers to any property for which a CCA deduction is permitted

**ITA 13(21) “proceeds from disposition”** includes sale price, compensation for property unlawfully taken, compensation for injury to property, insurance payments (not used to repair the property)

**Reg 1100(1)** permits a taxpayer to deduct a CCA in respect of property comprised in any of the 46 prescribed classes listed in **Schedule II**, each of which is allocated a particular CCA rate

Explicitly Not depreciable:

* **Reg 1102(1)(b) –** Inventory (deductible as a current expense)
* **Reg 1102(1)(c) –** Property not acquired for the purpose of producing income (if you rent out your house for business income, it is eligible)
* **Reg 1102(2)** – Land
* Most intangible property (this will change with new system in 2017)

**Capital Cost Allowance - Mechanics**

**ITA 13(21) “undepreciated capital cost”** UCC = (**A** + **B** + C + D + D.1) - (**E** + E.1 + **F** + G + H + I + J + K)

* Only need to know UCC = (A + B) – (E + F) for our course
* A = Total capital costs (before any depreciation) of acquisition of all assets in a particular class
	+ This means when a depreciable asset is acquired, add that to the UCC of that class
	+ Historical or actual cost to taxpayer including legal fees, accounting, engineering etc.
* B = Any recaptured income relating to property of that class for all prior years
	+ Occurs when UCC drops below zero – this brings it back up to zero
* E = Total depreciation allowed for assets of that class
	+ Deduct the CCA and any terminal losses
* F = If there is a disposition, the lesser of a) the net proceeds of the disposition or b) the capital cost to the taxpayer
	+ Deduct the proceeds of sale up to the cost of the asset
	+ Any amounts in excess of the capital cost are realized capital gains and left out of the UCC account
* The UCC represents the unrecovered costs of assets in a class and forms the basis for calculating the CCA
	+ Better described as original costs of all assets in a class minus CCA previously claimed and proceeds from sales
* Economic substance of a transaction is irrelevant as long as there is legal ownership – see **Canada Trustco Mortgage** sale-leaseback
* Property acquired as a gift is deemed to have been acquired at FMV **69(1)(c)**

**ITA 13(7)** The following rules apply for the purposes of regulations made pertaining to **20(1)(a)**

**(a)** If a property that was acquired for producing income is later converted to some other use, the taxpayer is deemed to have disposed of it at FMV at the time of conversion, and reacquired it immediately after at FMV

**(b)** If a property was acquired for some other purpose and is later converted to an income-earning purpose, the taxpayer is deemed to have acquired it at FMV at the time of conversion

**ITA 13(26)** When calculating UCC, no amount may be included as capital cost before the property is considered to have become made available to the taxpayer

**Reg 1100(2)** **Half-year Rule** – If there is a net addition of assets to a particular class in a year, the CCA is calculated from the notional UCC, which is the UCC of the class normally minus half of the net addition to UCC from the year

* If you acquire an asset partway through a year, the Act will pretend you only used it for half of the year for depreciation purposes
* In theory this evens out, but creates an incentive to make late-year purchases and avoid purchases earlier in the year
* Does NOT apply when a new asset is acquired, but others are sold resulting in a lower total UCC

**ITA 13(1) Recapture:** At the end of a taxation year, if (E + F) is greater than (A + B), the excess is included as business income

* Occurs when assets of a class are sold for greater than the UCC immediately before the sale
* The assets were depreciated too quickly, so the recapture puts the back into income the excess CCA that had been claimed
* Liability for recapture can be sheltered/deferred by acquiring new assets in the same class costing more than the amount of recapture because it isn’t calculated until the end of the tax year
* The excess proceeds above actual capital cost are treated as capital gains (because F is capped at actual capital cost)

**ITA 13(4) Exchange of Property** – recapture income may be deferred for one year if the proceeds from disposition of a business property were used to purchase a **replacement property**.

* Two year deferral period if the proceeds are used to replace stolen/expropriated property

**ITA 13(4.1) Replacement Property** – property can be considered replacement property for the purpose of **13(4)** if it is reasonable to conclude it was intended to replace the former property, it is put to the same or similar use as the former property, or it was acquired for the producing income from the same or similar business as the former property

* Must be in the same prescribed class

**ITA 20(16) Terminal Loss:** When all of the assets of a class are disposed of, and the proceeds of disposition are less than the UCC

* The assets were not depreciated fast enough
* A terminal loss is treated as a business loss and deductible against business income (not a capital loss)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Asset 1 | Asset 2 | Asset 3 | Asset 4 |
| Cost | 100 | 100 | 100 | 100 |
| UCC before sale | 40 | 40 | 40 | 40 |
| Proceeds of disposition | 40 | 50 | 30 | 110 |
| Recapture | 0 | 10 | 0 | 60 |
| Terminal Loss | 0 | 0 | 10 | 0 |
| Capital Gain | 0 | 0 | 0 | 10 |

**Limitations on CCA**

**Reg 1100(11)-(14)** **Rental Property stop-loss**– CCA deductions for rental properties may not exceed the rental income from properties in that class

* Property rented out for the purposes of earning gross revenue

**Reg 1100(15)-(17) Leasing Property stop-loss** – CCA deductions for leasing properties may not exceed the rental income from properties in that class

* Property leased for the purposes of producing gross revenue from leasing or royalty

**Reg 1101(1)** Where multiple properties are acquired for producing income from different businesses that would otherwise be in the same class, a separate class is prescribed for each property

**Reg 1101(1ac)** Any rental properties costing $50,000 or more must be prescribed to be in a class of their own

* **1101(1)** and **(1ac)** enforce mandatory separation of assets to prevent abuse of recapture rules by constantly deferring recapture through purchasing additional assets in the same class
* It is also possible to voluntarily include assets in their own separate class to facilitate terminal loss recognition
* Note: This is only for the purpose of calculating recapture, not CCA deductions

**Allocation of Purchase Price**

* A sale of assets may include a combination of various depreciable and non-depreciable property
	+ The seller would like to maximize the allocation to non-depreciable assets so that the capital gains are larger and the amount of recapture income from the depreciable assets is smaller
	+ Conversely, the buyer would like to maximize the allocation to depreciable assets so that larger amounts are added to their UCC giving a higher CCA
	+ Because of these competing interests, so long as the same taxation rules apply to both parties, the government should be indifferent as to their proposed allocation

**ITA 68(a)** If an amount received or receivable can reasonably be regarded as being in part the consideration for the disposition of property, the amount that can reasonably be regarded as such will be deemed to be the proceeds from disposition of that property, irrespective of the legal form of the agreement, and the person who acquires it will be deemed to have done so at an equal amount

* Places the onus on the taxpayer to show that their purchase price allocation was reasonable
* Purpose is to prevent collusion between two taxpayers with different rates against the government through purchase price allocation
* Can apply to transactions that are combined depreciable (trucks, sidewalks, buildings) and non-depreciable (land) property **Golden**
	+ Minority in **Golden** found the allocation reasonable of 5.1M to land and 0.75M to everything else, and majority found **s.68** did not apply (section since amended)

**ITA 13(21.1)** When a building and the land it is situated on are sold in the same tax year (or same time), and the sale of the building would give rise to a terminal loss, that amount is reallocated to the sale of the land to prevent a terminal loss and reduce capital gains

* Purpose is to prevent under-allocation of purchase price to buildings in order to abuse the terminal loss provision
* Note: This provision trumps a reasonable allocation under **s. 68**

**The Adjusted Cost Base (ACB)**

Generally, the capital cost is the actual historical cost of the asset to the taxpayer, however there are numerous special rules for determining the cost of the acquisition of property in certain cases

* Capitalized expenditures – some are required by statute E.G. **s. 18(3.1)**
	+ **18(3.1)** prohibits deductions for expenditures (including interest) reasonably related to construction or renovation of a building or the land it is on and instead requires those amounts be added to the ACB of the building
* Gifts under **s. 69(1)(c)** are treated as a disposition at FMV for capital cost purposes for the donor and the donee
* Government assistance or subsidies in respect of the acquisition or repair of property are required to be deducted from ACB
* Receipt of a damage payment that is capital in nature reduces the capital cost of the asset
* Roll-over rules, change of use rules

**Acquisition and Disposition: ownership change**

Encumbered Assets

* Taxpayers can gain an advantage from the accelerated depreciation of assets due to the timing of recapture
* This advantage can be achieved without using their own money by purchasing the assets with borrowed funds
* If the borrowed funds are a non-recourse loan (**Canada Trustco Mortgage Co**), the taxpayer is able to secure a tax advantage with no risk to themselves which does not seem proper for policy reasons
* Difficult to prevent this because alternative market arrangements can emulate this effect (personal liability + put option, or outright sale + call option)
* According to tax law, you can still retain the incidence of ownership even if you have eliminated all downside risk (**CTMC**)
	+ In **CTMC** the appellants used a sale-leaseback agreement backed by a non-recourse loan to purchase a fleet of trucks and lease them back to the vendor allowing them a substantial CCA claim. The Court ruled that transfer of title of ownership was sufficient despite them having no actual possession or use of the trucks.

**IT-285R2:** Generally, a taxpayer will be considered to have acquired a depreciable property at the earlier of:

 (a) the date on which title to it is obtained, and

* CRA position is transfer of title is sufficient to transfer ownership

(b) the date on which the taxpayer has all the incidents of ownership such as possession, use, and risk, even though legal title remains in the vendor as security for the purchase price (as is commercial practice under a conditional sale agreement).

* Possible to transfer ownership through transfer of incidents ownership

“The basic rule is that property in respect of specific assets passes, and is therefore acquired by the purchaser, at the time when the parties to the contract intend it to pass as evidenced by the terms of the contract, the conduct of the parties and any other circumstances.”

* Decided on the basis of intention of the parties, not purely objective analysis. Very liberal to the taxpayer

**Reg 1100(1.1)-(1.3)** Prohibits CCA deductions for “specified leasing property” as part of a sale-leaseback agreement that is the functional equivalent of a loan.

* Certain types of property are exempted from this, including freight trucks such as in **CTMC**

**A primer on amortization of intangibles**

**ITA 14(5)** “**Eligible capital expenditure**” an expenditure “on account of capital for the purpose of gaining or producing income from the business”, subject to a number of exclusions.

* The definition covers most capital expenditures for intangibles.
* The intangible property acquired with an eligible capital expenditure is described in **s.54** as “**eligible capital property**”.

**ITA 20(1)(b)** allows a deduction not exceeding 7% of the “**cumulative eligible capital**” (**CEC**) at the end of each year.

* The CEC account is operated in much the same way as the UCC account of a class of depreciable property.
* The CEC account is increased by 3/4 of each eligible capital expenditure (purchase of eligible capital property), and it is reduced by 3/4 of the proceeds of disposition of eligible capital property.
* A recapture and a terminal allowance (similar to “terminal loss”) each causes the account to be reset to zero.
	+ A recapture is included in income under **s. 14(1)**
	+ A terminal allowance is deductible under s. **24(1);** it occurs if the account has a positive balance when the taxpayer ceases to carry on the business.

# Capital Gains and Losses

## Investing vs Trading: Introduction to Capital Gains and Losses

**Characterization of Property as Capital**

Cases where the distinction between capital gain/losses and business income/losses generally fall into one of the following:

1. **Investment** – a dentist sells BCE stock which was acquired as an income-producing investment. Profit = capital gain
2. **Personal Use Property** – a bank employee sells his cottage which was acquired for recreation. Profit = capital gain
3. **Capital Asset** – shoe manufacturer sells her factory for more than she paid for it. Profit = capital gain
4. **Inventory** – car dealer sells a vehicle in the course of his business. Profit = business income
5. **Speculation** – lawyer sells gold which he acquired with a view to resale at a profit. Profit = business income

Controversies can arise from these distinctions

* Gain/loss from investment vs trading (or ACNT)
* What happens when investment property is converted into trading property (inventory)?
* What happens when trading property (inventory) is converted into investment property?

Issue was explored in **Regal Heights** where a partnership group purchased lands for the purpose of developing a shopping center, but sold the land at a substantial profit once it was determined the shopping center was no longer viable.

* **Majority**: Experienced investors knew of the speculative value which formed a secondary purpose and despite a bona fide primary purpose, the lands were purchased as an ACNT and gains subject to business income
* **Minority:** Primary purpose governs and the lands were an investment property and gains were of a capital nature
* There has been a ton of cases on the secondary intention doctrine since this, and they aren’t entirely consistent, but the general consensus seems to be the secondary intention must have existed at the time of acquisition, and have been a “motivating reason” for the purchase

Factors to consider when making the distinction between investment and business/ACNT:

* A longer holding period would be more likely to be of an investment nature than a trade
* A high frequency of trading or trading in a systematic manner is likely to be considered a business
	+ Using borrowed funds to make the deals is a further indication of a business
* When a series of transactions are related to the taxpayer’s ordinary work, this strengthens the trading inference
* A REOP would be more indicative of a business

## Tax Consequences of Capital Gains and Losses

**ITA 39(a), (b)** define capital gains and losses as residual – they are the gains/losses from disposition of property not otherwise included under **3(1)(a), (b)**.

* When the gain/loss is characterized as income from business, the property is considered inventory
* Characterization question: is the property disposed of in the course of the business or as part of an ACNT? If so, it gives rise to business income

**Realization Principle**: There are no tax consequences until there is a disposition and the gains/losses are realized

* Justified on the basis of administrability – difficult to require regular valuations, liquidity issues
* Alternative would be mark-to-market
	+ Subject to asymmetry as the taxpayer can elect to realize a loss at any time, but defer gains until disposition
	+ There are special rules such as roll-over provisions which can aggravate this asymmetry advantage further

**ITA 40(1)(a)(i), (ii)** Capital gains and losses from the disposition of property are the difference between the proceeds from disposition and the adjusted cost base of the property including sales expenses

* Capital Gain/Loss = PoD – (ACB + Sales Expenses)
* Capital losses may only be deducted against capital gains under **3(b)** (unlike business losses which may be deducted against any income under **3(d)**
	+ **3(d)** also implies that business losses can be deducted against capital gains
	+ Similarly, losses from listed personal property (**s.41**)are only deductible against gains from listed personal property, with the net amount being brought into income
* Allowable capital losses that can’t be fully deducted in the year of disposition may be carried back 3 years or carried forward indefinitely under **111(1)(b)**
* However, non-capital losses may be carried back 3 years, but carried forward a maximum of 20 years under **111(1)(a)**

**ITA 54 “adjusted cost base”** except as otherwise provided is, **(a)** the capital cost to the taxpayer at that time where the property is depreciable property or **(b)** the cost of the property to the taxpayer at that time, adjusted in accordance with **s.53**

**ITA 54 “capital property”** of a taxpayer is **(a)** any depreciable property or **(b)** any other property where the gain or loss from disposition of such property would be a capital gain or loss

**ITA 54 “personal use property”** includes property owned by the taxpayer primarily for the personal use/enjoyment of the taxpayer, or a person related to the taxpayer

**Canadian Securities**

**ITA 39(4)** subject to subsection **(5)**, if a taxpayer who disposes of a Canadian Security in a year, they may elect to have all Canadian Securities owned by them that year and any subsequent year to be deemed capital property

**ITA 39(5)** subsection **(4)** does not apply to securities traders/dealers, financial institutions, corporations with the principle business of lending or purchasing debt obligations, or non-residents

**ITA 39(6) “Canadian Security”** is a share of a Canadian corporation, or a unit of mutual fund, bond, debenture, bill, note, mortgage or similar claim issued by a resident of Canada

## Personal Property and Listed Personal Property

**ITA 54** “**Personal-use property”** is property owned by a taxpayer “that is used primarily for the personal use or enjoyment of the taxpayer” or of “a person related to the taxpayer”

**ITA 40(2)(g)(iii)** provides that a loss from the disposition of **personal-use property** (other than “**listed personal property**”) is deemed to be nil

* Losses are considered personal consumption, while gains are taxable as accretions to wealth

**ITA 54 “Listed Personal property”** includes: print, etching, drawing, painting, sculpture, or other similar work of art, jewelry, rare folio, rare manuscript, or rare book, stamp, or coin

* Loss on these items are not deemed to be nil under **40(2)(g)(iii)**
* **3(b)(i)(B)** includes in income net gain from dispositions of listed personal property in the year
* If there is a net loss from dispositions of listed personal property, it is not deductible, but can be carried back 3 years or carried forward 7 years to offset gains from listed personal property in those years under **41(2)**

**ITA 46(1) “$1000 rule”** deems both ACB and POD of **personal-use property** to be the higher of actual numbers or $1000

* Exempts small transactions from capital gains rules

**Example:**

* D disposes of a painting with ACB of $2,500 for POD of $400.
* A painting is **listed personal property**, thus **40(2)(g)(iii)** does not deem the loss to be nil.
* **46(1)** deems the POD to be $1,000, thereby reducing the capital loss from its actual figure of $2,100 to a deemed figure of $1,500

## Computation of Reserve

When there are deferred or partial payments for a disposition of property, portions of the capital gains may be deferred for up to 5 years in accordance with the reserve deduction in **40(1)(a)**

**ITA 40(1)(a)** a taxpayer’s gain for the year from a disposition of property is the amount, if any, by which

 **(i)** if the property was disposed of in that year, the total capital gain, or

**(ii)** if the property was disposed of in a prior year, the amount claimed under **(iii)** in computing the taxpayer’s gain from disposition for the immediately preceding year

**EXCEEDS**

**(iii)** the reserve deduction which can be claimed for that year which is lesser of

 **(C) reasonable reserve:** the product of: (total capital gain) x (PoD outstanding / total PoD)

 **(D) maximum reserve:** the product of: (total capital gain x 1/5) x (4 – number of tax years since disposition)

* Capital Gain Declared in Tax Year = (Total Capital Gain – Capital Gains Previously Declared – Reserve)

## Principal Residence Exemption

**ITA 40(2)(b)** if the taxpayer is an individual, the gain on disposition of property that was their principal residence at any time after the day on which they most recently acquired it is determined by the formula **A – A x B/C – D** where:

* A = the amount that would normally be the gain from disposition for the year
* B = 1 + number of tax years ending after acquisition date that property was the taxpayer’s principal residence AND while the taxpayer was resident in Canada – **“1 plus rule”**
* C = number of tax years ending after acquisition date during which the taxpayer owned the property (jointly or otherwise)
* D can be ignored

**ITA 54 “Principal Residence”** of a taxpayer for the year is a housing unit owned by the taxpayer (jointly or otherwise), if

**(a)** the taxpayer is an individual, and the housing unit is ordinarily inhabited by that taxpayer, their current or former spouse/CL partner, or their child

**(c)** the property must be designated as the principal residence in the prescribed form, and no other property has been so designated (by the taxpayer’s family)

**Folio S1-F3-C2**

**2.11** If the main reason for owning a housing unit is to produce income and the unit is only occupied by the taxpayer for a short period of time during the year, it will generally not be considered “ordinarily inhabited.” Incidental income earning is OK. If the main purpose is to earn income, but it is rented to the taxpayer’s child, that is OK.

**2.59** It is CRA practice to not apply the “deemed disposition rule” but rather consider the property to be a principal residence when the income-producing use is ancillary, there are no structural changes to the property, and no CCA is claimed

To make use of the “1 plus rule,” best practice is to designate property with the highest gain for the most number of years

**Example**

* A house was purchased by T in 2009 for $100,000, was ordinarily inhabited by T, and was sold in 2013 for $150,000. ($50K gain)
* A cottage was purchased by T in 2010 for $80,000, was ordinarily inhabited by T, and was sold in 2013 for $140,000. ($60K gain)
* A ski chalet was purchased by T in 2011 for $120,000, was ordinarily inhabited by T, and was sold in 2013 for $140,000. ($20K gain)

Suggested Designation:

|  |  |  |  |
| --- | --- | --- | --- |
|  | House  | Cottage | Ski chalet |
| Gain (G) | $50,000 | $60,000 | $20,000  |
| Years owned (Y) | 5 (2009–2013) | 4 (2010–2013) | 3 (2011–2013)  |
| Gain per year (G/Y)  | $10,000 | $15,000a | $6,667  |
| Years designated | 1 (2009) | 3 (2010–2012) | 1 (2013)  |
| Exemption (E) | $50,000 × (1 + 1)/5  | $60,000 × (3 + 1)/4  | $20,000 × (1 + 1)/3  |
|  | = $20,000 | = $60,000 | = $13,334  |
| Capital Gain = (G) - (E) | $30,000 | 0 | $6,666  |

## Change in Use Rules

**ITA 45(1)(a)** for the purpose of subdivision c, where a taxpayer,

**(i)** having acquired property for some other purpose, has commenced at a later time to use it for the purpose of gaining or producing income, or

**(ii)** having acquired property for the purpose of gaining or producing income, has commenced at a later time to use it for some other purpose,

the taxpayer shall be deemed to have

**(iii)** disposed of it at that later time for proceeds equal to its FMV at that later time, and

**(iv)** immediately thereafter reacquired it at a cost equal to that FMV

Recall there is also a similar provision under **13(7)** for depreciable property

**ITA 13(7)** The following rules apply for the purposes of regulations made pertaining to **20(1)(a)**

**(a)** If a property that was acquired for producing income is later converted to some other use, the taxpayer is deemed to have disposed of it at FMV at the time of conversion, and reacquired it immediately after at FMV

**(b)** If a property was acquired for some other purpose and is later converted to an income-earning purpose, the taxpayer is deemed to have acquired it at FMV at the time of conversion

**IT 218-R** The CRA’s position is the change in use rules are not triggered when property is converted from one income-producing purpose to another income-producing purpose. For instance when rental units are converted into condos for sale (inventory), **13(7)** and **45(1)** do not apply and there is no deemed disposition.

**IT 102R2** **Para 8** When capital property is converted to inventory, this is not a disposition.

* The taxpayer may elect to declare a notional disposition at the time of conversion with capital gains being calculated as FMV – ACB to be declared at the time of the actual disposition.
* The income or loss arising from the subsequent sale of inventory is based on an inventory valuation of FMV at the date of conversion

**Para 9** When inventory is converted to capital property, this is not a disposition

* For the purposes of CCA calculations, the property is valued at the FMV of the inventory at the time of conversion
* The half-year rule only applies if it was acquired in that year

**CAE** case held that when income-producing property (such as an aircraft simulator being leased out) is converted to inventory (the simulator was made available for sale), the change in use provisions such as **45(1)** and **13(7)** are triggered because holding property in inventory does not actually produce income. There will be a deemed disposition from this conversion.

* A leased simulator with a binding option for the lessee to buy was considered to be inventory because of the option

**CAE** is in direct conflict with the CRA’s stated position. While it is unclear exactly how this would turn out if litigated, the CRA has stated that they will continue to apply their own practice and will not follow the FCA ruling.

* Standard practice now is the taxpayer will declare a notional disposition at the time of conversion when it is to their advantage to do so
	+ Taxpayer will likely do so when converting Capital 🡪 Inventory when expecting a gain (portion of proceeds would become capital gains instead of entirely income)
	+ Taxpayer will likely do so when converting Inventory 🡪 Capital when expecting a loss (portion of loss would become business loss deductible against all losses, rather than strictly capital loss)

**ITA 45(2)** When a property is converted from a non-income producing property to an income-producing property, the taxpayer may avoid the deemed disposition under **45(1)** by electing to have been deemed not to have begun using the property for an income-producing use.

* This is valid until the taxpayer rescinds their election
* This postpones the recognition of any accrued capital gains (but losses that accrue after are disallowed because the taxpayer is deemed to still be using it for personal use)
* CCA cannot be claimed on the property during this time
* Income yielded by the property are still subject to business income tax, and all business expenses are deductible (except CCA)

## Superficial Loss Rules

**ITA 40(2)(g)(i)** a taxpayer’s loss from disposition of property to the extent it is a **superficial loss** is nil

**ITA 54 “superficial loss”** loss from disposition of property where **(a)** the taxpayer or an affiliated person acquires a **substitute property** that is the same property or identical to it during the period between 30 days before and 30 days after the disposition, and **(b)** at the end of the period the taxpayer or affiliated person owns or had a right to acquire the property

* Affiliated person defined in **251.1(1)** as spouse/CL partner, corporations controlled by person, majority interest partner in partnership, majority interest beneficiary in trust, etc.
* Primary purpose is to prevent sale-buy back of securities in order to recognize losses

**ITA 53(1)(f)** The amount of the superficial loss from a disposition is added to the ACB of the **substitute property**

* Corresponding provision to **40(2)(g)(i)** to completely reverse the effects of the disposition

## Exchange of Property Rules

**ITA 13(21)(b-d) “proceeds of disposition”** include proceeds from involuntary dispositions such as compensation for property unlawfully taken, property destroyed (damages or insurance payments), or property lawfully taken by statutory authority

**ITA 44(1) exchange of property rollover** when an amount has become receivable as PoD of capital property (that is not a stock) that is either

 **(a)** property for which the PoD are from an involuntary disposition under **13(21)(b-d)** or

 **(b)** property that was business property immediately before disposition

And the taxpayer has

 **(c)** before the end of the 2nd taxation year following the disposition in the case of **(a)** or

 **(d)** before the end of the 1st taxation year following the disposition in the case of **(b)**

Acquired property that is **replacement property** for the former property, the taxpayer may elect to

 **(e)** deem the capital gains to be the lesser of

 **(i)(A)** the amount by which the PoD exceeds the (ACB + disposition costs) of the former property

 **(i)(B)** the amount by which the PoD exceeds the (cost or capital cost of replacement property + any disposition costs), and

 **(f)** deem the cost of the replacement property to be the actual cost minus the amount by which **(e)(i)(A)** exceeds **(e)(i)(B)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Example 1 | Example 2 | Example 3 |
| a | Former Property PoD | 100 | 100 | 100 |
| b | Former Property ACB | 60 | 60 | 60 |
| c | Disposition Costs | 0 | 0 | 0 |
| d | Replacement Property Cost | 40 | 80 | 120 |
| e.1 | CG = (e)(i)(A) = a-(b+c) | 100 – (60 + 0) = **40** | 100 – (60 + 0) = 40 | 100 – (60 + 0) = 40 |
| e.2 | CG = (e)(i)(B) = a-(d+c) | 100 – (40 + 0) = 60 | 100 – (80 + 0) = **20** | 100 – (120 + 0) = **(-20) or nil** |
| f | Excess A over B = e.1-e.2 | 40 – 60 = (-20) or nil | 40 – 20 = 20 | 40 – nil = 40 |
|  | Replacement ACB = d-f | 40 – nil = **40** | 80 – 20 = **60** | 120 – 40 = **80** |

* When property is exchanged for replacement property costing less than the original, normal rules apply (Example 1)

**ITA 44(5) replacement property** is property where it is reasonable to conclude was intended to replace the former property, used for the same or similar use as the former property, or used for the same income-producing purpose as the former property

**ITA 13(4) and (4.1)** allow the taxpayer to elect to have any excess **13(21)(b-d)** loss compensation PoD above UCC of the class to be deferred and reduced from the UCC of the class of replacement property in the year its acquired (provided within time limits) to avoid premature recapture

## Inadequate Considerations – FMV Provision

**ITA 69(1) Inadequate Considerations**

**(a)** When a taxpayer acquires property from a non-arms-length (NAL) party for greater than FMV, they are deemed to have acquired it at FMV

**(b)** When a taxpayer disposes of property

 **(i)** to a NAL party for nothing or less than FMV or

 **(ii)** to anyone as a gift

The taxpayer is deemed to have received proceeds equal to FMV

**(c)** Where a taxpayer receives property as a gift, bequest, or inheritance, they are deemed to haved acquired it at FMV

## Spousal Rollovers and Income Attribution Rules

**ITA 56(2) Indirect Payments** – payments or property transfers to another person for the benefit of the taxpayer are included in the income of the taxpayer to the extent it would have been if the taxpayer received the payment/transfer instead

**ITA 56(4) Transfer of Rights to Income** – When a taxpayer transfers or assigns to a NAL party the rights to an amount that would normally be included in the taxpayer’s income, that income is to be included in the taxpayer’s income

* Only applies to proportion relating to when taxpayer was resident in Canada
* Does not apply to income from property if the property was transferred as well

**ITA 73(1.01) Qualifying Transfer** is when property is transferred by an individual

 **(a)** to a spouse or CL partner

 **(b)** to a former spouse or CL partner in a settlement of rights arising out of the former marriage/partnership

 **(c)** to a spousal trust created by the individual

**ITA 73(1)** When there is a **qualifying transfer** by an individual and both parties are resident in Canada at that time, unless the individual elects out of this Part, the property is deemed

 **(a)** to have been disposed of by the individual for proceeds equal to

 **(i)** in the case of depreciable property of a particular class, the UCC of class x (FMV of property / FMV of class)

 **(ii)** in all other cases, the ACB of the property to the individual at that time, and

 **(b)** the property is deemed to acquire the property at those amounts

* Spousal transfers are rolled over by deeming dispositions at cost rather than FMV so no gain or loss recognized for transferor
* Entire gain would be recognized on later disposition, but attributed to transferor (if current partner) by virtue of attribution rule in **74.2**

**ITA 74.2(1) Spousal Attribution of Capital Gain/Loss**– if an individual has directly/indirectly transferred or lent property to a spouse or CL partner (or someone who has since become one), the following rules for the individual and the recipient apply:

 **(a)** the amount, if any, by which

**(i)** the recipient’s total capital gains from transferred or lent property (other than listed personal property) during the period they reside in Canada and are the spouse/CL partner of the individual

Exceeds

**(ii)** the recipient’s total capital losses from transferred or lent property during that period

Shall be deemed capital gains of the transferor

**(b-d)** [similar provision for net capital losses, net capital gains from listed personal property, net capital losses from listed personal property]…

**(e)** capital gains or losses from **(a-d)** are deemed not to be attributed to the recipient

* Capital gains or losses from spousal transfers on subsequent disposition are attributed to the transferor and not the recipient
* Note: no equivalent capital/gain loss provision for transfer to minors

**ITA 74.1(1) Spousal Attribution of Income/Loss** – if an individual has transferred/lent property to a spouse/CL partner (or has since become one), any income/loss related to that property (or substituted property) during the period the person is resident in Canada and are the spouse/CL partner, is attributed to the transferor

* Income/loss from property attributed to transferor, not recipient

**ITA 74.1(2) Income/Loss Attribution with Transfer to Minor** – any income/loss from transfer of property to a person under 18 who is a NAL party, or niece/nephew of the transferor, during the period the person is resident in Canada and is still under 18 at the end of the tax year, is deemed to be income/loss of the transferor

* Income/loss from property attributed to transferor so long as recipient is minor at end of tax year

**ITA 74.5(1) Transfers for FMV – 74.1** and **74.2** do not apply if the transfer was for FMV consideration (with a reasonable interest rate if the consideration included indebtedness), or if the transferor elects not to apply **73(1)** in a spousal transfer

**ITA 74.5(11) Artificial Transfers – 74.1** to **74.4** do not apply if it is reasonable to conclude one of the main reasons for the transfer was to reduce tax on the income or gains from the transferred property

**ITA 245** – General Anti-Avoidance Rule (GAAR)