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DISPUTE RESOLUTION, STATUTORY INTERPRETATION & TAX AVOIDANCE

DISPUTE RESOLUTION

The disputants in a tax dispute are: **the individual taxpayer** (TP) and the **Canada Revenue Agency** (CRA).

Onus: the burden of proof is always on the individual TP to disprove any assessment made by the CRA.

The tax process begins with the filing of a return by the TP and flows as follows:

(a) **Return**
- ***ITA s. 150***: *every individual TP must file and submit a return by April 30 if tax is payable.*

(b) **Initial Assessment**
- Official act of the CRA, who verifies the tax return and sends out a **Notice of Assessment** (NOA) to the TP by the end of July.

(c) **Further Reassessment**
- A NOA is an "initial assessment" as the CRA has **3 years to reassess a return**, from the date of the Initial Assessment sent by the CRA
- This can either be a **reassessment** or an **additional assessment** adding new sources of income.

(d) **Objection**
- TP can file a **Notice of Objection** (NOO) within a certain time period, which begins the appeal process, moves the taxpayer's file to the CRA Appeals Branch, and holds payment.
- NOO must state the legal/factual error the claim is baed on.

(e) **Appeal**
- If the TP disagrees with the CRA's reassessment, they can file a **Notice of Appeal** within a certain time period with: (1) the Tax Court of Canada (TCC); (2) next, the Federal Court of Appeal (FCA); (3) next, with the Supreme Court of Canada (SCC).
- *Note:* "Compromise settlements" are not permitted in tax disputes (***CIBC World Markets****, CRA cannot compromise their duty to enforce the ITA;* ***ITA s. 220;*** *MNR must enforce the ITA; a settlement to avoid nuisance of going to court is inconsistent with the idea of assessing tax according to the law*).

(f) **Alternative Relief** (option)
- Available to TP when the law is against them whereby they seek a **Remission Order** from the **Treasury Board**
- A Remission Order is an Order in Council provided by ***Financial Administration Act s. 23(2)***: allows government to forego taxes when an individual has no legal grounds of appeal but they believe it is unreasonable, unjust, or not in the public interest to pay so much tax
- TP must make demonstrate extreme hardship, incorrect action or advice by CRA, financial setback, extenuating circumstances, or an unintended or inequitable effect of the legislation

RETURNS AND ASSESSMENT

RETURNS

The tax process always begins with the filing of a return by the TP (***ITA s. 150***). An **individual** must file a tax return if tax is payable OR capital property has been disposed of (*capital gain/loss*). A **corporation** must file a tax return every year regardless of whether or not tax is payable.

Key sections of the *Income Tax Act* with regard to tax returns:

(a) "**Taxation year**"
- ***ITA s. 249(1):*** for purposes of this Act, a "taxation year" is:
  (a) for a **corporation** or Canadian resident partnership, **a fiscal period**, and
  (b) for an **individual**, a **calendar year** (*i.e. from January 1 to December 31*)

(*cont'd*)

(b) **All individual TP must file a return**

- ***ITA s. 150(1)(d)(i):*** all individual TPs must file a return of income in a prescribed form containing prescribed information each taxation year, due on **April 30 for individuals**
- ***ITA s. 150(1)(d)(ii):*** **June 15** deadline **for those carrying on a business**, such as self-employed individuals and their spouses (*ex. sole practitioners*), however the balance due date (April 30) does not change (*so interest is payable on any taxes owing from April 30–June 15*).
- If a TP misses the deadline, interest starts to accrue starting April 30 in addition to late penalty

(c) **Minister can demand a return at any time**

- ***ITA s. 150(2):*** every person, whether or not liable to pay tax, must file on demand from the Minister of National Revenue (MNR), such as when a person does not file for some time
- An individual must respond within 2 years or face the civil criminal penalties (below)

(d) **TPs must estimate amount of tax payable in return**

- ***ITA s. 151:*** every TP who is required by ***s. 150*** to file a return must estimate the amount of tax payable in the return
- TPs are liable for civil and criminal penalties for false statements

ASSESSMENT

Key sections of the *Income Tax Act* with regard to tax assessment:

(a) **Assessment**

- ***ITA s. 152(1):*** MNR shall "**with all due dispatch**" examine the TP's return, assess the amount of tax payable, and determine the amount of tax or refund

(b) **Overpayment**

- ***ITA s. 152(2):*** CRA must send NOA with a cheque for a refund if the taxpayer has overpaid

REASSESSMENT

Key sections of the *Income Tax Act* (ITA) with regard to tax reassessment:

(a) **3-year limitation period for reassessment or additional assessment**

- ***ITA s. 152(3.1)(b):*** the notional reassessment period has a 3-year limitation period that starts to run from the CRA's mailing of the original NOA to the TP
- In this 3-year period, the CRA can reassess for any reason whatsoever
- Can also be invoked if a TP forgets to make a deduction and wishes to amend a return
- *Note:* this limitation period is subject to a possible extension under the "fairness package"

(b) **However, assessment and reassessment really have no limits**

- ***ITA s. 152(4):*** the MNR may make an assessment or reassessment at any time if the TP has:
  (a) Made a **misrepresentation due to neglect, carelessness, willful default, or fraud**
  (b) Filed a **waiver** within the ordinary 3-year limitation period

(c) **Arbitrary or "net worth" assessment**

- If the CRA notices that a TP has not filed a tax return, or don't trust the figures reported by the TP, they can make an arbitrary "net worth" assessment
- ***ITA s. 152(7):*** Assessment is **not dependent on return or information supplied by the individual TP**, as the MNR may make arbitrary or "net worth" assessment, and is not bound by the return information supplied by the individual TP
- This is another method of assessment where the government compares a TPs net worth (*assets – liabilities*) from the beginning to the end of the year and makes any increase in net worth taxable
- ***Eldridge:*** any increase in net worth creates a **rebuttable presumption** that it is taxable income

(d) **Retention of records**

- ***ITA s. 230(1):*** TPs must keep tax records and documentation for 6 years
- CRA does not keep records and documentation

REFUNDS, INTEREST AND PENALTIES

(a) **Refund:** repayment of any tax payments that exceed the tax owing
(b) **Interest:** if tax is overpaid, interest is given and prescribed by regulation, but TPs must report this interest as income (it is taxable)
(c) **Penalties:** non-deductible civil and criminal penalties for late or false returns

Key sections of the *Income Tax Act* with regard to interest charges and penalties:

(a) **Interest charges**
- ***ITA s. 161:*** if tax is outstanding, the interest is charged to the taxpayer at a "prescribed rate" by regulation quarterly

If a TP does not pay taxes, there are **non-deductible civil penalties** imposed by the ITA that act as additional charges on the TP to assist the Minister with "administration and enforcement of the Act:"

(b) **Failure to file income return the first time**
- ***ITA s. 162(1):*** TP is liable for a penalty equal to **5% of total tax payable** AND 1% unpaid tax multiplied by the number of months (up to 12) from the date that the return was supposed to be filed to the date on which it was actually filed

(c) **Repeated failures to file return**
- ***ITA s. 163(1):*** TP is liable for a penalty equal to **10% of total tax payable** if there is a repeated failure in any of 3 preceding years

(d) **Civil penalty for false statements or omissions**
- ***ITA s. 163(2):*** TP knowingly/negligently reported misleading tax figures
- CRA most commonly uses this provision because, unlike ***ss. 238–239*** (which imposes criminal penalties and carries higher fines) there is no requirement to prove *mens rea* beyond a reasonable doubt

(e) **Third party civil penalties**
- ***ITA s. 163.2:*** those who make, participate in, or **acquiesce in a false statement** made with regard to another's tax situation can be held liable
- Aimed at promoters of tax shelters and overly aggressive tax advisors
- Exemption for clerical staff and those acting in good faith

The DOJ may also launch a **criminal prosecution** and charge TPs under the ITA's criminal provisions (where *mens rea* is required) for serious tax evasion maneuvers by TPs:

(f) **Offences and punishment**
- ***ITA s. 238(1):*** persons who fail to file a return as required under the Act or fail to comply with certain sections of the Act are guilty of an offence and are liable on summary conviction for a fine between $1,000 and $25,000 and/or imprisonment not exceeding 12 months

(g) **Other offences and punishment**
- ***ITA s. 239:*** persons who make false/deceptive statements, evade payment by altering or destroying records/books are guilty of an offence and are liable on summary conviction for a fine and/or imprisonment
- ***Jarvis:*** there is a demarcation between the audit and investigative functions under the ITA

Voluntary Disclosures Program ("**tax amnesty**")

Taxpayers may avoid being penalized or prosecuted if they make a **voluntary disclosure** *before* the CRA begins investigating them. If the taxpayer comes forward *voluntarily* and pays the *taxes owing plus interest*, they may avoid civil and criminal penalties (***IC-00-IR: Voluntary Disclosures Program*** (October 22, 2007)).

Elements: (a) must be *voluntary* (b) the taxpayer must be facing penalties for criminal tax evasion (c) taxes must be more than one year overdue (d) there must be *full disclosure*.

Note: **there is a difference between tax planning, tax avoidance and tax evasion:**

(a) **Tax planning**

- Tax planning consists of **open attempts** to take advantage of tax laws by rearranging the one's affairs to reduce the amount of tax payable.
- Proper tax planning is to use the devices offered by the ITA as they were intended: consistent with **wording** and **intent** of the ITA**.**
- **Tax planning is permissible** (***Copthorne Holdings* 2011 SCC**).
- Taxpayers are entitled to select courses of action or enter into transactions that will minimize tax liability (***Duke of Westminster***).

(b) **Tax avoidance**

- **Abusive tax planning** is complying with the **wording** of the ITA, but **not with the intent**
- Tax avoidance provisions are designed to counteract tax avoidance: (a) reassessment (b) civil penalties
- Civil/criminal penalties and interest owing on taxes in arrears are not tax-deductible (***ITA s. 18(1)(t)***)

(c) **Tax evasion**

- Deliberate or willful violation of the ITA
- Tax evasion is subject to criminal prosecution (***ITA ss. 238–239***) and/or civil penalties (***ITA s. 162(1)***).

THE "FAIRNESS PACKAGE"

The "fairness package" is also known as "**taxpayer relief provisions**" which give the MNR the discretion to "administer the tax system more fairly" by:
(a) Extending the limitation period for tax refund applications farther than 3 years
(b) Canceling or waiving interest/penalty charges if extenuating circumstances exist for non-culpability
(c) Extending the election deadline up to 10 years (i.e. non-resident status)

Reference: ***IC 07-01: Taxpayer Relief Provisions*** (June 4, 2007)

This is all a matter of administrative discretion and TP can file for judicial review if not satisfied. *Comment: t*his may be effective as a threat rather than actual procedure to get CRA to forgive penalties.

Note: with the "fairness package," can only waive interest or penalties, not the principal sum owing.

OBJECTIONS AND APPEALS

Objections

If a TP doesn't like their assessment, they can ask the CRA to reconsider the assessment:

(a) **File a Notice of Objection**

- ***ITA s. 165(1):*** TP must file a NOO within:
  (a) **90 days** from the date of the Notice of Assessment, or
  (b) **1 year** from the due date of the return (April 30), **whichever is later**
- Since the government has 3 years to reassess, NOA may come 2-3 years after the filing due date
- There is no prescribed form, however the NOO must set out the reasons for the objection and state all relevant facts

(b) **Onus on TP to appeal decisions**

- ***ITA s. 152(8):*** tax assessments are deemed to be valid, subject to objection or appeal by the TP or CRA within the 3 year limitation period

(*cont'd*)

Appeals

A TP who has filed a NOO may appeal the assessment or reassessment with the Tax Court of Canada (TCC):

(a) **Appeal**
- ***ITA s. 169(1):*** if a TP has served a NOO, the TP may appeal to the TCC to have the assessment varied or vacated if **90 days have elapsed** after service of the NOO OR after the MNR has confirmed the assessment

(b) **Frivolity penalty**
- While the dispute process is going on, taxes do not have to be paid, however the objection or appeal is dismissed (*i.e. TP loses*), **10% interest** may be payable on the unpaid taxes (***ITA s. 179.1***).

(c) **Burden of proof**
- TP has civil burden of proof to displace factual assumptions by CRA (***Johnston v MNR* 1948 SCC,** *assumptions of Minister in making assessment presumed correct unless specifically disproved by TP*).

Appeals for a reassessment go to the TCC, of which there are **two procedures:**

Informal Procedure (*like small claims court*)
- Amount of taxes/penalties in dispute must be $12,000 or less
- Counsel not required
- No costs awarded upon loss
- Decisions fully appealable to FCA (since 2003)
- Limited judicial review opportunities

General Procedure
- Amount of taxes/penalties in dispute must be more than $12,000
- Legal representation desirable (but not required)
- Formal rules of evidence apply
- Costs awarded against losing party
- Appeal to FCA (*within 30 days*), or SCC with leave

SETTLEMENTS

93% of objections are resolved within the CRA; 7% unresolved go to court. Therefore, informal negotiations between the TP and CRA can begin at the audit stage and disputes are often settled without going through the formal objection and appeals procedures.

A **compromise "split the difference" settlement** agreement between a TP and the CRA is not enforceable as the minister has a statutory duty (***s. 220(1)***) to assess the amount of tax payable based on the facts and in accordance with the law (***Galway v MNR* 1974 FCA; *CIBC World Markets v Canada* 2012 FCA**). However, **where there is a genuine dispute on the facts or on the law**, a compromise settlement may be available (***CIBC World Markets***).

On the bright side, compromise settlements are not binding on TP either (***Consolotex v Canada* TCC**).

AUDIT AND INVESTIGATION

While voluntary compliance and self-assessment comprise the essence of the ITA's regulatory structure, the system is "voluntary" only in the sense that a TP must file income tax returns without being called upon by the Minister. The Minister is vested with extensive powers that may be used **"for any purpose related to the administration or enforcement of the ITA"** (***ITA s. 231.1,*** *power to audit*). The audit must occur **within 3 years** (but there is no limit if TP has made a misrepresentation or waived the time limit).

Three stages of audit:

(a) **Desk audit:** CRA checks what you file (documents, calculations, matching items, etc.)
(b) **Office audit:** CRA calls the TP into the office, asks TO to bring cheques, receipts, etc.
(c) **Field audit:** CRA pays the TP a friendly visit at their home or office to investigate

Civil auditing powers in the *Income Tax Act* where the TP has no rights:

(a) **Civil powers of investigation and enforcement**

- ***ITA s. 231.1(1):*** grants various powers to the Minister:
  - (a) allows a person authorized by the Minister to "inspect, audit or examine" a wide array of documents, reaching beyond those the ITA might otherwise require the TP to maintain
  - (b) in the course of the inspection, audit or examination, the authorized person may enter into any premises or place that is not a dwelling house
  - (c) there is a correlative duty upon persons at the premises or place to provide "all reasonable assistance and to answer all proper questions relating to the administration or enforcement of the Act"

(b) **Judicial warrant**

- ***ITA s. 231.1(2):*** absent the occupant's consent in ***s. 231.1(d)***, a judicial warrant may be obtained for entry into a dwelling house

(c) **Requirements power**

- ***ITA s. 231.2(1):*** the Minister may compel any person to produce any information or document

Criminal investigative powers in the *Income Tax Act* trigger *Charter* rights:

(a) **Summary offence**

- ***ITA s. 238(1):*** summary offence that is triggered by non-compliance with filing requirements or with other of the Act's provisions, such as ***s. 231.1(1)***

(b) **Indictable offence**

- ***ITA s. 239(1):*** creates additional offences that can proceed by indictment for false/deceptive statements, destruction/alteration of documents, false/deceptive documents, willful evasion of income tax, and conspiracy to engage in prohibited activities
- Basically, ***s. 239*** offences bear formal hallmarks of criminal legislation (prohibition + penalty)

***ITA* and the *Charter* (*R v Jarvis* 2002 SCC)**

When the "**predominant purpose"** of the inquiry is a determination of penal liability, criminal investigatory techniques must be used and thus ***Charter*** rights are engaged for the TP's protection. Rights include ***s. 7*** right to silence/self-incrimination, ***s. 8*** unreasonable search and seizure, and ***s. 10*** right to counsel.

When Charter protections are engaged in the determination of penal liability under ***s. 239***, investigators must provide the taxpayer with a **proper warning**.

Civil auditing powers of compulsion in ***ITA ss. 231.1(1)*** and ***231.2(1)*** are not available under a criminal investigation, and search warrants are required in order to further the investigation.

TEST: to determine **the line between audit and investigation**, officials "cross the Rubicon" when the inquiry in question engages the adversarial relationship between the taxpayer and the state. This determination is contextual and depends on the following factors:

- (a) Did the authorities have reasonable grounds to lay charges?
- (b) Was the general conduct of the authorities consistent with the pursuit of an investigation?
- (c) Had the auditor transferred his/her files and materials to the investigators?
- (d) Did the auditor effectively act as agent for the investigators?
- (e) Does it appear that the investigators intended to use the auditor as their agent?
- (f) Is the evidence sought relevant to the taxpayers general liability, or does it go to mens rea?

***Charter* protection does not apply during audit stage**, only once criminal investigation launched. Although a criminal investigation commences, the audit powers may continue to be used. While the info gathered from the audit before the criminal investigation may be used in prosecution, the results of the audit can't be used in pursuance of the investigation/prosecution.

COLLECTIONS

TP must pay *all* income tax payable by April 30 (not just file return). If TP can't pay taxes by the "balance due date," return should still be filed, as failure to file is an offence. TP has 30 days from date of NOA to pay taxes.

Key sections of the *Income Tax Act* with regard to collections:

(a) **Seizure of third party gifts**

- ***ITA s.160:*** CRA can seize property from third parties to pay your taxes (*i.e. Gifts, etc.*)

(b) **Creditor remedies for CRA**

- ***ITA s.223:*** CRA can issue a "**judgment by certificate**" for any debts, and then put a lien/charge on the debtor's property to satisfy the amount owing
- ***ITA s.224:*** CRA can make a "**third party demand**" for garnishment to any bank, as they are a super-creditor and can serve notice on any bank without knowing where account is
- ***ITA s.225:*** CRA can also execute a writ of seizure and sale to satisfy tax arrears
- ***Silva:*** CRA seized a $300,000 yacht for a $30,000 debt, sunk, but TP was still liable for the tax

SOURCE CONCEPT OF INCOME

LEGISLATIVE AND JUDICIAL DEVELOPMENT OF THE SOURCE CONCEPT OF INCOME

LEGISLATIVE FRAMEWORK

There is **no definition of "income"** in the ITA. Instead, the system is based on a "source concept" of income. In general, income must come from a recognized source (either inside or outside Canada) to be taxable.

Key sections of the *Income Tax Act*:

(a) **Tax payable by all persons resident in Canada**

- ***ITA s. 2(1):*** an income tax shall be paid, as required by this Act, on the **taxable income** for each taxation year of **every person resident in Canada** at any time of the year
- This is the basic charging section of the ITA
- "**Taxable income**" is net income from each income source (*revenue – expenses = profit/loss*)
- "**Taxation year**" is a calendar year (i.e January–December)

(b) **Income must come from a taxable source**

- ***ITA s. 3(a):*** to determine the TP's income for the year, determine the **total of all amounts** each of which is the TP's income for the year (other than a taxable capital gain from the disposition of property) **from a source inside or outside Canada**, including, without restricting the generality of the foregoing, the TP's income for the year from each **office**, **employment**, **business**, and **property**
- If a receipt does not come from a recognized source, it's not considered income and not taxable
- *Note:* **residents of Canada** are taxed on their worldwide income, while **non-residents** are taxed on their sources of income in Canada

(c) **Income from each source is calculated separately**

- ***ITA s. 4(1):*** income from each source is calculated separate, and then the income (or loss) from each source is aggregated to compute a TP's total income
- This assumes that the TP had no income or less except from those sources

(d) **Parliament can add other sources** "*broadening the tax base*"

- ***ITA s. 56:*** examples of specific types of taxable receipts Parliament has added: **pension benefits**, **EI benefits**, **income received out of a RRSP**, and **retiring allowances** which might otherwise not be considered attributable to a source
- *Note:* scholarships and bursaries are now, contrary to the text (***ITA s. 56(1)(n)***), not taxable since 2006 (***ITA s. 56(3)***)

"**Netting out**"**:** under ***ITA s. 4***, losses from one source can be deducted from other sources when calculating net income. *Note:* while you can use losses from "ordinary sources" to reduce income from other sources, you **can only deduct capital losses from capital gains** (½ "allowable capital loss" from ½ "taxable capital gain").

"**Loss carryover**"**:** if a capital loss is not deductible in the current year because it exceeds the annual capital loss ceiling, the loss may be carried over to future (or previous) years.

"Income from a Source"

General rule: if an income source does not fit into one of the ***s. 3*** recognized sources or the ***s. 56*** additional sources, it is not taxable. The concept of "**ordinary income**" is set out in ***ITA s. 3(a)*** which includes several recognized sources:

(a) **Office and employment:** "office": judge, MP, etc. – holds an office and receives income from a source
(b) **Business:** self-employed individuals receive income from business
(c) **Property:** yield from investment of bonds, stocks, real estate, etc.
(d) **Taxable capital gains:** since 1972, ½ of capital gains are taxable and ½ of capital losses are deductible (against capital gains) (***Carter Commission***: *all additions to wealth should be taxable*).
(e) **Other sources:** Parliament can "add sources of income" (***ITA s. 56***).

"Income" is thus differentiated from the "source of the income" (*"tree" vs "fruit of the tree"*). The **capital** is the "source" (it is something the TP holds onto which produces income); the **income** is the "yield" (it is the recurring flow from exploitation of the capital asset during the year).

Example: contract of service is a capital asset for an employee TP, with salary/wages as the income.

"Ordinary income" has 3 hallmarks to classical economists:

(a) **Activity:** TP's activities or from TP's property "earnings"
(b) **Recurrence:** periodic or recurring "year" (like crop from a tree)
(c) **Convertible:** cash or convertible into cash "received"

Non-taxable sources include:

(a) **Gifts**
- Not taxable unless from an ER as consideration/*quid pro quo* (***Savage***)
- However, if a trust is set up and there is income flowing periodically, this income from the trust is treated as income from the trust property

(b) **Windfall gains**
- These are an unexpected/unplanned payment not of a recurring nature
- Not income because they are accretions to wealth by chance
- Includes betting, lottery money, accidental finding of valuable property (***Graham***)
- Gambling as a business/vocation could become a taxable source (*ex. bookies*) (***Walker***)

(c) **Strike pay**
- Payments no in the nature of "income from a source" within the meaning of ***s. 3(a)*** (***Fries***)

(d) **Life insurance proceeds**
(e) **Lump-sum/periodic damages**
- Includes personal injury/wrongful death payments, as what is being replaced is the capital asset

(f) **GST/HST refundable tax credits**
(g) **Inheritances of property**
- However, the donor of the property may be liable for taxes

ROLE OF THE COURTS IN DEFINING SOURCES OF INCOME

ITA s. 3(a) "without restricting the generality of the foregoing." While **income from unenumerated sources** can be found to be taxable under ***ITA s. 3(a)***, the Courts will not add additional sources of income (***Schwartz***). *Note:* constitutional standard of Parliamentary supremacy and "no taxation without representation."

In ***Bellingham***, the Court notes that what constitutes income for tax purposes has two views:
(a) ***Carter Commission:*** broad definition of income that captures all accretions to wealth
(b) **Modern jurisprudence:** narrow definition of income that only captures income received by TPs on a recurring basis

In ***Bellingham***, the Court applies the source concept of income and adopt's ***Cranswicks's*** **indicia of income** that can be applied when assessing whether a receipt is "income from a source":

(a) Does the TP have **enforceable claim to the payment**
(b) Is there an **organized effort** on the part of the TP to receive the payment
(c) Was the payment **sought after or solicited** by the TP in any manner
(d) Was the payment **expected** by the TP either specifically or customarily
(e) Did the payment have **foreseeable element of recurrence**
(f) Was the payor **customary source of income** for the TP
(g) Was the payment in consideration for or **in recognition of property, services, or anything else** provided or to be provided by the TP
(h) Was the payment **earned by the TP,** either as a result of any activity or pursuit of gain carried on by the TP or otherwise

Surrogatum* principle test:** amounts received by TP in place of income from a source may be included in income as if such amounts were income from that source (Bellingham***). Must look to the **nature and purpose of a particular payment** when assessing how it will be dealt with for tax purposes.

Q: what is the money replacing? What does it relate to? Is it replacing income or capital? **A:** if an amount received is a substitute for a capital right/earning potential, it is tax-free.

Compensation for **loss of income** is **taxable** but compensation for **loss of capital** (including income earning potential) is likely **tax free**. **Punitive damages, damages for mental distress, damages for defamation** are also **tax-free** (***Bellingham***).

Damages for wrongful dismissal are considered a "retiring allowance" under ***s. 56(1)(a)(ii)***, however, if employment is **terminated before start of employment**, the damages are merely compensation for a capital asset (the employment contract) and are therefore **not taxable** (***Schwartz***).

NEXUS BETWEEN A TAXPAYER AND A SOURCE OF INCOME

(a) **Who is a taxpayer?**

- ***ITA s. 248(1):*** each individual is a "person" under the ITA, regardless of age, capacity, etc.
  - (a) **Taxpayer:** includes any person whether or not liable to pay tax
  - (b) **Person:** or any word or expression descriptive of a person, *includes any corporation*
  - (c) **Individual:** means a person other than a corporation
- Therefore, TPs can be individuals, shareholders, company/corporations, beneficiaries of a trust/ estate, partners of a partnership (but not the partnership itself), etc.
- Three points on specific TP's:
  - (a) **Subsidiary corporations:** each corporation in a corporate group is a separate TP, so losses of one subsidiary can't be used to offset profits of another company in the same group
  - (b) **Trusts/estates:** the entity isn't taxable, but income from it is
  - (c) **Sole proprietorship:** not a legal entity; TP is the proprietor who gets income from business

(b) **What is a business?**

- A business is an enterprise that's entered into **for the purpose of earning income** (***Buckman***)
- Unlike property, which is passive income from investment, business is active income from effort, risk, trading, multiple transactions, etc.
- Money obtained illegally (**fraud, embezzlement, etc.**) is taxable as income from business if a source analysis reveals that the activity has the qualities of a business: (a) **entrepreneurship** (b) **repeated transactions** (c) **method (system)** (d) **reward of profit/risk of loss**. The illegality of their activities does not prevent them from being taxable on that source (***Buckman***).

Note: a person is liable to pay tax on income if they are **beneficially entitled to that income** (i.e. if they are entitled to spend it as they see fit, it is their income). However, if an individual *is entitled to the income in law*, but does not receive the *benefit* of that income, that person is not liable for taxes on that income, i.e. the nexus between taxpayer and income requires the taxpayer to have the *benefit* of the income (***Field***).

INCOME SPLITTING

Income splitting is a method of reducing a family's income tax (used in jurisdictions with progressive tax).

If one member of a household earns considerably more income than another, they will likely be in a higher tax bracket, and thus have to pay more income tax. Income splitting works by shifting some of the income to the lower income earner, and thus **shifting the higher income earner to a lower tax bracket**. Persons carrying on business or investors receiving property income and getting capital gains upon sale often "split" their sources of income among their family members.

The **CRA does not favour income splitting** and often responds to income splitting techniques by enacting rules to attribute/return split income back to the original earner of that income ("**attribution rules**"). However, the courts are sometimes reluctant to enforce attribution rules (***Boutillier***).

In 2000, the CRA introduced the kiddie tax:

- ***ITA s. 120.4:*** imposes a tax at the highest marginal rate (43.7%) on certain types of income received by persons under 18 years (*child, grandchild, niece, nephew*).
- **The kiddie tax applies to:** (a) taxable dividends (b) shareholder benefits on the shares of a private corporation (i.e. not listed on an exchange) (c) income from a partnership or trust that is derived from the provision of goods or services by the partnership or trust (c) non-arm's length business relationship.
- **The kiddie tax does *not* apply to:** (a) employment income (b) business income for services provided (independent contractor).
- The kiddie tax was presumably introduced as a response to the SCC's decision in ***Neuman*** and ***Boutilier*** where family corporations/trusts were used to split income, and is designed to counteract income-splitting insofar as children are concerned.

How to split income successfully: an employee may split income with a qualified family member by amending the contract of employment to hire an **assistant/substitute** (Form T2200), whose salary would be paid out of the salary of the employee. If an assistant/substitute is required by the contract of employment, their salary is a deductible expense for the employee (***ITA s. 8(1)(i)(ii)***). *Note:* the expense amounts **must be reasonable in the circumstances** (*in terms of the value of services rendered, etc.*) (***ITA s. 67***).

Other popular income-splitting techniques are:
(a) **Indirect receipt:** Direction of payment by 3rd party to person other than the taxpayer who earned income
(b) **Income assignments:** Assignment of a right to income from one TP to another
(c) **Property transfer:** Transfer of property that generates the income or gain
(d) **Income attribution:** Use of low-interest or non-interest bearing loans

INDIRECT RECEIPT

ITA s. 56(2): a payment or transfer of property **made pursuant to direction of, or with concurrence of, a TP to another person for the benefit of the TP**, or as a benefit that the TP desired to have conferred on that other person (other than assignment of pension plans) **shall be included in computing the TP's income** (*attribution rule*). *i.e. If someone directs a payment to someone else, which would have been income to the TP, it is attributed back to the original TP who was supposed to receive it.*

CRA must prove 4 elements for application of *ITA s. 56(2) attribution rule*:

(a) **Payment must be to a person other than the reassessed TP**
ex. payment usually written to a lawyer would instead be written to the lawyer's child

(b) **Allocation must be at the direction or with the concurrence of the reassessed TP**
ex. laywer tells the client "please make the payment to my child

(c) **Payment must be for the benefit of the reassessed TP** or f**or the benefit of another person** whom reassessed TP wished to benefit
ex. lawyer and child are in same family unit and live under the same roof, and giving the money to the child would keep the money in the same family unit and benefit the lawyer

(d) **Payment would have been included in the reassessed TP's** income if it had been received by him/her.
Q: would payment be included in lawyer's income from business for tax purposes?

If income hadn't been received by Mrs. Neuman, it would not have gone to Mr. Neuman, he was not entitled to the dividend unless it was declared by the director (***Neuman***, *failed #4, income splitting successful*).

If money is diverted as a dividend of a company, it is successful in splitting income because it does not meet the 4th condition in ***s. 56 (2)*** which requires that the diverted money would have been part of the taxpayer's income (***Neuman***, *husband own shares in corporation funded by his law firm. Wife directs dividends to be paid to herself. They can't be attributed to husband because they belong to the corporation. Husband wouldn't have received it, failed 4th element of s. 56(2)*). **Good idea to make a business a corp and distribute dividends to wife and adult kids!**

INCOME ASSIGNMENT

ITA s. 56(4): where a TP has, at any time before the end of a taxation year, **transferred or assigned to a person with whom the TP was not dealing at arm's length the right to an amount** (other than a retirement pension) that would, if the right had not been transferred or assigned, be included in computing the TP's income for the taxation year, the part of the amount that relates to the period in the year throughout which the TP is resident in Canada **shall be included in computing the TP's income** (*attribution rule*) for the year unless the income is from property and the TP has also transferred or assigned the property.

Requirements for application of *ITA s. 56(2) attribution rule*::

(a) There is a transfer of a right to income (from any source: O/E, B, P)
(b) To be to a non-arm's length person (*family, companies owned by TP*) and
(c) The income could have been transferor's income (*beneficial entitlement*)
(d) ***Unless*** it is income from property and the property is also transferred (*may be caught by spouse/minor attribution rule if not at arm's length*).

(***Boutilier***, *unsuccessful attempt to assign right to income to his corporation* **but** court said it *could have been* done if the paperwork was carried out properly; ***Neuman*** did it properly: the company was a distinct legal entity from Mr. and Mrs. Neuman, he respected the corporate veil and all the directors resolutions were properly documented, etc.)

PROPERTY TRANSFERS, LOANS AND INCOME ATTRIBUTION

In this case, **income from "property"** is attributed back to the TP if the property is transferred to a spouse or minor/relative under 18 years that is not at arm's length with the TP.

ITA s. 56(4.1): where an individual receives a loan from another individual **not dealing at arm's length**, and it can be reasonably considered that **one of the main reasons for making the loan was to reduce or avoid tax** by causing income from the property to be included in the income of that individual, **the income shall be deemed to be income of the creditor**.

(a) **Transfers and loans to spouse**

- ***ITA s. 74.1(1):*** where an individual has **transferred or lent property** either directly or indirectly (except with respect to a retirement pension), by means of a trust or any other means whatever, **to or for the benefit of a person who is the individual's spouse** or common-law partner, any income or loss of that person… **shall be deemed to be income or loss of the individual and not of that person.**
- *i.e. where A transfers or lends property to spouse, income is deemed to be A's income*

(b) **Transfers and loans to minors**

- ***ITA s. 74.1(2):*** if an individual has **transferred or lent property**, either directly or indirectly by means of a trust or any other means, **to or for the benefit of a person who was under 18 years of age** and who does not deal at arm's length with the individual or is the niece or nephew of the individual, **any income or loss of that person is deemed to be the income/loss of the individual** and not of that person unless that person has attained age 18 before the end of the taxation year.
- *i.e. transfer or loan to a minor is attributed back to transferor (only the yield, capital transfer is tax-free)*

(c) **Definitions of "related persons and "others**

- ***ITA s. 251(1)(a):*** "related persons": child or other dependent, brothers/sisters, nieces/nephews
- ***ITA s. 251(1)(b):*** "others" is a question of fact

LOSSES

CURRENT YEAR LOSSES

The logical extension of the source concept of income is that, since income from each source is calculated separately and are taxed at different rates, that losses from one source can only be offset against income from that source.

Therefore, while ***ITA s. 3*** is premised on the source concept of income, in reality it implements a "**global income tax**" under which income from various sources is aggregated, and the total is subjected to a single tax rate (that also takes losses into account).

Distinction between ordinary losses and capital losses in the *Income Tax Act*:

(a) "**Ordinary income" losses**

- ***ITA s. 3(d):*** current year losses from office/employment, business or property can be deducted from all sources of income, including taxable capital gains
- **"Netting out"**: applying current year losses from sources of income against income from all sources

(b) "**Quarantine rule" for capital losses**

- ***ITA s. 39(1)(c***): allowable capital losses are "quarantined" and can only offset taxable capital gains
- Under this subsection, only ½ of capital losses are deductible ("**allowable capital loss**")
- **Remember:** if investments decline in value, investor only has an "**accrued loss**" as long as the stock is retained; it is only when stock is sold that there is a "**capital loss**" from the sale
- **Policy:** without this limitation, TPs may manipulate timing of realization of capital gains and losses to deduct losses earlier than inclusion of gains, reducing overall tax revenue
- **Exception:** in year of death (and preceding year), can deduct capital losses from all sources

Note: in 2003, the Department of Finance proposed that a source required a reasonable expectation of profit before business losses were recognized (see ***Stewart*** in "Income From Business or Property"). However, ***s. 3.1(1)*** was never implemented (probably due to political consequences).

But if you set up a business just to lose money, while "reasonable expectation of profit" is not required, admission of lack of profit motive can allow a court to transfer business to personal losses (personal and living expenses are not tax deductible, as these are "hobby businesses" (**ITA s.18(1)(h)**).

LOSS CARRYOVERS

Loss carryover: a significant income tax deduction whereby, if the TP can't use current year losses in the year that they arise because they exceed income, can "carry over" the losses to subsequent years.

The ITA distinguishes between "ordinary income" losses and "allowable" capital losses:

(a) **Non-capital losses**

- ***ITA s. 111(1)(a):*** losses from "non-capital losses" (i.e. office/employment, business, property) are deductible against all income sources
- **Carry back:** can deduct non-capital losses for **3 years** immediately preceding
- **Current year:** can "net out" losses against other sources pursuant to ***ITA s. 3***
- **Carry forward**: can carryover up to **20 years**

(b) **Allowable capital losses**

- ***ITA s. 111(1)(b):*** **allowable capital losses** (½) are deductible against **taxable capital gains** (½)
- If the capital loss is more than the capital gain for that year, TP will have "**net capital losses**" that can be carried over (but only to other taxable capital gains)
- **Carry back:** can deduct allowable capital losses up to **3 years** immediately preceding
- **Current year:** no netting out against other sources allowed under ***s. 3*** (only against capital gains)
- **Carry forward:** ***ITA s. 111(2):*** can carryover up until death; deductible against all sources in the year of death and in the previous year.

WHO IS SUBJECT TO CANADIAN INCOME TAX?

WHAT JURISDICTIONAL BASES ARE AVAILABLE?

(a) **Citizenship or nationality** (USA)
- All citizens must pay cost of government services, regardless of whether they are living in the country
- Not a factor in the Canadian income tax system (but exists in USA tradition)

(b) **Residence** (Canada)
- "Benefit theory": only those who benefit from government should pay tax to support it
- Closer relationship with country than citizenship (but not as close as domicile as no intent)

(c) **Source of income**
- Government imposes tax on non-residents who derive their income from a source in Canada
- Also impose income tax on "worldwide income" earned by residents working in foreign countries, have business, or receive income from investments over $100,000 in foreign countries
- ***ITA s. 4:*** source has geographical locations

RESIDENTS

"Benefit theory" of taxation, under which there are 2 types of TP's in Canada (*discussed in **Thomson***)**:**

(a) **Residents in Canada**
- ***ITA s. 2(1):*** **resident TPs** are subject to income tax on all of their **worldwide income**.
- They get the benefit of Canada and Canadian laws anywhere in the world; therefore they are subject to tax on worldwide income
- Residents must report investments from outside Canada if total cost is greater than $100,000

(b) **Non-residents** (***ITA s. 2(3)***)
- ***ITA s. 2(3):*** **non-resident TPs** are subject to tax only on **income from Canadian sources**
- Subject to Canadian tax only for their sources of income that are in Canada

There is no definition of "residence" in the ITA; it is a question of fact (***Thomson***).

Double taxation: everyone is a resident somewhere, and sometimes are residents of multiple nations; the TP will be subject to double taxation unless:
(a) **Foreign tax credit:** ***ITA s.126*** – Canada gives credit for every dollar of tax paid in another country
(b) **Tax treaty** – tax treaties prevail over the ITA

INDIVIDUALS

There are 3 ways of becoming a resident of Canada for ITA purposes:
(1) Factual residence
(2) Deemed residence
(3) Ordinary residence

(1) Factual Residence

You are **factually resident** in Canada if you are resident under the ordinary, dictionary meaning of the word "resident" (***Thomson v MNR***, *found to have significant residential tie (**IT-221 R3** para 5(a) dwelling place that is available to you); he had a house in Canada; **Lee v MNR,** had dwelling place + spouse (**IT-221 R3** para 5(b))*). "The quality of residence is chiefly a matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question" (***Thomson***).

The factors assisting in determining whether someone is a **deemed resident of Canada** for tax purposes while abroad are located in the information bulletin:

IT-221 R3 (Consolidated): Determination of an Individual's Residence Status

(a) **Significant residential ties** (paras 4–7)

- Dwelling place in Canada (para 5): *having a home available to you here* (***Thomson***'s downfall)
- Spousal or common-law partner in Canada: *having a spouse or dependent here* (***Lee***'s downfall)
- Dependents in Canada: *having dependents living in Canada*

(b) **Secondary residential ties** (paras 8–9)

- Having social ties here
- Having personal property here
- Having economic ties here
- Hospitalization and medical insurance here
- Driver's licence/Canadian passport
- Seasonal dwelling
- Membership in a Canadian union
- Financial connections
- Employment connections

If you have one significant factor, you are well on their way to being a resident of Canada. Then you look for other significant factors or some secondary factors. A combination of these significant and secondary factors would make someone resident of Canada. This is an area of uncertainty.

Canada-US Income Tax Convention, Art IV: Residence

Contains tie-breaker rules: a method of reaching a conclusion about which country is the country of taxation. This solve the problem of dual residence/double-taxation. You go through them step by step until you find one that resolves the dilemma:

1. Permanent home/centre of vital interests? (***Art IV 2(a)***): *Thomson: both Canada and US*
2. Habitual abode? (***Art IV 2(b)***): *Thomson: both Canada and US*
3. Citizenship? (***Art IV 2(c)***): *Thomson: citizen of Canada; this was the tie-breaker*
4. Component authorities (***Art IV 2(c)***)

(2) Deemed Residence

There are some legal definitions of "resident" in the ITA that create "**deemed residents**":

(a) **Sojourning**

- ***ITA s. 250(1)(a):*** a person shall be deemed resident throughout a taxation year if the person sojourned in Canada for **a total of 183 days or more**
- If they have a "presence in Canada…for a temporary purpose" for 183 days or more (*can be added up over the calendar year*), they are a "deemed resident" in Canada for the entire taxation year – irrebuttable presumption under the ITA
- *ex.* Olympic organizers in Canada for a temporary purpose but intending to leave Canada
- An individual who **has not established sufficient residential ties with Canada to be considered factually resident** in Canada, but who sojourns (that is, is temporarily present) in Canada for a total of 183 days or more in any calendar year, is deemed to be resident in Canada for the entire year, under paragraph ***ITA s. 250(1)(a)*** (***IT-221 R3***).
- **Partial days count:** the CRA considers any part of the day to be a day for the purpose of determining the number of days that an individual has sojourned in Canada
- **Deemed residence for entire year** (January 1–December 31, not date of arrival to date of departure. So you can't split your year if you are caught as a sojourner (contrary to factual or ordinary residence).
- **Cross-border commuting** does not constitute "sojourning" for tax purposes (***IT-221 R3 para 21***).

(3) Ordinary Residence

"**Ordinarily resident**": an individual who is physically absent but has not severed all residential ties to Canada, and thus still must pay Canadian income tax

- ***ITA s. 250(3):*** where an individual **has not severed all of his residential ties with Canada** but is physically absent for a considerable period of time (extending over a period of several months or years), they may be "ordinarily resident" in the place where in the settled routine of life they customarily live.

Intention is key: an individual can be "ordinarily resident" while physically absent as long as they show an intention to return and no intention to permanently sever ties (***Canada v Reeder***).

"Part-Time Resident"

If a TP is resident in Canada in the year, then he is resident for the *entire* year (***ITA s. 2(1)***) UNLESS he has immigrated/emigrated; if a TP comes or leaves the country permanently, the taxation year will be split and the TP will be categorized as a "**part-time resident**" (***ITA s. 114***).

- Splitting taxation year can't be done regularly, as it's an exception to the general rule that a TP who is resident for part of a year is resident for entire year; only applies to a permanent relocation
- One consequence of leaving Canada is a "**departure tax**" where there is a large capital gains tax on assets even if they are not sold
- People who enter into Canada are deemed to acquire capital property at fair market value, therefore, they must pay capital gains tax on any increases in value after entry into Canada

TRUSTS AND ESTATES

Trusts and estates are taxed separately in a manner similar to, but not identical with, tax treatment of individual TPs. Trusts are not as a "legal person" but **as an individual** because the trustee is a multiple TP for himself and on behalf of the trust.

The residence of a trust is analogous to the corporation: **central management of contro**l (***Fundy Settlement***).

- Residence is established by where the trust management decisions by the trustee are made.
- Location of trust assets is also a factor, but decision-making location is the main determinant

Note: location of beneficiaries is not relevant in determining residency because they have no control over trust property, it is all in the control of the trustee.

CORPORATIONS

Under the Act, a corporation is treated as a TP separate from its shareholders; therefore, a corporation may be a resident or non-resident of Canada for income tax purposes.

If company is a Canadian resident TP, they will be taxed on all world-wide (foreign-sourced) income.

Various bases of taxation:

(a) **Place of incorporation**
- Statutory deemed residence: If incorporated anywhere in Canada, considered a legal person for tax purposes (after 1965)
- This is true regardless of where the place of business is or where the shareholders live

(b) **Location of central management**
- Common law rule of residence: location where the Board of Directors meet can establish residence of the corporation for that year, even if not incorporated in Canada

(c) **"De facto" principle**
- If the Board is just a rubber stamp in another country, and central decisions are being made in Canada, the corporation will be considered a resident of Canada
- Local management irrelevant, just central management important

Deemed Residence

(a) **Incorporation after April 26, 1965** (subject to ITA)
- ***ITA s. 250(4)(a):*** a corporation incorporated in Canada after April 26, 1965 is a resident in Canada throughout a taxation year
- Therefore, wherever the Board of Directors meet, shareholders live, or company carries on business is irrelevant
- To move corporation jurisdiction, must remove company from the register and then register in another jurisdiction

(b) **Incorporation before April 27, 1965** (not subject to ITA) UNLESS:
- ***ITA s. 250(4)(c):*** a corporation incorporated in Canada before April 27, 1965 will be deemed a resident only if, at any time in the taxation year or at any time in a preceding taxation year ending after April 26, 1965, they were
  - (i) **Resident in Canada** *(i.e: central management or control exercised in Canada*), or
  - (ii) **Carried on business in Canada**
- After one of these two triggering events, the company will be permanent residents forever after
- *i.e. company foolishly decides to have a Board of Directors meeting in Canada*

Foreign Corporations

Foreign corporations (i.e. companies incorporated outside Canada) can become a resident of Canada under the case law principles:
- A corporation is resident "**where its central management and control actually abides**" (*the exercise of power and control by the board of directors*)
- Usually where do the directors meet (*de jure control*)? Where is the head office/board room? Where are the highest-level strategic decisions being made? (*de facto control*) (***De Beers v Howe* 1906 UKHL**)?
  - CRA can still find that a company is under de facto control, even where the corporation is incorporated abroad and Board meets abroad, but the CRA audit still finds one person in Canada making decisions (i.e. director or controlling shareholder)

This is an **annual determination**, so if the CRA finds de facto control, the corporation will become a deemed resident of Canada, *i.e. can be non-resident one year, resident for tax purposes the following taxation yea.*

NON-RESIDENTS

There are two methods of taxing non-residents on their Canadian income:

(1) **Income from employment, carrying on business, or disposition of property**
- ***ITA Part I, s. 2(3):*** federal income tax on "**net income**" includes:
  (1) Income from employment in Canada
  (2) Income from carrying on a business in Canada
  (3) Taxable capital gains on disposing of taxable Canadian property

(2) **Current investment income**
- ***ITA Part XIII, s. 212:*** where certain payments are made **by a resident to a non-resident**, a non-resident "**withholding tax**" must be paid on the gross amount by the resident payor

PART I: INCOME FROM EMPLOYMENT, CARRYING ON BUSINESS, OR DISPOSITION OF PROPERTY

ITA Part I, s. 2(3): federal income tax on "**net income**" includes:

(a) **Income from employment in Canada** (***ITA s. 2(3)(a); ITA s. 115(1)(a)(ii)***)
- Employee must be **performing duties *in* canada** (***ITA s. 115(1)(a)(i)***): employment in requires that the non-resident be employed (i.e. have a contract of service) and carry on at least some part of the employment in Canada (concept of physical presence in Canada).

(b) **Income from carrying on a business in Canada** (***ITA s. 2(3)(b)***)
- "**Business**": defined in ***ITA s. 248(1)***, *actively pursuing a profit, not passive* (***Buckman***)
  - Includes a profession, calling, trade, manufacture, or undertaking of any kind whatsoever and…an adventure or concern in the nature of trade but does not include an office or employment
- *"***In Canada**": is a matter of case law and ***ITA s. 253(b)*** (extended meaning from ***Gough***)
  - ***Gough:*** Where were the contracts of sale for business made? *i.e. place of acceptance.*
  - ***ITA s. 253(b):*** soliciting orders or offering anything for sale in Canada through an agent or servant, whether contract is to be completed inside or outside Canada, will be **deemed** to be "carrying on a business in Canada." (*meant to reverse* ***Gough***)
  - But court made a restrictive interpretation of "**agent**" in ***Sudden Valley***: soliciting of orders or offers means *binding* offers (capable of being accepted), therefore **an agent must have *authority* to bind the principal**, so even with ***s. 253(b)***, ***Grainger*** would still be decided the same way (*was an independent contractor, not a servant or agent*).
- *Note:* the **substance** of doing business in Canada (*contracts, payments, deliveries, bank accounts, intent, etc.*) will take precedence over **lack of form** (*no offices/official agents in Canada*) (***GLS Leasco***)

(c) **Taxable capital gains on disposing of taxable Canadian property** (***ITA s. 2(3)***)
- Canadian resident purchasers of real estate must be mindful of the ITA:
  (i) **Real Estate Provisions**
    - ***ITA s. 2(3)(c):*** non-resident taxable for capital gains from disposition
    - ***ITA s. 115(1)(b):*** "Taxable Canadian property" includes real property in Canada
    - ***ITA s. 116:*** if a non-resident is disposing of property and submits an estimate of capital gain and payment for 25% of that amount, the Minister shall issue a certificate as proof of payment for the resident purchaser
  (ii) **Onus on the resident purchaser**
    - Purchaser is required to make a "**reasonable inquiry**" into the vendor's residency status
    - *i.e. get a "clearance certificate" and pre-pay tax on transaction; otherwise, if vendor is non-resident, the purchaser must collect and remit tax to the CRA or else be personally liable.*

- Therefore, under ***s. 2(3)***, non-residents are subject to income tax if they earn income, carry on business, or dispose of property in Canada.
- They must file an income tax return in the same way as all residents of Canada
- Purchaser of a business/property in Canada must ensure the vendor has paid taxes if they are a non-resident, otherwise the CRA will demand the tax from the purchaser (check box on form)
- Usually, non-resident TPs prefer income from business so that they can deduct business expenses

***PART XIII*: CURRENT INVESTMENT INCOME**

ITA Part XIII, s. 212: where certain payments are made **by a resident to a non-resident**, a non-resident "**withholding tax**" must be paid on the gross amount by the resident payor

Under ITA, there is an obligation on a payer (resident in Canada) to remit to the Receiver General:

(a) **25% withholding tax on gross amount of passive property payments to non-residents**

- ***ITA s. 212(1):*** non-resident must pay 25% tax on any payment from a resident for:
  - (i) Management fee
  - (ii) Interest (***Sudden Valley***)
    - **Update:** in ***ITA s. 212(1)(b)***, as of 2008, any form of interest payments to non-residents are no longer subject to withholding taxes
  - (iii) Estate or trust income
  - (iv) Rents, royalties, etc.(***GLS Leasco***)
    - **Update:** alimony is no longer subject to withholding taxes either
- ***ITA s. 212(2):*** non-resident must pay 25% tax on dividends from corporate residents in Canada
  - Again, this can be reduced through tax treaties to 10% or 5%

(b) **Other provisions**

- ***ITA s. 214(1):*** taxes payable under ***s. 212*** are payable **without deductions for expenses** from the amounts (see ***Sudden Valley*** and ***GLS Leasco***) so paying tax on net profits in Part I is much more favourable than paying on gross amount of property income in Part XIII
- ***ITA s. 215(1):*** resident payor is responsible for paying the withholding tax
- ***ITA s. 215(6):*** if a resident fails to withhold tax from a non-resident, they are personally liable
- ***ITA s. 216(1):*** **non-resident landlords** who get rental income from Canadian property can elect to be taxed on "net basis" under Part I (and thus can deduct expenses: *operating expenses, property taxes, interest charges, capital cost allowance on improvements*)

(c) **Exemptions – bonds and foreign currency deposits**

- ***ITA s. 212(1)(b)(ii):*** bonds, including federal, provincial, and municipal bonds
- ***ITA s. 212(1)(b)(vii):*** long-term corporate bonds
- ***ITA s. 212(1)(b)(iii)(D):*** foreign currency deposits at financial institutions

Q: in a real estate transaction, if a Canadian purchaser buys from an American seller, do they have an obligation to remit a withholding tax to the CRA: Yes, as CRA knows they can't go after the non-resident so they go after resident purchaser.

Every conveyance in Canada must be done with a standard form where the vendor must declare their residency status; vendor can deal with this ahead of time by paying CRA and obtaining a clearance certificate absolving the Canadian from withholding obligations

INCOME FROM OFFICE AND EMPLOYMENT

WHO IS AN EMPLOYEE?

TAX IMPLICATIONS OF DISTINGUISHING BETWEEN INCOME FROM EMPLOYMENT AND INCOME FROM BUSINESS

A person retained to provide services to another person is either an "employee" or an "independent contractor" under the Income Tax Act. An employee earns income from employment (EE) whereas an independent contractor (IC) earns income from business.

4 major differences in tax treatment between employees and independent contractors:

(a) **Payment and withholding of tax**

- ***ITA s. 153:*** ER must withhold and remit prescribed amount from each payment made to an EE
- i.e: EE benefits like CPP payments, EI, etc.
- No withholding obligations for payments made to an independent contractor

(b) **Basis of measurement**

- Income from office/employment generally calculated on a "cash basis," recognized when "received" and permitted employment expenses when "paid"
- Income from business is calculated on an "accrual/earned basis", even before client is billed, and is recognized when "earned" and expenses deductible when "incurred"
- Largely a question of timing

(c) **Reporting period**

- ***ITA s. 249:*** income from employment on a calendar-year/taxation-year basis (Jan-Dec)
- ***ITA s. 249.1:*** independent contractors report on a "fiscal period" basis

(d) **Scope of deductions**

- EE relies on ER for provision of working conditions; therefore, very few deductions are allowed for an EE in terms of their employment
- Self-employed independent contractors have considerably wider scope to deduct income-earning expenses under ***ss. 9*** and ***20***

See the chart below for other differing financial consequences:

	EE under a contract OF employment	**IC under a contract FOR services**
EI	• EE qualifies for EI but must pay premium	• Formerly ineligible… now can opt in
CPP	• ER pays ½ of CPP premiums	• Must pay 100% of CPP premiums
Benefits	• EE benefits taxable under ***ITA s. 6(1)(a)***	• "Benefits"? What are "benefits"?
Other	• Can get "retiring allowance" as severance	• Can deduct business expenses

CHARACTERIZING WORKING RELATIONSHIPS: EMPLOYEE OR INDEPENDENT CONTRACTOR?

There are two sections in the ITA with definitions, both of which are pretty unhelpful in determining whether an individual is an EE or an IC:

(a) **Statutory definitions**

- ***ITA s. 248(1):*** In this Act:
  "office": office-holder may include elected official, director, executor, judge, tribunal member, chairperson, or union officer entitled to a fixed or ascertainable remuneration
  "employed": performing the duties of an office or employment
  "employee": includes officer
  "employer": in relation to an officer, means the person from whom the officer receives the remuneration
  "employment": the position of an individual in the service of some other person and servant or employee means a person holding such a position

(b) **Withholding of tax**

- ***ITA s. 153(1)(a):*** every person paying at any time in a taxation year salary, wages, or other remuneration…shall deduct or withhold from the payment the amount determined in accordance with prescribed rules and shall remit that amount to the Receiver General on account of the payee's tax for the year

There have historically been different tests for classifying the TP:

(a) **Control Test** – Baron Bramwell in ***R v Walker***

- Based on the nature and degree of control over the work done
- IC told "what" must be done; EE is told not only "what" must be done but also "how" to do it
- **4 factors:**
  (i) Power of selection of the servant
  (ii)Payment of wages…EE paid for time, IC paid for achieving a certain result
  (iii)Control over method of work…ER controls EE methods, IC control their own method
  (iv)Master's right of suspension or dismissal
- Also known as the **"specific result"** test, whereby IC merely undertakes to produce a specified result, employing his/her own means to produce that result
- *Note:* this is no longer the accepted test, as most EE's work more independently nowadays

(b) **Total Relationship Test** – Lord Wright's "4 in 1 test" in ***Montreal Locomotive***

- Adopted by Fed. CA in Wiebe Door; used most often and preferred by CRA, it considers:
  (i) **Control:** same as control test above, but adds the following three factors
  (ii)**Ownership of tools:** IC provides their own tools, maintenance costs, insurance, etc.
  (iii)**Chance of profit:** EE has less opportunity to share in profits than IC; EE gets remuneration based on time while IC gets paid at completion of project
  (iv)**Risk of loss:** EE entitled to payment regardless of whether business profits; IC has risk of not getting paid if he/she screws up and must re-do the work

(c) **Integration Test** – Lord Denning's "Organization Test" in ***Stevenson***

- This test examines the question from the point of view of the individual worker
- Test of whether the person provides a service that is **integral** to the operation of the hirer or do they have their own activity which is **ancillary** to the work of the hirer?
- Distinction made between:
  (i) **Contract *of* service:** man is employed as part of a business and his work is done as an integral part of the business
  (ii)**Contract *for* services:** man's work, although done for the business, is not integrated into it but is only accessory to it

Note: another factor: **"common intention"** of the parties (not emphasized at all in ***Wiebe Door***) BUT the common intention test has come back into the picture and now has respectability. It is now a legitimate factor to be considered in addition to the total relationship test (i.e. as a 5th factor). The job of the court is to **balance all of these considerations** in deciding whether someone is an employee or an independent contractor.

The CRA emphasized the "integration test" in ***Wiebe Door*** and the FCA said this is not the correct test; **the correct test is the 4 in 1 test (total relationship).** To determine whether a person is an EE or an IC, apply the "4 in 1" test, weigh all relevant factors, and ask: "is the person who has engaged himself to perform these services performing them as a person in business on his own account"? (***Wiebe Door Services Ltd. v MNR* 1986 SCC**).

The **issuance of T-4 is not a determinative factor** in determining whether the relationship is that of employer/employee or independent contracting; it is for Courts rather than the ER to determine whether income is income from employment (***Cavanagh v Canada* 1997 TCC**).

ATTEMPTS TO AVOID CHARACTERIZATION AS AN OFFICE OR EMPLOYMENT

The obvious advantage of being an IC is being able to **deduct business expenses** instead of being limited to specific deductions in ***ITA s. 8*** as an EE.

- Also beneficial for ER to change EE's classification because they don't have to withhold tax from IC.
- For these reasons, there are various common arrangements designed to avoid the status of an EE.

The 3 most common methods of redefining the employment relationship include:

(a) Interposing a contract *for* services
(b) Interposing a corporation or a trust
(c) Capitalization of the employment benefit

Interposing a Contract for Service

Employment relationship is characterized by an underlying contract *of* service, whereas ICs are engaged on the basis of a contract *for* services.

Common way to redefine the relationship is through the **introduction of a different form of contract**

- However, can't merely change K wording from EE to IC, must do it in substance as well as form
- Instead, following ***Wiebe Door***, both parties must alter the terms of the agreement and follow them in order to change an EE's classification to an IC

Key: EE **must have a break in employment** (*i.e. retire and rehire*) and change some of the terms so it is a different contract, as individual can't just come back the next day and do the same job as an IC

Interposing a Corporation or Trust

Some TPs have attempted to alter their employment relationship by interposing either:

(a) Trust – TP and family members become beneficiaries
(b) Corporation – owned by former EE

In these situations, the EE becomes a business and the ER becomes the principal employing the business.

However, government has tried to diminish the effects of this arrangement through classification of a **"personal services business":**

(a) **No saving in small business tax rate; gets general corporate tax rate**

- ***ITA s. 125(7):*** a "personal services business" carried on by a corporation means an individual who performs services through the corporation to a would-be ER, where but for the service company, the individual would've reasonably had EE status
- So the corporation is taxed at a general corporation tax rate of 25% and it doesn't not get the benefit of the small business deduction (small business tax rate of 13.5% on $500,000 active business income)

(b) **Can't deduct business expenses**

- ***ITA s. 18(1)(p):*** in computing the income of a TP from a business or a property, no deduction shall be made in respect of limitation regarding personal services business expenses
- So the only thing they can deduct is the salary to the employee

So all the benefits of being self-employed are taken away.

However, note: A **PSB** is a business where:

(a) The employees of the business are **formerly the employees of the hirer** of the corporation (so you are interposing a corporation onto what was formerly an employee/employer relationship) AND
(b) The corporation has **5 or fewer employees**

So you can escape categorization by employing at least 5 employees

Problem with trusts: (a) *inter vivos* trusts taxed at highest MR and cannot accumulate income at a favourable tax rate (b) attribution rules (***s. 56(4)***) would attribute income back to employee (c) kiddie tax if minor child

CAPITALIZATION OF THE EMPLOYMENT BENEFIT

The expression "capitalization of the employment benefit" refers to various methods intended to convert what would otherwise be income from office or employment into income from a capital source, which is either exempt or only partially taxed as a capital gain.

Schwartz: employment relationship begins when EE actually begins working, so payments received before this date are categorized as capital receipts.

At common law, termination of employment is a loss of a capital asset (i.e: employment K) which was also a capital receipt until the 1980s. Source of employment ends when an EE is retired, terminated, or resigns.

Opportunities for capitalizing employment benefits often arise at the end of an employment relationship when an ER makes an extraordinary payment to a departing EE (i.e: severance).

- EEs in receipt of these extraordinary payments have attempted to characterize these amounts as something other than income.

However, the Minister has two major statutory tools to prevent tax avoidance in this area:

(a) **Payments by employer to employee**

- ***ITA s. 6(3):*** an amount received by one person from another…during a period while the payee was an officer or in the employment of the payer, or on account of an obligation arising out of an agreement made by the payer with the payee immediately prior to, during, or immediately after the period of the employment, shall be deemed remuneration for the payee's services rendered as employment
- *i.e.* amounts received before AND after period of actual employment can be included in employment income and are presumed to be remuneration for services under ***s. 5***
- Therefore, gifts, back pay, and reimbursement of expenses can be considered as income from employment under this rebuttable presumption

b) "**Retiring allowances**"

- ***ITA s. 56(1)(a)(ii):*** without restricting the generality of ***s. 3***, there shall be included in computing the income of a TP:
  - (i) Pension benefits, EI benefits, ect…any amount received by the TP
  - (ii) A retiring allowance, other than an amount received under an EE benefit plan, retirement compensation agreement, or a salary deferral arrangement
- ***ITA s. 248(1):*** a "retirement allowance" is an amount received:
  - (i) on or after retirement of TP from office or employment in recognition of TP's long service
  - (ii) in respect of a loss of an office or employment of a TP, whether or not received as damages or pursuant to an order or judgment of a competent tribunal

  by the TP or, after the TP's death, by the TP's dependent, relation, or legal representative

Payments as Remuneration for Services

There are ways to rebut and ways to get caught under ***s. 6(3)***:

(a) **Presumption can be rebutted**

- If reimbursement of expenses was incurred while individual was still working as an EE

(b) **Presumption is irrebuttable if:**

(i) ***ITA s. 6(3)(c):*** "inducement payment" – **signing/hiring bonuses** in the context of employment

(ii) ***ITA s. 6(3)(e):*** **non-competition agreements** (good for ERs but not EEs) and confidentiality agreements

Note: where a **signing bonus-style payment** is made to induce a person into a subsequent employment agreement, and not to acquire the rights of the EE against the current ER or strictly as compensation for loss of a future pension, the payment will be categorized as income (***Curran v MNR* 1959 SCC**).

"Retirement Allowances"

Until the 1980s, a TP could call a wrongful termination a "loss of a capital right" and not pay tax
- However, the government changed the rules and created the concept of a "retiring allowance"
- Goal: catch "golden parachutes" even though source of income (employment) has ended

Employment law: if a former ER terminates an EE without cause or sufficient notice/wages in lieu of notice, the ER is liable for damages flowing from wrongful dismissal. These wrongful dismissal damages have been taxable since the 1980s; therefore, even involuntary retirement allowances are taxable as income.

Money received from termination of employment can be taxed under:
(a) **Income from employment** (***ITA s. 5, s. 6(3)***)
- If EE works through the notice period until termination, it's merely income from employment
- Deductible legal fees incurred in connection with employment income under ***s. 8(1)(b)***

(b) **Income from other (new) sources** (***ITA s. 3, s. 56(1)(a)(ii)***)
- ***ITA s. 56(1)(a)(ii):*** applies when an EE is terminated against their will and collects damages "in respect of a loss of office or employment", whether or not received as damages or a settlement
- ***ITA s. 60(o.1)(i)(B):*** legal expenses incurred by the TP to collect or establish a right to lump-sum damages flowing from wrongful dismissal
- ***ITA s. 153(1)(c):*** ER required to deduct at source from retiring allowance, except the amount that the EE is permitted to rollover into a RRSP (~$2000/year)
- ***ITA s. 60(j.1):*** the former ER can, instead of paying money directly to EE, can agree with EE to put money into EE's pension plan or RRSP and "roll-over" the money/put the money in tax-free
- Note: can only make tax-free contributions if working in the same job since 1996; if you started work after 1996, you're out of luck

Q: Why can't the EE take retiring allowance or severance money tax-free?
A: Under ***Bellingham*** and the surrogatum principle (*i.e. what is the money is replacing?*), it can be:
(a) ***ITA s. 5:*** taxed as employment income if it's intended to cover that (working notice, back pay)
(b) ***ITA s. 3:*** taxed as income from other sources (retirement allowance, wrongful termination damages)

Note: ***Schwartz***: TP received $360,000 in damages on the unilateral termination of his employment contract before he had actually started working – this amount found neither to be a "retiring allowance" nor income from a source under s. 3.

These heads of damages are tax-free as they don't relate to the loss of office or employment:
(a) Damages before employment K begins (***Schwartz***)
(b) Punitive damages (***Bellingham***)
(c) Penalties under ***Employment Standards Act*** or ***Human Rights Code***
(d) Damages for defamation
(e) Intentional infliction of mental distress

AMOUNTS INCLUDED IN COMPUTING INCOME FROM OFFICE OR EMPLOYMENT

SALARY, WAGES AND OTHER REMUNERATION

ITA s. 5: includes in TP's income any amounts received as salary/wages, gratuities, and "other remuneration"
(a) **"Salary and wages"**: includes compensation for services rendered by EE in course of their duties
(b) **"Gratuities"**: voluntary payments made in consideration of services rendered in the course of O/E
(c) **"Other remuneration"**: includes honoraria, commissions, bonuses, gifts, rewards, and prizes provided as compensation for services

BENEFITS

Introduction

Although the term "other remuneration" in ***s. 5*** is sufficiently broad to include most benefits received other than by way of salaries, wages, and gratuities, there is another catch-all provision:

(a) **Amounts to be included as income from office and employment**

- ***ITA s. 6(1)(a):*** TP must include the value of "**board", "lodging" and "other benefits of any kind whatever**" (cash and non-cash) received by the TP in respect of their office and employment in computation of their income

Policy: taxation of benefits is done because of several considerations:

(a) **Revenue:** erosion of income tax base if EEs receive part of remuneration from indirect benefits
(b) **Equity:** not fair for those who get indirect benefits to get better tax treatment than direct cash EEs
(c) **Administrative:** too costly to keep an accurate record of all benefits an ER confers on EEs

The traditional approach is that only money or something capable of being turned into money can constitute income for tax purposes, and that a **mere benefit** is not includible in income.

Note: if the benefit is really intended to benefit the employer, and not to benefit the employee, then it is not considered a taxable benefit (***Sorin v MNR* 1964 AB**).

"In Respect of, in the Course of, or by Virtue of an Office or Employment"

The fact that a TP "received or enjoyed" a "benefit" does not automatically make the benefit taxable.

- Rather, ***ITA s. 6(1)(a)*** requires that the benefit is "received in respect of, in the course of, or by virtue of an office or employment"

Traditional approach was that in order to be a taxable benefit, the benefit had to be of the character of remuneration for services; modern approach is much broader: **taxable benefits need not be for services rendered, but merely conferred on the TP in relation to or in connection with their employment in any way** (***Canada v Savage* 1983 SCC**).

Gifts from the ER to an EE

(a) **General rule**

- ER can give a gift to an EE as long as it isn't regular, part of a program, or given to everyone
- However, prizes (*i.e.* group incentives, employee-of-the-month) will be considered remuneration

(b) **Exception for gifts under $500**

- ***ITA s. 258***: CRA now permits program gifts up to $500, providing they are not in cash but in kind
- These gifts are tax-exempt; ER can deduct the costs of these gifts, but need not withhold anything and EE doesn't have to pay tax
- *i.e.* ER can give the "employee of the month" a $499 gift such as a watch

(c) **Exception for scholarships**

- ***ITA s. 56(1)(n):*** amounts to be included in income include scholarships, bursaries, prizes for achievements, etc.
- ***ITA s. 56(3):*** however, exemption for scholarships, fellowships, bursaries, prizes…if less than $500

Where regular gifts are made to EEs by ERs **in order to obtain future beneficial results for the business**, the gifts are taxable as income (***Laidler v Perry* 1965 UKHL**; *vouchers were given year after year to promote loyalty, and EEs came to expect them as a regular practice that went with their service*).

"Benefit of Any Kind Whatsoever"

These expenses can include:

(a) Business trip expenses (***Lowe***)
(b) Clothing expenses (***Huffman***)
(c) Relocation expenses (***Ransom***)
(d) Personal moving expenses (***Phillips***)

Despite the SCC's suggestion in ***Savage*** that "the meaning of 'benefit of whatever kind' is clearly quite broad," the courts have had difficulty determining whether various apparent economic advantages enjoyed by EEs are taxable "benefits."

- Again, there must be a benefit of some kind to an EE, either in cash or in kind (non-cash)
- If an ER requires an EE to do something (*i.e.* travel, buy clothes, move), it is not a "benefit" to the EE

A trip (or part of a trip) may be regarded as a personal benefit under ***s. 6(1)(a)*** unless it is a mere incident of what is primarily a **business trip**. If a trip is primarily for business (*i.e. benefits ER*), it is a tax-free benefit (***Lowe v Canada* 1996 FCA**).

Savage: based on the "primarily business test" from ***Lowe***, if the ER had paid for the courses up-front, the tuition would be tax-free because it was primarily for the ER's benefit (same for PLTC).

Benefits that reimburse expenses incurred by EEs at the order of the ER, which restores an EE to his/her pre-expense economic situation, is not a taxable benefit under ***s. 6(1)(a)*** (***Canada v Huffman* 1990 FCA**).

Relocation benefits/payments which reimburse the EE for **actual losses** incurred on a sale of the EE's house are not taxable (***Ransom v MNR* 1967 ExCt**; *the payment by Ransom's ER "put nothing in his pocket"; it "merely saved his pocket". The payment made to compensate Ransom only served to make the EE whole*).

Note: in 1998, ERs started reimbursing too many EE relocation expenses and the government responded to ***Ransom*** by **setting limits on reimbursement:**

(a) Benefit re housing loss

- ***ITA s. 6(19):*** for purpose of para. 1(a), an amount paid at any time in respect of a housing loss…is deemed to be a benefit received by the TP at that time because of the office or employment

(b) **Benefit re eligible housing loss**

- ***ITA s. 6(20):*** maximum limit of $15,000 for ER reimbursements for eligible moving expenses and other incidental expenses to relocation
- If the reimbursement is over $15,000, ½ of the additional amount must be included in taxable income as an employment benefit

Note: one issue that is often litigated is the issue of **reimbursement of personal moving expenses:**

(a) **<u>Moving expenses</u>**

- ***ITA s. 62(1):*** deductions of moving costs are permitted if they are not paid by the ER
- Applies to EEs, self-employed individuals, and post-secondary students
- The distance between the old residence and the new work location has to be **40 km further** than the distance between the new residence and the new work location
- **"Cost of moving"** expenses = transport/storage costs, legal fees, temporary hotel fees
- While EE always better served to get 100% reimbursement from ER rather than apply for a tax deduction, deductions are still possible under ***s. 62***

(b) **<u>Eligible relocation</u>**

- ***ITA s. 248(1):*** relocation of a TP where it enables the TP to carry on business or to be employed in Canada or to be a full-time student at a post-secondary level, with both old and new residences in Canada, and distance between old residence and new work location is not less than 40km greater than the distance between the new residence and the new work location

In addition to ***s. 6(20)***, ***Canada v Phillips*** also narrows the CL approach articulated in Ransom. The ***Ransom*** principle does not extend to reimbursements for the increased cost of housing, as a more expensive house adds to the net worth of the individual (***Canada v Phillips* 1994 FCA** *EEs only reimbursed for moving expenses if no benefit to EE*). ***So: always ask for tax-free reimbursement of moving costs when changing to new employer.***

Note: ***ITA s. 62(3):*** definition of **"moving expenses"**: non-deductible moving expenses include loss on sale of old residence.

Valuation

If the benefit is taxable, how is it valued? See the Act:
(a) Value of benefits

- ***ITA s. 6(1)(a):*** requires that the "value" of a taxable benefit be included in income
- **"Value"** under Canadian law is **fair market value**, i.e. the amount that a person not obligated to buy would pay to a person not obligated to sell

There are legislated values for interest-free/low interest loans, as well as company cars for personal use

After 2009: CRA gave up and no longer taxed frequent flyer points; they are now exempt and are tax-free for practical purposes.

ALLOWANCES

Ransom: there is a distinction between an "allowance" and a "reimbursement", as an "allowance" is an **arbitrary amount** usually paid in lieu of reimbursement without any reference to actual expense/cost

- Big advantage to EEs: the EE is not required to account for money spent from an allowance

Subject to certain exceptions, "allowances" are taxable under the *Income Tax Act*:

(a) **Personal or living expenses**

- ***ITA s. 6(1)(b):*** requires allowances received by a TP to be included in income from an office or employment if it is "an allowance for personal or living expenses or as an allowance for any other purpose"

(b) **Exceptions**

- ***ITA s. 6(1)(b)(i):*** government travel or person expenses
- ***ITA s. 6(1)(b)(v)*** or ***(vii):*** reasonable allowances for business travel expenses
- ***ITA s. 6(1)(b)(vii.1):*** reasonable automobile allowances are tax-free (but must keep logbook)

Receipt of an allowance to compensate for the costs of **voluntary services rendered** is taxable as income and is not subject to deductions for the costs of the service (***Campbell v MNR* 1955 TAB;** *use of EE's vehicle without accounting for costs is a taxable allowance*).

Reimbursement of an ***actual* expense** is not taxable (***Canada v Huffman* 1990 FCA;** *undercover policeman didn't get allowance for plain clothes*).

DEDUCTIONS IN COMPUTING INCOME FROM OFFICE AND EMPLOYMENT

GENERAL

ITA s. 8 authorizes a number of deductions in respect of employment income, but ***s. 8(2)*** limits deductions that may be claimed by an officer or EE to those expenses set out in ***s. 8***

- **Bottom line:** if an expenditure is not listed in ***s. 8***, EE is not entitled to deduct it from gross income

ITA s. 67: limitations apply to all deductions from any source including income from office or employment

- Only the portion of the expense that is reasonable will be deducted, and this is a **question of fact**
- **Exception:** ***ITA s. 67.1*** arbitrarily restricts deduction of expenses incurred for food, beverages, and entertainment to 50% of the cost of those items (*i.e.* Canucks games)

General principles on deductions in computing income from office and employment:

(a) **Employment contract:** expenses must be required by the contract of service
(b) **Income-earning purpose:** expenses must be related to earning employment income
(c) **Apportionment of expenses:** expenses are partly deductible if for business and personal use, but purely personal expenditures are not deductible
(d) **Current v. capital expenditures:** only current expenditures are deductible (*i.e.* recurring annual expenses); once in a lifetime or infrequent expenditures are not (*i.e.* initiation fees)
(e) **Reasonableness requirement:** ***s. 67*** mandates all expenses be reasonable in the circumstances
(f) ***ITA s. 8:*** if an expenditure is not listed in ***s. 8***, it is not deductible pursuant to ***s. 8(2)***
(g) **Applies to all deductions from any source:** ***ITA s. 67***

SPECIFIC DEDUCTIONS

Traveling Expenses

The requirements for claiming travel expenses for all employees are in ***s. 8***:

(a) **<u>Requirements for claiming travel expenses</u>**

- ***ITA s. 8(1)(h):*** EE's required to pay their own travel costs can deduct them if they:
  - (i) Retain receipts for proof
  - (ii) Are obliged by their employment K to travel
  - (iii) Have not received a tax-free reimbursement

(b) **<u>Motor vehicle expenses</u>**

- ***ITA s. 8(1)(h.1):*** EEs can claim their own motor vehicle expenses (gas, oil, repairs, insurance, fines) if required to perform duties away from ER's place of business or in different places as long as not already reimbursed by the ER
- **Note:** once at work, ***s. 8(1)(h)*** applies and the EE must meet the deduction requirements

(c) **<u>Interest costs</u>**

- ***ITA s. 8(1)(j):*** interest costs to finance the purchase of a vehicle are deductible as well as depreciation relating to its use to earn employment income
- This **capital cost allowance** allows for reimbursement for wasting asset (*i.e.* car) of 30%

(d) **<u>Commuting</u>**

- Commuting is a personal expense, as where one chooses to live is a personal choice (***Martyn***)
- Self-employed individuals getting income from business that have a home office can get tax deductible expenses; he was traveling while at work, not traveling to work (***Cavanaugh***)
- **Note:** there are transit pass tax credit (U-Pass and EE passes)

(*cont'd*)

Certain kinds of EE's may more generously deduct traveling expenses from their income tax:

(a) **EEs working on commission**
- ***ITA s. 8(1)(f):*** commission sales employees have generous tax relief for traveling expenses

(b) **"Ordinarily required"**
- Whether under ***s. 8(1)(h)***, ***s. 8(1)(h.1)***, or ***s. 8(1)(f)***, a TP must be "ordinarily required" to carry on duties of employment away from his/her ER's place of business
- Not proven by a percentage argument; rather, being "ordinarily away from the ER's place of business" had to be a contractual obligation (***Neufeld***)

Note: if you are the EE, it's always better to get reimbursement for travel costs up front to put EE back in the original position rather than trying to get a deduction after for expenses to reduce taxable income
- If EE applies for a deduction, important to keep receipts/vouchers to support claim for expenses

Legal Expenses

An EE is entitled to deduct amounts paid on account of legal expenses incurred to establish a right to salary or wages, as well as to collect any such amount that is owed:

(a) **Legal expenses only on amounts "owed"**
- ***ITA s. 8(1)(b):*** deduction allowed only in respect of an amount "owed" by current or former ER
- ***ITA s. 6(1)(j):*** any award or reimbursement received by a TP for legal expenses must be included in income unless taken into account in reducing the amount claimed in the deduction

(b) **Definition of "salary or wages"**
- ***ITA s. 248(1):*** includes any amount under ***ss. 5, 6,*** and ***7***

(c) **"Retiring allowance"**
- ***ITA s. 60(o.1):*** if EE is terminated and has a claim for wrongful dismissal, ***s. 60(o.1)*** provides a tax deduction in collecting the "retiring allowance" or pension as "other source of income"

Professional and Union Dues

Section 8 also provides for a deduction for annual professional and union dues:

(a) **Professional and union dues**
- ***ITA s. 8(1)(i)(i):*** union members can deduct union dues; similar deduction for members of law society who pay dues
- Payment of additional fee on entry is not a deductible employment expense because the deductible dues must be annual
- ***ITA s. 8(1)(i)(iv):*** deduction available for annual dues to maintain membership in a trade union
- ***ITA s. 8(1)(i)(v):*** deduction available to those required to pay union dues as condition of employment even though they are not members of the union
- ***Schwartz***: if EE is on strike, and gets strike-pay, that strike-pay is tax free (not from a source)

(b) **Dues providing benefits**
- ***ITA s. 8(5):*** dues that provide benefits to members are deductible as long as they are required in order to maintain professional status
- Therefore, initiation fees are not deductible (however, malpractice insurance premiums are)

Note: the profession under which the TP claims a deduction must be:
(a) **Recognized by statute as a professional status**
(b) **Required to be paid by statute in order to be part of a profession**
- Therefore, while you can deduct LSBC dues, can't deduct CBA or Trial Lawyers Assoc. dues unless you are a self-employed lawyer
- EE would want to be reimbursed by ER for these CBA expenses

Home Office

If you own a home, can only deduct expenses if you are a commission salesperson or self-employed; if an EE, the only deduction available is rent

See the *Income Tax Act* for EEs and self-employed individuals working from a home office:

(a) **Rent for home office**

- ***ITA s. 8(1)(i)(ii):*** can only deduct home office rent; if home is owned, can't make any deductions
- ***ITA s. 8(1)(i)(iii):*** office supplies are also deductible
- ***ITA s. 8(1)(f):*** commission salespeople get much more liberal deductions for home office expenses
- **Note:** only rent here…so no deduction of utility bills, property taxes, ect…unless self-employed

(b) **Limits on deductions**

- ***ITA s. 8(13):*** enacted in 1994 for all EE's (including commission salespeople) that limits deduction for home office expenses for office or employment similar to limits set on self-employed individuals by ***s.18(12)***
- Must be required by ER (explicitly or implicitly) to keep a home office
- Pro-rated expenses based upon space that occupies (ie: mortgage interest, insurance, maintenance costs, utilities, property taxes, long-distance telephone calls, ect…)
- To qualify for the deduction, must show that:
  (i) Home office is the **principal place of work** (more than 50% of the time), OR
  (ii) Have a s**pace set aside exclusively for employment purposes**, must meet with clients on a regular and continuous basis in that space
- Other household occupants can't access space; use must be "exclusive"
- *i.e.* Cavanaugh as self-employed could deduct both office expenses and "commuting" expenses

INCOME FROM BUSINESS OR PROPERTY

THE STATUTORY SETTING

This section of the course deals with income from two sources:
(a) **Income from business** = self-employment income
(b) **Income from property** = investment income/yield

Note: both are known as "ordinary income" as opposed to "special income" (i.e. capital gains/losses)

Remember: revenue (accrual = earned) – expenses (accrual = incurred) = profit (or loss) – based on:
(a) ***ITA s. 9(1):*** TP's income for a taxation year from a business or property is the TP's **profit** from that business or property for the year
(b) ***ITA s. 9(2):*** If a TP's expenses are more than income, then there is a **loss**
(c) ***ITA s. 9(3):*** income or loss from business or property does not include capital gains or capital losses
- After this, ***ss. 10*** to ***37*** set out more detailed rules for the computation of profit

Businesses usually keep "two sets of books" to calculate profit in order to make "tax adjustments":
(a) **Financial accounting** – starting point
- Uses GAAP (generally accepted accounting principles), used for presentations to shareholders
- This is a **question of fact** usually proven by calling expert evidence at trial

(b) **Tax accounting** – more generous for tax purposes
- While GAAP is the starting point for tax accounting, the ITA provides more generous provisions for tax purposes than GAAP permits
- Therefore, tax accounting and distinguishing between profit/loss is a **question of law** and the ITA prevails over GAAP if GAAP are inconsistent with the ITA (***Imperial Oil*** and ***Royal Trust***)

- *Note: International Financial Reporting Standards (IFRS) has replaced GAAP*

Five important distinctions between income from business and property:

(a) **Small business deduction**
- Active business income of Canadian-controlled private corporations is taxed at a special low rate because of the tax credit under ***s. 125***; not available for property income

(b) **Dividend refund**
- Dividend refund available to private corporations under ***s. 129*** excludes income from active business

(c) **Attribution rules**
- Attribution rules in ***ss. 74.1*** and ***74.2*** apply to income from property but not from business

(d) **Rental and leasing property rules**
- Certain rules with regard to rental and leasing properties apply to income from property
- Designed to prevent TP's from creating or increasing losses from rental property through deduction of capital cost allowance

(e) **Non-residency** (*TS says this is the only important point*)
- Tax liability of non-residents is tied to source
- Income from business carried on in Canada is taxable on net basis under ***Part I***
- Income from property generally subject to 25% withholding tax on gross basis under ***Part XIII***
- If non-resident earns income from property in Canada, they are subject to withholding tax on gross amount under ***ITA Part XIII*** (***Sudden Valley***)
- If non-resident gets income from "carrying on business in Canada," they are subject to tax (and deductions) under ***Part I*** (***GLS Leasco***)

INCOME FROM A BUSINESS

WHAT CONSTITUTES A BUSINESS?

1. Organized Activity

See the ITA for definition of a "**business**":

- ***ITA s. 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 (isolated transaction) but does not include an office or employment
- i.e. buying/selling inventory, speculation, performing services to increase value, etc

Note the distinction between:

(a) **Business vs windfall gains:** business are expected, planned, **organized**, and recurring efforts with a profit motive; windfalls are exactly the opposite
  - Gambling winnings are not a source of income; they are windfalls and irrational agreements with one side winning and the other side losing (***Graham v. Green* 1925 TCC**)
  - However, gambling winnings may constitute business income in certain fact situations (***Walker v MNR* 1951 Ex Ct**, *because he had inside information, he wasn't just going by the odds anymore*)
  - Each case of gambling gain must be decided on its own facts; the test is whether the TP's object was to conduct an enterprise of a commercial character or whether it was primarily to entertain himself/ herself (***MNR v Morden* 1961 Ex Ct**)
  - Gambling must be extensively organized for it to be a business. Courts focus on the organization of the TP's activity in determining if there is a business (***Leblanc v Canada* 2006 TCC**)

(b) **Business vs hobby:** if motive is to make a profit, it's business; if it's for fun and enjoyment, it's a hobby which means the income is tax-free but expense deductions are unavailable

CRA: "A business is an activity that you intend to carry on for profit and there is evidence to support that intention." You don't actually have to end up with profit – the business activity may result in losses BUT it is the **intention** that counts. No longer is there a requirement that the taxpayer have a *reasonable* expectation of profit – all that is necessary is **evidence of the intention** that you are carrying on the activity for profit.

"Business income includes income from any activity you do for profit. For example, income from a service business is business income. However, you do not include employment income as business income" (***Stewart***)

2. The Pursuit of Profit

The CRA picked up Dickson J's reasoning in ***Moldowan* 1977 SCC**, where he said that the taxpayer must have a **reasonable expectation of profit** – criteria:

1. Profit/loss in the past year (recurring losses)
2. The taxpayer's training (had the person taken a course or something?)
3. His intended course of action (did he have a business plan?)
4. Capability of venture to show profit

This later became a test invoked by the Minister to deny the recognition of deductible losses on the basis that they weren't derived from a business.

BUT ***Stewart*** changed the test of whether the taxpayer has a business source of income: **two-step approach:**

(1) Is the activity undertaken in pursuit of profit or is it a personal endeavor?
  - This stage assesses the general question of whether or not a source of income exists
  - Does the TP intend to carry on activity for profit, and does evidence support the intent?
  - If the activity contains **no personal element** and is **clearly commercial**, no further inquiry is necessary; it is income from business under ***s. 9*** and losses are deductible

(2) If it is not a personal endeavor, is the source of income business or property (*s. 9(1)*)?
  - This stage categorizes the source of income as either business or property under ***s.9(1)***

(*cont'd*)

Reasonable expectation of profit should only be used as a factor to demonstrate that an activity is a business **when a personal element is involved**, not as a required element (***Stewart v Canada* 2002 SCC**).

There are 3 types of situations:
(1) **business:** activity is exclusively commercial, no personal element, don't need to show REOP
(2) **personal:** hobby situation where it is purely for pleasure, it is conclusive because the nature of the activity is not commercial, so losses are not deductible because it is not a source of income
(3) **middle ground:** mixture of commercial and personal motivation, here REOP concept can be used as *one* of many factors as to whether the activity qualifies for tax deduction or not; What is the predominant intention of TP? Does TP intend to carry on an activity for profit? Is there evidence to support that intention? Requires TP to establish that predominant intention is to make a profit from the activity and the activity has been carried out in accordance with the objective **standards of business-like behaviour:**
    (a) Profit/loss experience – profit/loss in the past year? (recurring losses)
    (b) Taxpayer's training (had the person taken a course or something?)
    (c) His intended course of action (did he have a business plan?)
    (d) Capability of venture to show profit (anticipated capital gains on sale qualify, ***Stewart***)
    (e) Reasonable expectation of profit

SO: REOP is *not* required unless the activity you are pursuing **also has a personal element** (mixed commercial and personal) in which case, REOP is not *required* but is a factor to be considered.

Note: In 2003, ***TIA s. 3.1*** temporarily reversed Stewart, putting REOP back as a determinative factor in determining if income is from a business. ***ITA s. 3.1(2)*** made Stewart's **anticipation of capital gains** not qualify as a REOP – must look to operating profit or loss separately.

These provisions have now been repealed so ***Stewart*** is once again good law, despite the REOP information on the Revenue Canada website saying "business income includes income from any activity you do for profit or with reasonable expectation of profit" – this is not true, as losses can constitute business income as long as it's not a purely personal endeavor.

3. Adventure or Concern in the Nature of Trade

Adventure or concern in the nature of trade is specifically included in statutory definition of "**business**"

- ***ITA s. 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 (*isolated transaction*) but does not include an office or employment
- If TP enters into an isolated transaction, the transaction is speculative and intended to yield the profit, the income may be taxable as business income even if the TP is not a trader

Therefore, ***ITA s. 9(1)*** applies even if the TP didn't conduct a "business" in the ordinary sense of the word. Rather, it's sufficient if the TP engaged in "**an adventure or concern**" that was similar to, or had the characteristics of, a business or a trade

Example: main concern is purchase and sale of real estate (i.e. "flipping" properties), as it can be income from business or capital gain. At the time of purchase of the property, what was the intention of the TP? If purchased with *intention of holding*, gain is **capital gain**; if purchased with *intention of selling at first opportunity*, it is **income from business**; if both, it's a question of fact.

Bellingham: bought house in land centre to flip it, which is a hallmark of a speculator (gains are taxable as income from business).

INCOME FROM A BUSINESS DISTINGUISHED FROM OTHER SOURCES OF INCOME

Income from Office or Employment Compared

Income characterization rules don't come from the ITA; rather, they are based on case law. This is important because different income from different sources receives different tax treatment.

Difference between income from a business (that is, income from the services of an IC or a self-employed person) and income from an office or employment (that is, income from the services of an EE or officer) is crucial because the **scope of deductions** and the **payor's withholdings obligations** differ.

Capital Gains Compared

A profit from the sale of property may be characterized as either a capital gain or income from business:

(a) **Income from a business**

- When a TP is in the business of buying and selling property
- If a speculative transaction **produces a loss**, TP want to characterize the transaction as an adventure or concern in the nature of trade so that the loss is fully deductible in computing income…whereas only ½ of a capital loss would be deductible and only against capital gains

(b) **Capital gain**

- When a TP buys property for investment purposes and eventually sells the property for a gain
- Treated more favourably than business income, as only ½ of capital gains is included in income
- If a speculative transaction is **profitable**, TP wants to characterize the transaction as a CG

Income from Property Compared

Difficult because property is involved in earning both income from property and income from business

- ***Stewart***: whether loss was a loss from property or a business loss was the same for tax purposes
- Therefore, characterization doesn't really matter, but if there are tax implications, it will usually more positively impact income from business

Again, no statutory definition, so the case law distinction generally depends on the **extent of activity of the owner** (or the owner's agents) in earning the income:

(a) **Active income** = **business income**, as it's the result of efforts made or time/labour of the TP
(b) **Passive income** = **investment income**, as it requires little activity/time/organization

What about characterization of rental income where the owner provides services to tenants?

- *Level of services will be determinative, i.e. difference between storage warehouse and self-service storage*
- *Generally, the income will be income from property unless owner is operating a hotel/motel*

INCOME FROM PROPERTY

CONCEPT OF PROPERTY AND LIABILITY TO TAX

"Property" gets a wide definition in the ITA:
(a) **Statutory definition of property**

- ***ITA s. 248(1):*** ""property" means property of any kind whatever, whether real or personal or corporeal or incorporeal, and without restricting the generality of the foregoing, includes:
  (i) A right of any kind, a share, or a chose in action
  (ii) Unless a contrary intention is evident, money
  (iii) A timber resource property, and
  (iv) The work in progress of a business that is a profession

This broad definition of property means that:
(a) Something of value is generally considered to be property for the purposes of the Act, and
(b) Income from property is generally derived from the ownership of property

Therefore, under ***ITA s. 248(1)***, income from property can include income from:
(a) **Interest income**
(b) **Rents and royalties** – i.e. TP owning real property earns rental income from leasing the property
(c) **Capital gains and losses**
- See ***ITA s. 9(3)***, which specifies you disregard capital gains when computing income from business or property, and you also disregard losses)

(d) **Dividends** – preference for dividends among different sources

Note: best ways to invest personal savings:
(a) **Imputed income**
- Simply owning (rather than renting) assets such as home, car, etc – no yield but creates return

(b) **Principal residence**
- Home is tax exempt so can increase wealth through increased value of owner-occupied home

(c) **Dividends**
- Dividend tax credit: TP owning shares in a publicly traded Canadian company that pays dividends can get an income tax credit according to the tax paid by the corporation

(d) **Capital gains**
- Can time capital gain realization when most optimal, pay only ½ tax on disposition

(e) **TFSA: tax-free savings account**
- TPs can put up to $5000/year into the accounts tax-free and invest in the same kind of investments that a RRSP or pension-contributing holder can make
- While no tax break on entry, there is also no tax when interest begins to accumulate

INCOME FROM PROPERTY DISTINGUISHED FROM OTHER SOURCES OF INCOME

Capital Gains Compared

Income from property is included in ***ITA s. 3(a)*** and is fully taxable, while capital gains are included in ***ITA s. 3(b)*** and only ½ of the capital gain is included in income

ITA s. 9(3): property income does not include any capital gain from the disposition of property…ie:
(a) **"Tree" = property**, which if sold for a gain is a capital gain
(b) **"Fruit" = interest, dividends, rent, or royalties**, in which case the fruit is categorized as either income from business or income from property

Therefore, TPs seek to characterize a property transaction as a sale of capital property – problems when:
(a) Capital property is sold and the sale price is paid in installments
(b) The amount paid for capital property is dependent on use/production of the property

Imputed Income Compared

Distinction between:
(a) **Income from property** – value derived by the owner from allowing another to use the property
(b) **Imputed income** – economic value derived by the owner from use of their own property

Examples to distinguish:
(a) **Imputed income**
- **Owner-occupant:** TP occupies own home instead of getting rental income from a tenant
- **Farmer:** TP consumes own produce instead of selling it and buying proceeds with groceries
- **Home gardening:** TP cuts own lawn instead of hiring a gardener

(b) **Income from property**
- **Landlord:** TP receives rent from tenant because it's a marketplace exchange

Imputed income is not taxable under the ITA and is excluded from a TP's income because:
(a) It is non-cash income, or income in kind, and
(b) Arises outside of the marketplace

INTEREST INCOME

Legal Meaning of Interest

ITA s. 12(1)(c): any amount received "as, on account of or in lieu of payment of, or in satisfaction of, interest" is included in a TP's income

What is considered to be "interest" and when must it be included in income? If a payment is considered "interest", when must the amount be included in a TP's income for a year?

Interest: not defined in the ITA; common law: defined interest as **compensation for the use of money** belonging to another person, referable to a principal amount that accrues daily at a particular rate.

Therefore, **interest = principal** x **rate** (*i.e.* principal amount of debt obligation x interest rate)
- loan principal = $1000 for one year
- rate = 10%
- interest = $100
- if the interest accrued daily: $100/365 days = $0.27/day

Bonuses

Bonus/penalty: an amount **in excess of the stated interest and principal payable** on maturity of a debt obligation, early repayment, or an event of default.

Case law has generally held that **bonus payments ≠ interest**. However, if a bonus varies with the term of a loan where no rate of interest is stipulated, *a bonus may be regarded as interest*.

Tip: instead of using the word "interest", can use the word "bonus" and the excess amount can be characterized as a capital gain, only ½ of which would be included in TP's income for the year.
i.e. loan = $1000, repayable = $1050 (with $50 being a "bonus", as no rate was used to calculate repayment).

Blended Payment or Capitalized Interest

Blended payment: where a TP receives a **single payment** under a contract or other arrangement which includes both the repayment of capital and interest. *ex.* mortgage payments, deferred payments for sale of capital property, bonuses, etc.

Apportionment: when a TP must divide and allocate what portions of a payment are taxable as income and what portions of a payment are taxable as capital (*cont'd*)

Apportionment is required for blended payments or capitalized interest under the ITA:
- **Income and capital combined:** ***ITA s. 16(1):*** where, under a contract or other arrangement, an amount can be reasonably be regarded as being in part interest or other amount of an income nature and in part an amount of a capital nature, the interest/income part will be included in the TP's income.

When a single payment is considered to be a blended payment is a question of fact. Where a payment is structured in a way that subverts interest, under s.16(1), a portion of that payment can be assessed as interest and taxed as such (***Groulx v MNR* 1967 SCC**)

Sudden Valley: for purchaser, if interest qualifies, it is tax deductible

"Ordinary Interest" vs Pre-Judgment Interest

Damages for personal injuries and wrongful dismissal aren't paid immediately. Instead, court awards damages and "court-ordered interest" under Court Order Interest Act. This **court-awarded interest is a separate head of damages** (not interest) **and is tax-free if the underlying sum of money payable is also tax free.**

(a) **Pre-judgment interest not taxable**
- ***IT-365R2:*** "Where an amount in respect of damages for personal injury or death has been awarded by a Court or resolved in an out-of-court settlement, no part of such amount will be income to the recipient, even though the amount includes or is augmented by an amount which, pursuant to the terms of the Court order or the settlement agreement, is referred to as interest"
- *i.e.* in ***Bellingham***, P got $100,000 from property plus another $1000 pre-judgment interest – since the underlying sum was business income, interest is also characterized as business income
- In personal injury, death, defamation that is tax-free money…pre-J interest which takes its character from the underlying claim should also be tax-free

(b) **Post-judgment interest taxable**
- ***IT-365R2:*** "However, where an amount that has been awarded for damages is held on deposit, the amount of interest earned will be included in the income of the injured TP"
- This post-judgment interest is classified as interest
- i.e. in ***Bellingham***, if there was delay in getting the reward (even in personal injury or defamation cases), the interest would be taxable

Timing of Interest Inclusion

TPs are permitted to select either the received or receivable method of reporting interest income for each debt obligation: ***ITA s. 12(1)(c):*** interest must included in income when it is received or receivable, "depending on the method regularly followed by the TP in computing his profit"

There are 2 main methods of accounting:
(a) **Received method:** report cash when money is received, i.e. cash method
- All that is accounted for in an accounting period is revenue actually received by the TP and expenses actually paid by the TP
- Common method to compute income from office/employment or income from property
- Most people report property income (ie: dividends) on a "cash basis"

(b) **Receivable method:** report cash when money is legally "receivable"
- While TP has choice for this method, TP can only defer interest income for one year at most
- If TP defers longer using the "receivable method", must report using the "accrual method"

(c) **Accrual method:** report income as it is earned in the year
- Used most commonly by businesses to report income from business or property
- Most business report their revenue as earned on an accrual basis and expenses incurred in the year in which liability arises, regardless of when they are actually paid

(*cont'd*)

Example: if 10% x $10,000 GIC, $5000 interest paid on maturity in year five, how is interest reported?
If TP is on cash received method, would have to pay on $5000 when received in year five. If TP is on accrual method, would have to pay on $1000 accruing each of the five years.

Note: the method that an individual TP uses to report income other than interest is generally irrelevant.

RENT AND ROYALTIES

Meaning of "Rent" or "Royalty"

Payments based on production or use: ***ITA s. 12(1)(g):*** "any amount received by the TP in the year that was dependent on the use of or production from property whether or not that amount was an installment of the sale price of the property" must be included in the TP's income

Although the words "rent" or "royalty" aren't specifically used in ***ITA s. 12(1)(g)***, they usually mean:
(a) **Rent**
- Fixed payments for the use of property for a given period of time
- After a period of time expires, the right to use expires and reverts back to the owner

(b) **Royalty**
- Mineral royalties and royalties for use of intangible/intellectual property
- i.e. copyright, invention, trademark, patent
- Original owner gets to share in the profits or a percentage of the profits based on use or on the number of units, copies, or articles sold, rented, or used (ie: rock bands)

Policy: prevent TPs from converting what would otherwise be fully taxable rent or royalty incomes into ½ taxable capital gains.

Example: a vendor that sells a capital asset assumes that it should only result in a capital gain. However, if the selling price fluctuates based on production or use of the property, then it will be considered a royalty and treated differently than a capital gain. As it's a sale price determined by a formula, it's a "capital" receipt classified as taxable income. *Note:* only the formula part becomes income – original asset is still capital.

How should vendor TP's avoid being caught by ***ITA s. 12(1)(g)***: Always sell capital assets for a fixed price. If need to use any formulas, make the installments determined by a formula or a maximum/minimum sale price that is reducible/additional according to a formula.

Payments Based on Production or Use

Royalties and rents must always be distinguished from sales profits, which are capital gains.

What happens when there is a sale by an owner of land and oil is found on the land? Since neither the vendor nor the purchaser knows how much oil there is, the purchaser may wish to base the price on the number of gallons of oil extracted. Are the payments capital or royalty income for the vendor? See Spooner…

Parliament passed ***s. 12(1)(g)*** to catch sales of property where the sale price is dependent on the production or use of the property, however, if acting for the vendor, there are a few techniques for avoiding ***s. 12(1)(g)***:
(a) Sell for a fixed price
(b) Sell for a fixed price, but installments determined by a formula
(c) Sell for a maximum fixed price that is reducible according to a formula
(d) Sell for a minimum fixed price and a formula

DIVIDENDS

Meaning of "Dividend"

Dividend: a payment on the shares of the corporation that represents the return on equity investment.

Stock dividend: a dividend that is paid not in cash but rather with new stock of the corporation.

No definition of "dividend" in ITA except ***ITA s. 248(1)*** which provided that a dividend includes a stock dividend; common law: any pro rata distribution from a corporation to its shareholders is a dividend.

Dividends may be paid in cash, in kind, or with new stock of the corporation (i.e. a stock dividend).

Special Treatment of Dividends

Dividends are taxed at a lower rate than other forms of property income; even better than capital gains.

ITA provides special rules to provide relief from double taxation by allowing:
(a) **Individual shareholders:** pays tax, but can reduce tax through "enhanced dividend tax credit"
- Beyond the scope of this course, but reduced since company already paid tax on profits

(b) **Corporate shareholders:** receive dividends tax-free
- Dividends from publicly traded Canadian corporations pass tax free to corporate shareholders

Note: since dividends are a distribution of profits, so they aren't a deductible expense because the expenses have already been deducted in the calculation of profit.

DEDUCTIONS IN RESPECT OF INCOME FROM BUSINESS OR PROPERTY

STRUCTURE OF THE ACT

The general subsection in the ITA that contains the primary rule for deductions is:
- **Deductions: *ITA s. 9(1):*** TPs income from a business or property is defined as the "profit therefrom for the year"
- **"Profit"** = revenue [– expenses] is not defined in the ITA, but "net profit" is generally determined by:
  (a) **GAAP:** generally accepted accounting principles, or
  (b) ***ITA:*** GAAP apply unless they are overridden by other provisions in the Act or the case law

The key sections of the Act that either disallow or allow various deductions from business or property income include:
(a) **Section 18 specifically limits deductions for certain expenses**
- ***ITA s. 18(1)(a):*** no deductions for expense that are not incurred for the purpose of earning business or property income
- ***ITA s. 18(1)(b):*** no deductions for capital expenditures
- ***ITA s. 18(1)(h):*** no deductions for personal or living expenses

(b) **Section 20 overrides section 18 and allows various deductions**
- ***ITA s. 20(1)(a):*** allows deductions for capital cost allowances
- ***ITA s. 20(1)(c):*** allows deductions for interest
- However, to the extent that s.20 limits on the availability and amount of a deductions, s. 18 applies to prohibit the deduction of a particular expense

(c) **Section 67: requirement of reasonableness**
- ***ITA s. 67:*** denies deduction of expenses that are otherwise deductible to the extent that the amount of the expense is unreasonable

(d) **Section 67.5: public policy override**
- ***ITA s. 67.5:*** no deductions for business expenses if they are prohibited on the ground of public policy under s. 67.5 or case law principles

General rule: business expenses get much more favourable tax treatment than personal expenses.

GENERAL APPROACH TO DEDUCTIONS

General rule: an expenditure properly deducted under GAAP will be deductible for tax purposes **unless** it is prohibited by some provision of the ITA. Conversely, an amount not deductible pursuant to GAAP will not be deductible for tax purposes unless the ITA specifically provides for a deduction.

Therefore, there is a **2-part test** when considering the deductibility of a business expense:
(a) **Is the expense deductible according to GAAP for financial statement purposes?**
- This is a question of fact for accountants to answer
- Relies on ***ITA s. 9(1)*** and GAAP

(b) **If the expense is not deductible for a financial statement, does the ITA overrule GAAP to permit the deduction?**
- This is a question of law for lawyers to answer
- Relies on ***s. 18(1)(a)*** and whether the expense is incurred for the purpose of earning business or property income

BUSINESS PURPOSE TEST

ITA s. 18(1)(a): **business deductions: *ITA s. 18(1)(a):*** "an expense is deductible to the extent that it is made or incurred for the purpose of earning income from a business or property."
- Therefore, there is no deduction for an outlay or expense **except to the extent that** it was made/incurred for the purpose of gaining or producing income from business or property.
- "Made" = personal property income; "Incurred" = business expenses on accrual basis
- Purpose of the expense is the important consideration, not the result

Is there a condition of deductibility of an expense under ITA s. 18(1)(a) that a business expense, in order to be deductible, must produce income? Or is it OK if it produces a loss?

An item of expenditure may be properly deductible even if it is not productive of any income at all and **even if it results in a loss –** as long as the **liability is incidental to the business**, it is a deductible expense (***Imperial Oil Limited v MNR* 1947 Ex Ct**).

So after ***Imperial Oil*** and ***Stewart***, a failure to earn income is not a condition of its deductibility, as long as **purpose** is to produce income from the business.

Note: Imperial Oil's legal fees in defending the case would be deductible as the legal fees flowed from the damages which had the purpose of producing income.

It is **not necessary that the expense actually *result* in the income**, or that income is traceable to it. It is sufficient that an expense be made **in accordance with the principles of commercial trading** and **consistent with good business practice** to make it deductible as a business expense under ***ITA s. 18(1)(a).*** (***Royal Trust Co v MNR* 1957 Ex Ct**, *social club membership fees a deductible expense for the company, there was evidence of a causal connection between expense and profit because of industry practice evidence from chartered accountant*).

Note: while the principle in ***Royal Trust*** that GAAP + business purpose = deductible business expense, the expenses at issue would now be prohibited by ***ITA s. 18(1)(l)***, which states that no business deductions shall be made for payments for use of recreational facilities and club dues.

PERSONAL OR LIVING EXPENSES

General

Generally, personal or living expenses are not deductible in computing income from a business or property because it is prohibited by the general requirements in ***ITA s. 9(1)*** ("income" defined as "profit") and ***ITA s. 18(1)(a)*** (not for the "purpose" of earning income).

As if this is not enough, there is a further limitation in ***ITA s. 18***:
(a) **General limitations on deductions**
- ***ITA s. 18(1)(h):*** no deduction shall be made in respect of personal or living expenses of the TP, other than travel expenses incurred away from home in the course of carrying on TP's business

(b) **Definition of "personal or living expenses"**
- ***ITA s. 248(1):*** non-exhaustive list, so anything could be considered "personal or living expenses" for the purposes of ***s. 18(1)(h)***

Note: not all expenses with personal elements are non-deductible, as there is:
(a) ***ITA s. 63:*** authorizes a deduction for child care expenses
(b) ***ITA s. 62:*** allows certain moving expenses

However, you can apportion personal expenses if combined for business/personal purpose (***Cumming***), *ex.* holiday/business trip where a lawyer takes their files with them, emails, etc. – with a $30,000 limit. *ex.* $30,000 car, can claim $15,000 deduction for depreciable part of the car.

Variability of the Expense

Under ***ITA s. 18(1)(a)***, expenses can be apportioned between personal and business/investment uses.

Factors to consider if an expense is for a business purpose (***Leduc***):
(a) Is the deduction ordinarily allowed as a business expense by accountants and therefore widely accepted as a business expense?
(b) Is the expense normally incurred by others in the TP's business?
(c) Would the expense have been incurred if the TP was not engaged in pursuit of business income?
(d) Would the need for the expense exist apart from the business?

TPs must apportion expenses between actual business use and personal use, as under ITA s. 18(1)(a) expenses are only "deductible to the extent incurred for business purposes" (***Benton v MNR* 1952 DTC, *test:*** does the TP need the expense because of work, or do they have the need regardless?)

Note: unlike in 1952, there are now tax breaks available for a poor guy like Mr. Benton:
(a) ***ITA s. 64:*** tax credit for attendant care expenses
(b) ***ITA s. 118.2:*** tax credit for medical expenses (including nursing home, full-time companion care, etc.)

Legal Expenses

If criminal charges stem from **an activity carried on in the normal course of business**, then the **legal expenses** incurred to defend those acts are deductible. However, if the activity that led to charges is not a normal part of the production of income, they are not deductible (***Leduc v Canada* 2005 TCC,** *couldn't deduct legal fees for sexual exploitation, despite facing disbarment*).

Child Care Expenses

TPs often incur child care expenses while away from home earning income. Since ***ITA s. 63*** (*tax credit for child care expenses*) is available, the SCC has declined to consider whether child care expenses are deductible as a business expense under ***ITA s. 18(1)(a)*** (***Symes v Canada* 1994 SCC**).

ITA s. 63: $7,000 for each child under 7 years; $4,000 for each child between 7–16 years; $10,000 for disabled children of any age; ⅔ of the income of the spouse with the lower income is the upper limit for deductions.

Food and Beverages

Traditionally, personal consumption of food and beverages has always fallen under ***ITA s. 18(1)(h)*** as non-deductible personal or living expenses for the obvious reason that *all humans* need food and water.

If a typically personal need can be characterized as a business need, it will be deductible from business income, so if TP required by business to consume extra food/beverage, it is a deductible expense (***Scott v MNR* 1998 FCA,** *argued if a courier in a vehicle can deduct fuel expenses, foot carriers should do the same*).

Note: after ***Scott***, CRA responded with a special provision for self-employed food and bicycle couriers and rickshaw drivers that allow them to deduct $17/day; if they wish to claim more, they need receipts.

TS: opportunity for anyone other than couriers to take advantage of this tax relief hasn't happened yet, so it seems like a TP needs an equivalent occupation that somehow runs on fuel.

Commuting Expenses

Expenses incurred by TPs to travel between home and work are generally personal or living expenses.
Policy: the choice of where to live is considered a personal consumption decision.

However, **travel expenses are a routine cost of doing business** and will commonly be unquestioned as deductions for tax purposes, even though there is sometimes a personal element.

Provided there is a base of self-employment, a TP may deduct commuting expenses and can apportion them on a reasonable basis (***Cumming v MNR* 1967 Ex Ct,** *use of vehicle to and from hospital and home office is deductible*).

Note: there are limits on the deductions a commuting TP can make:
(a) ***ITA s. 13(7)(g):*** maximum capital cost allowance for a depreciating vehicle is $30,000
- In ***Cumming***, Court held that proper apportionment between personal and business use of a car was 50/50, so Cumming could only claim $15,000

(b) ***ITA s. 67.2:*** TP can claim interest but maximum is $300/month for a passenger vehicle
(c) ***ITA s. 67.3:*** TP can claim leasing cost but maximum is $800/month for a passenger vehicle

Home Office Expenses

While ***Cumming*** could've written off his home office space in addition to his commuting expenses, the **government has declared war on home offices**. Like commuting, maintenance of a home office gives rise to difficult-to-characterize expenses, i.e. home office more convenient than late nights at office v home office business necessary.

However, since home office space is part of the home, the inference that the office expenses are of a personal nature is difficult to rebut, especially with:
- ***ITA s. 18(12)***: **work space in home:** deductions by an individual of home office expenses are prohibited unless homeowner is:
  (i) TP's "principal place of business," OR
  (ii) Used exclusively for business AND on a regular and continuing basis for meeting clients, customers, or patients.

*What is an **appropriate and reasonable amount** for a deduction of a home office?* Expenses are usually apportioned based on square footage of the house (i.e. determine amount of space occupied by the office compared to total usable area of the home), and then a proportionate amount of the expenses of the home are then taken as a business deduction. ex. renting = % of rent/utilities/insurance; homeowner = % of mortgage interest, insurance, property taxes, maintenance fees, utilities, and possible capital cost allowance.

Entertainment Expenses and Business Meals

Prevailing rule is that if the principal purpose of entertainment is business, then expenses are deductible. If part of the entertainment expense would be disallowed because it served a personal purpose, TP usually won't be able to substantiate the full amount claimed.

There are provisions in ***ITA s. 67*** that limit the deduction of food and entertainment expenses:
(a) ***ITA s. 67.1:*** 50% disallowed for ER deductibility of meals/entertainment expenses when EEs or clients are being entertained (still must have genuine business purpose)
(b) ***ITA s. 67.2:*** limits deduction of interest on money borrowed for passenger vehicle
(c) ***ITA s. 67.3:*** limits deduction of lease costs for passenger vehicle

Education Expenses

Educational expense have generally been characterized as non-deductible personal expenses, however, courts can distinguish between:
(a) **Post-graduate courses:** deemed a personal expense and non-deductible
- ***ITA s. 118.5:*** provides tax credit for tuition fees paid towards a post-secondary education

(b) **Professional refresher courses:** deemed a deductible business expense
- *ex.* Continuing Legal Education courses taken by lawyers

PUBLIC POLICY CONSIDERATIONS

Expenses of Carrying on an Illegal Business

The source concept of income in ***ITA s. 3*** does not distinguish between income derived from legitimate business activities and income from illegal business activities.

If income from illegal business activities is taxable under the Act, are the expenses of carrying on an illegal business also deductible? Or are the deductions prohibited as being against public policy?

Expenses incurred to earn income in illegal businesses are deductible if receipts are provided as evidence of the expenditures (***MNR v Eldridge*** **1964 Ex Ct**).

Obviously the government didn't like this, so they added a provision to prevent deductibility of bribes:
Non-deductibility of illegal payments: *ITA s. 67.5:* no deduction allowed for expenses incurred for bribing public officials.

However, other than this specific prohibition, the general principle of ***Eldridge*** is still good law.

Fines and Penalties

If public policy considerations don't prevent the deduction of expenses of carrying on an illegal business, what would be the reasons for disallowing fines and penalties as deductions?

The common law position is that statutory and non-statutory fines/penalties are deductible (***65302 British Columbia Ltd v Canada*** **2000 SCC**, *deducting fines is not against public policy*).

However, the common law position that statutory fines are tax deductible has been **overridden by statute:**
(a) **Statutory fines and penalties not deductible:**
- ***ITA s. 67.6:*** fines and penalties are not deductible if they are imposed under federal, provincial, territorial, or foreign law.
- ***ITA s. 18(1)(t):*** interest on tax arrears and penalties not deductible either
- *ex.* disciplinary measures by professional bodies under Legal Profession Act not deductible

(b) **Private contractual fines and penalties still deductible**
- Therefore, while ***ITA s. 67.6*** prohibits deductibility of statutory fines, if no statutory authority for fines, still deductible under ***65302 BC.***

INTEREST EXPENSE

General

Interest: a capital outlay that occurs when someone has borrowed money and will repay the principal with interest over time at a specified rate

- **Capital outlay:** expenses laid out to benefit a business for future years
- Since there is a time factor, the interest payments are regarded at CL as capital outlays and are not deductible for tax purposes
- Therefore, in order to make interest payments tax deductible, TPs must comply with the strict requirements of the ITA

However, under statute, the deduction of interest on borrowed money is also prohibited:

- ***ITA s. 18(1)(b):*** no deduction of capital expenditures except as expressly permitted by the provision
- If a capital asset is going to benefit a business for many years, can't deduct the full amount in the year that it is purchased

Since deductibility of interest is prohibited by the common law and by ***ITA s. 18(1)(b)***, **interest is only deductible pursuant to the statutory exceptions in *ITA s. 20***:

(a) **<u>Borrowing money for the purpose of earning business/property income</u>**

- ***ITA s. 20(1)(c)(i):*** TP can deduct amounts paid (incurred) or payable (accrued) in the year pursuant to a legal obligation to pay interest on borrowed money for the purpose of earning business/property income (other than exempt income or to acquire life insurance)
- Therefore, interest is not deductible to finance personal expenditures
- i.e. purchase a home (except home office), purchase car (except for business purposes at $300/month), credit card balances (except business expenses), loans to contribute to tax-deferred accounts like a RRSP or TFSA, etc.
- TS: while borrowing money to invest is a good idea, borrowing money for personal expenditures is a bad idea because of tax deductible purposes

(b) **<u>Purchase price of asset used to earn business/property income</u>**

- ***ITA s. 20(1)(c)(ii):*** TP can deduct interest payable on the unpaid balance of the purchase price of an asset used by the TP to earn business or property income

Therefore, ***ITA s. 20(1)(c)***: allows deduction of interest expense as long as:
(a) Paid or payable in the year pursuant to a legal obligation to pay interest
(b) Borrowed money must be used for the purpose of earning income from business or property, or to acquire property for the purpose of earning income

Key: what is the money being used for? Interest is deductible if you borrow money to buy a car/phone for *business use but not for personal use*.

Strict compliance with ***ITA s. 20(1)(c)*** has been demanded from courts, leading to 2 areas of litigation:
(a) Is interest deductible if the property or business that the loan was used to finance no longer exists?
(b) Does borrowed money used for the purpose of earning income for business or property require that income actually be generated?

Deductibility of Interest Where Original Source No Longer Exists

Generally, when the income-earning "source" ceases to exist, courts have generally held that the related interest expense is no longer deductible.

However, ***ITA s. 20.1*** was enacted in 1994 to deal specifically with the continuing deductibility of interest after a source of income ceases to exist. Therefore, if value of a property collapses, CRA must allow full amount of interest to be deducted.

Note: future interest payments on student loans (not student lines of credit) are eligible for a tax credit under ***ITA s. 118.62*** (may need certificate from financial institution) to facilitate repayment.

Direct or Indirect Use of Loan Funds

ITA s. 9(3): interest on loan to purchase investment only for capital gains not deductible

- ie: ***Stewart***, but got out of this by arguing he was borrowing money to gain rental income even though he was looking to make capital gains in the long run
- Also, common stock that doesn't pay interest but has dividend-earning potential can deduct
- Remember, no more REOP requirement after Stewart

Despite the fact that it can be characterized as indirectly preserving income, borrowing money for an **ineligible direct purpose** ought not to entitle a TP to deduct those interest payments (***Canada v Bronfman Trust* 1987 SCC**, *borrowing was not to acquire assets for the trust but to keep assets in the trust, interest deductible only when loan is used* ***directly*** *to produce income*).

Problems: after ***Bronfman***, companies wouldn't be able to get tax deductible interest if they borrowed money to pay salaries or declare a dividend to pay out to shareholders.

TP's motive or *bona fide* purpose is not relevant in categorizing whether the borrowed money was used for the purpose of earning income from business or property; **all that is needed is a direct link** between the borrowed money and eligible use – the direct use to which the TP put the borrowed money is the main consideration. **Motive is irrelevant** (***Singleton v Canada* 2002 SCC**, *Singleton borrowed money from business to buy a home, and then borrowed money to pay back the loan to the business, interest was tax-deductible*).

So: a strict equitable tracing is not required; all that is required is a direct link between borrowing money and eligible use…if direct link is discovered, the interest is tax deductible.

Miscellaneous Restrictions on Deductibility

The following are miscellaneous restrictions on deductibility:

(a) **Compound interest**

- ***ITA s. 20(1)(d):*** compound interest is deductible (in the year it is paid) on an mount paid under s. 20(1)(c) so it is treated the same as simple interest
- **Simple interest:** interest rate is applied to the principle at whatever rate
- **Compound interest:** outstanding interest is added to the principal, so the interest rate ias applied to the principle + the interest that has been added (ie: paying interest on interest)

(b) **Replacing borrowed funds**

- ***ITA s. 20(3):*** interest on money borrowed to repay an existing loan shall be deemed to have been used for the purpose for which the previous borrowings were used

(c) **Interest and property taxes on vacant land**

- ***ITA s. 18(2):*** payments not deductible unless property is used in the course of business or used to earn property income

THE REQUIREMENT OF REASONABLENESS

Reasonableness requirement

- ***ITA s. 67:*** no deduction shall be made in respect of an outlay or expense otherwise deductible under the Act except to the extent that the outlay or expense was reasonable in the circumstances
- Therefore, unreasonable deductions aren't prohibited but s. 67 serves to reduce the deduction to a reasonable amount
- i.e. reduces amount of deductions that are largely personal in nature

APPENDIX A: OVERVIEW & CHECKLIST

I. **Dispute Resolution**
- A. Return (*file by April 30*)
- B. Initial assessment (*Notice of Assessment by end of July*)
- C. Reassessment (*3 years from date of initial assessment*)
- D. Objection (*Notice of Objection*) – moves file into CRA Appeals Branch and holds payment
- E. Appeal (*Notice of Appeal*) to TCC ➔ FCA ➔ SCC (*with leave*) – *compromise settlements not allowed*
- F. Alternative Relief (*Remission Order from Treasury Board*) – *unreasonable/unjust/not in public interest*

II. **Source Concept of Income**
- A. **"Netting out"** (***s. 4***)
  1. Losses from one source can be deducted from other sources when calculating income
  2. *Note:* capital losses can only be deducted from capital gains
- B. **Taxable sources of income:**
  1. Office and employment
  2. Business
  3. Property
  4. Taxable capital gains
  5. Parliament can add other sources (***s. 56***)
  6. *Compensation for loss of income* (***Bellingham***)
  7. Damages for wrongful dismissal are considered "retiring allowance" under ***s. 56(1)(a)(ii)***
     a) **But** if employment is terminated before start of employment, damages are compensation for loss of a capital asset (the employment contract) and tax-free (***Schwartz***)
- C. **Non-taxable sources of income:**
  1. Gifts unless from employer as consideration/*quid pro quo* (***Savage***)
  2. Windfall gains (***Graham****: gambling vs* ***Walker****: gambling business*)
  3. Strike pay (***Fries***)
  4. *Punitive damages, damages for mental distress, damages for defamation* (***Bellingham***)
  5. *Compensation for loss of income earning potential* (***Bellingham***)
- D. The courts will not add sources of income (***Schwartz***)
- E. **Surrogatum principle:** amounts received by TP *i*n place of *income from a source* may be included as taxable income as if it came from that source (*must look to the nature and purpose of the payment – what is the income replacing?*) (***Bellingham***)
- F. A person is liable to pay tax if they are beneficially entitled to that income but the TP must also have the *benefit* of that income, not only be entitled to the income in law (***Field***)
- G. **Income-splitting:**
  1. Kiddie tax (***s. 120.4***) applies to:
     a) Taxable dividends
     b) Shareholder benefits on shares of a private corporation
     c) Income from a partnership or trust
     d) Non-arm's length business relationship
  2. Kiddie tax does not apply to:
     a) Employment income
     b) Business income for services provided
  3. Income splitting:
     a) **Indirect receipt:** money diverted as dividends of a company does not meet ***s. 56(2)*** attribution rule (***Neuman:*** *successful,* ***Boutilier:*** *unsuccessful, corp not separate entity*)
     b) **Income assignment:** (***s. 56(4)***)
     c) **Property transfer:** to spouse or minor – yield will be attributed to TP (***s. 56(4.1); s. 74.1***)
     d) **Income attribution:** use of low/no-interest loans (***s. 74.1***)
     e) *You can also split income by hiring a qualified family member as an assistant if your employment contract requires an assistant* (***s. 8(1)(i)(ii)***)

(*cont'd: Losses*)

H. **Losses**
1. Current year losses
   a) **Ordinary income losses** can be netted out against other sources of income
   b) **Allowable capital losses** can only offset capital gains (**quarantine rule**)
2. Loss carryovers
   a) **Ordinary income losses:**
      (1) Carry back 3 years
      (2) Carry forward 20 years
   b) **Allowable capital losses:**
      (1) Carry back 3 years
      (2) Carry forward until death (*deductible against all sources in year of death +preceding*)

III. **Who Is Subject to Canadian Income Tax?**

A. **Residents** are taxable on their world-wide income
1. Factual residence:
   a) Dictionary meaning of the word "resident;" *quality of residence* (***Thomson***)
   b) ***IT-221 R3:*** determination of individual residence status:
      (1) Significant residential ties (***Thomson:*** *dwelling place in Canada,* ***Lee:*** *spouse in Canada*)
      (2) Secondary residential ties
2. Deemed residence: **sojourning:** total of 183 days in Canada (***s. 250(1)(a)***)
3. Ordinary residence: a person who is physically absent but has not severed all residential ties to Canada (***s. 250(3)***) – *the key is: intention to return* (***Reeder***)
4. "Part-time resident": if you have immigrated/emigrated, taxation year is split (***s. 114***)

5. **Corporations:**
   a) Incorporation after Apr 26, 1965: resident in Canada if incorporated in Canada
   b) Incorporation before Apr 27, 1965: deemed resident if in taxation year ending after April 26:
      (1) They were resident in Canada (*i.e. central management or control in Canada*) OR
      (2) Carried on business in Canada
   c) Foreign corporations can become resident of Canada under case law principles: "central management and control"
   d) Residence of a trust analogous to corporation: "central management of control" (***Fundy***)

B. **Non-residents** are taxable on their Canadian-source income – two methods of taxing non-residents:
1. ***Part I:*** Income from employment, carrying on business or disposition of property
   a) Income from employment (performing duties *in* Canada) (***s. 2(3)(a); s. 115(1)(a)(ii)***)
   b) Income from carrying on business in Canada: (***s. 2(3)(b)***)
      (1) Actively pursuing a profit, not passive (***Buckman***)
      (2) Where were the contracts made? (***Gough***)
         (a) Extension: **soliciting orders** or **offering** anything for sale in Canada through "agent" will be **deemed** to be carrying on business (***s. 253(b)***)
            i) Restrictive interpretation: soliciting of orders or offers means **binding** offers (*i.e. agent must have authority to bind principal*) (***Sudden Valley***)
   c) Taxable capital gains on disposing of taxable Canadian property (***s. 2(3)***)
      (1) Real estate provisions – onus on resident purchaser
2. ***Part XIII***: Current investment income
   a) **25% withholding tax** on gross amount of passive property payment to non-resident
      (1) Management fee
      (2) Interest (***Sudden Valley;*** *but note: as of 2008, interest payments to non-res not subject*)
      (3) Estate or trust income
      (4) Rents, royalties, et. (***GLS Leasco***)
      (5) Dividends from corporate residents in Canada
   b) **No deductions** for expenses (***Sudden Valley; GLS Leasco***)
      (1) *Note:* non-resident landlords can elect to be taxed on "net basis" under Part I

IV. **Income from Employment**

A. Correct test for classifying TP: Total Relationship (4 in 1) test (***Montreal Locomotive; Wiebe Door***)
   1. Control (from ***R v Walker***)
   2. Ownership of tools
   3. Chance of profit
   4. Risk of loss
   5. Common intention (*now considered in addition to total relationship test*)

B. Ways to avoid characterization as employee
   1. Contract *for* service – retire/rehire (***Wiebe Door***)
   2. Capitalization of employment contract

C. What is included in income from office or employment
   1. Wages/remuneration
   2. Benefits
      a) Need not be for services rendered but merely conferred in relation to employment (***Savage***)
      b) Can include:
         (1) Business trip expenses (***Lowe***)
         (2) Clothing expenses (***Huffman***)
         (3) Relocation expenses (***Ransom***)
         (4) Personal moving expenses (***Phillips***)
   3. Allowances
      a) "allowances" are taxable
      b) "reimbursements" are not taxable

D. Deductions: (*mostly **s. 8***)
   1. Traveling expenses
   2. Legal expenses
   3. Professional and union dues
   4. Home office

V. **Income from Business and Property**

A. **Income from business**
   1. What constitutes a business?
      a) Organized activity (planned, organized efforts)
      b) Pursuit of profit (ROEP only a factor if there is a personal element in the activity (***Stewart***))
      c) Adventure of concern in the nature of trade
         (1) House flipping/speculator (***Bellingham***)
      d) **3 elements of business income**
         (1) **Activity**: active income vs passive income (***Buckman***)
         (2) **Organization:** "scheme" (***Buckman***) "system" (***Graham***)
         (3) **Risk/reward:** profit motive (though ROEP not required) (***Stewart***)
   2. Income from business distinguished from other sources
      a) Income from employment: contract of service vs contract for services
      b) Capital gains: speculator (business) vs investment
      c) Income from property: active vs passive income

B. **Income from property**
   1. Types of income from property:
      a) Interest income (***s. 12(1)(c)***) (vs bonuses)
      b) Rents and royalties (***s. 12(1)(g)***)
      c) Capital gains and losses (*not included as income from property*)
      d) Dividends (***s. 248(1)***) – special treatment of dividends
   2. Income from property distinguished from other sources
      a) Capital gains: "tree" vs "fruit"
      b) Income from business: active vs passive income
      c) Imputed income

(*cont'd: Deductions*)

C. Deductions:
   1. **Business purpose test:** expense must be incurred *for the purpose* of gaining or producing income from business or property
   2. Personal or living expenses:
      a) Factors to consider (***Leduc***)
      b) Child care expenses (***s. 63***)
      c) Food and beverages (***Scott***)
      d) Commuting expenses (***Cumming***)
      e) Home office expenses (***s. 18(12)***)
      f) Entertainment expenses and business meals (***s. 67***)
      g) Education expenses (***s. 118.5***)
   3. Public policy considerations
      a) Expenses of carrying on an illegal business (***Eldridge***)
      b) Fines and penalties
   4. **Interest expense** is only deductible pursuant to statutory exceptions in **s. 20**
      a) Borrowing money for purpose of earning business/property income
      b) Purchase price of asset used to earn business/property income
   5. **Reasonableness requirement** (***s. 67***)

APPENDIX B: IMPORTANT CASES

DISPUTE RESOLUTION

***CIBC World Markets v Canada* 2012 FCA**

CRA not bound by compromise settlements

Facts: CIBC made an offer of settlement (which was favourable to the CRA), the CRA did not respond. CIBC was forced to go to court and was successful.

Held: CRA could not accept settlement, so the CRA can disregard compromise settlements. But **if there is a genuine dispute on the facts or on the law** (some cases go one way, other cases go another way) then a **compromise settlement may be available.** But if the facts or law are not in dispute, then the CRA cannot accept a compromise settlement – the settlement must be made on the facts and in accordance with the law.

Analysis: The CRA cannot "split the difference" – they cannot enter into an agreement, except as permitted by the law, to compromise in order to reach a settlement. The basic principle comes from ***s. 220(1)*** which says: "the Minister shall administer and enforce this Act." This Court is bound by its decision in ***Galway v MNR.*** In that decision: "**the Minister has a statutory duty (*s. 220(1)*) to assess the amount of tax payable on the [facts] as he finds them in accordance with the law as he understands it.**" In his view, "it follows that he **cannot assess for some amount designed to implement a compromise settlement**." Minister is obligated to assess "**on the facts in accordance with the law** and not to implement a compromise settlement."

***R v Jarvis* 2002 SCC**

Criminal investigation when "predominant purpose" is to determine penal liability

Facts: Jarvis operated 2 businesses: profitable farm and a less profitable sideline business selling wife's art. Wife died unexpectedly and J later sold her art for an income of $680,000, most of which he didn't report as income in his 1990 tax return. CRA civil auditor determined that J had committed "gross negligence" in omitting the income, which could result in civil penalties and possibility of tax evasion prosecution under ***s. 239***. However, the auditor never mentioned the tax evasion possibility to J, turned over the file to the special investigations branch of the CRA, and never informed J of his rights to silence and unreasonable search/ seizure under ***Charter ss. 7*** and ***8***. As part of the criminal investigation, the special investigators applied to court for a criminal search warrant and obtained it on "reasonable and probable grounds", leading to a charge of tax evasion.

Issue: Is there a distinction between the CCRA's audit and investigative functions under the ITA? If so, when does the CCRA exercise each function?

Analysis: There were two arguments:

(a) **Jarvis:** Charter rights violated: J's counsel argued that the audit was not civil or regulatory but in fact criminal. As a result, he should've been informed of his Charter rights, and since the information was obtained in violation of the Charter, the evidence should be inadmissible

(b) **Crown:** civil in nature: Gov't argued that all the evidence was admissible because the audit was civil in nature and the Charter only applied to the subsequent investigation, of which they obtained a valid search warrant and collected evidence in compliance with the Charter

Held: Iacobucci J holds that while the ITA is a regulatory statute, there is a clear demarcation between audit and investigative functions that it grants to the Minister. **But** Crown failed to prove *mens rea* as Jarvis may have been distraught over his wife's death leading to the underreported income.

SOURCE CONCEPT OF INCOME

Bellingham v Canada 1996 FCA

Punitive damages are windfall gains and therefore tax-free

Facts: Town of Grand Centre expropriated Bellingham's land, and the Land Compensation Board gave Bellingham a compensation award 6 times what the town offered. Had he sold the land, it would've been income from business; instead, gets a settlement offer. Litigation ensured, with B accepting an offer substantially less than the Board's award. B's share of the settlement had 3 components, and all 3 were taxed:

(a) Compensation for value of land
(b) "Ordinary interest" on the principal compensatory amount under the Court Order Interest Act
(c) "Additional interest" under the Expropriation Act

B appealed the rulings on the character of compensatory payment and additional interest.

Issue: Should compensation received for loss of income be taxed in the same way the income would've been taxed had it been earned from employment? (*yes*) Is the "Additional interest" taxable? (*no*)

Held: For B in part, won on interest award but not on the compensation for value of the land

Analysis: FCA notes that ***ITA s. 3(a)*** makes it clear that the named sources of income are not exhaustive and thus income can arise from other unidentified sources. Parliament chose to define income by reference to a restrictive doctrine (source concept) while recasting it in such a manner as to achieve broader ends. That said, there are several categories of funds that are excluded from taxation, i.e. gambling gains provided TP is not a professional gambler, gifts, inheritances, and residual category of windfall gains.

For the compensation of value of land award, there were two arguments:

(a) Bellingham – it was a capital gain that should be investment income from property
(b) MNR – B was going to flip the money immediately so it was income from business

Test: breaking down heads of damages into elements, what is each sum of money replacing? Here, the Court applied the **surrogatum principle** to the different heads of damage:

(a) **Compensation for the value of the land – taxable:**
B's intent was to flip it (land speculation = business). This was a compensatory receipt that constituted income from a productive source. Therefore, B doesn't get the ½ taxable treatment of capital gain investments.

(b) **"Ordinary interest" on the principal under the Court Order Interest Act – taxable:**
This was an award to B to compensate him for the delay in getting the case resolved. Since the underlying award was taxable, the interest on damages is a head of damages itself and gets the same tax treatment as the underlying sum. Note: under this reasoning, *if this was "ordinary interest" on tax-free personal injury damages*, the interest award would also be tax-free.

(c) **"Additional interest" under the Expropriation Act – not taxable:**
This was a punitive award treated as a tax-free windfall, as it was merely a statutory slap on the wrist to the town for treating B poorly. Payment fit within all of the Cranswick criteria because it was "unusual and unexpected."

Schwartz v Canada 1996 SCC
"retiring allowance" only taxable if employee actually starts working

Facts: Dynacare hired Schwartz for a senior position; they executed the employment K but before Schwartz started work, Dynacare changed its mind and said he was no longer needed. S sues for wrongful dismissal; after negotiations, Dynacare pays S him a lump sum of $360,000 in settlement of his claim for breach of his employment K, plus $40,000 for legal costs.

Issue: Under the source concept of income, were the damages from wrongful dismissal from a source?

Held: No, for S, he received the $360,000 tax-free

Analysis: Two arguments here:
(a) Schwartz – employment was capital asset; without an employment K, no money from source
(b) CRA – "employment" starts the moment the employment K is entered into by the parties, regardless of whether or not the EE actually starts working…offer was taxable "retiring allowance"

La Forest J. eventually concludes that the settlement offer and legal costs were received tax-free:
(a) **Was it employment income?**
s. 248(1): "Employment" is "position of an individual in the service of some other person." Since S was never "in the service" of Dynacare, nor could he have "lost" employment when the K was unilaterally cancelled by Dynacare.
(b) **Was it a "retiring allowance"?**
If S was never an employee, sum can't be considered a "retiring allowance" under *s. 56(1)(a)(ii)*. **Damages for wrongful dismissal was a retiring allowance, but since S never started working for Dynacare, this was merely compensation for loss of a capital asset – the employment K.**
(c) **Was it from another source?**
While *s. 3(a)* gives the Court the power to add sources, Parliament has already chosen to deal with the taxability of these payments in the "retiring allowance" provisions

Field v Canada 2001 TCC
Nexus requires taxpayer to receive benefit of the income

Facts: Wife was his financial advisor. She was in a fiduciary capacity but emptied his RRSP, put money into their joint account and then forged his signature and took the $ for herself. CRA pounced on Field and said the withdrawn money was taxable. He claimed he didn't do it himself but his spouse did it through forgery and breach of fiduciary duty.

Issue: Did the income belong to Mr. Field? Should Mr. Field be taxed on the withdrawals from his RRSP?

Held: No. If anyone should be taxed on this money it would be the spouse because she got the benefit of the money.

Reasoning: Mr. Field was not taxable on this money because **he is not the one who was beneficially entitled to the money. He WAS entitled to it in law, but he never actually got it** – so you can't say it is his income. He did not receive any money from the RRSP withdrawal and therefore did not receive any benefit from the withdrawal.

The sensible thing to do would be for the Minister to include the amount of the fraudulent money into the income of the offending party, Mrs. Fields, especially when the taxpayer has handed over enough details to support such an assessment.

Buckman v MNR 1991 TCC

Embezzled funds can be income from business depending on situation

Facts: A solicitor had 2 businesses: the solo practice of law/mortgage broker, and embezzlement. He embezzled funds from clients, and MNR taxed the shady lawyer on the embezzled funds. B argued that embezzled funds weren't income because they didn't come from recognized source.

Issue: Were the embezzled funds taxable? Did embezzlement carry the "hallmarks of a business"?

Held: Yes, for MNR

Analysis: General rule: money from criminal activity is not taxable unless it comes from a recognized source. Here, Buckman argued that since the funds were misappropriated in the course of his sole practitioner business, the source must be business, and to calculate the profit from his business, the MNR must use generally accepted accounting principles (GAAP). **Under GAAP, funds wouldn't be included in the profit from his business** because Buckman didn't have use of the funds absolutely without restriction, as they belonged to his clients at all times. Since he recognized an obligation to repay the funds, he argued he should be treated as a borrower rather than a thief.

Court held otherwise: GAAP principles are not law. The number of appropriations and methods employed by Buckman had all the earmarks of a business (risk/reward) **source analysis test:**

(a) **Entrepreneurship**
(b) **Repeated transactions**
(c) **Method (system)**
(d) **Reward of profit/risk of loss**

Therefore, embezzlement was 2nd business separate and was apart from his law/brokerage business. No difference whether the thief acted as solicitor, agent, or employee; the fact that the funds are being treated as income flowed from the reality of the situation. Since TPs can have multiple sources of income over the year, he had 2 taxable sources.

Note: if he's taxable on 2 sources, he can net **out his loss on his embezzlement and deduct it from his profit under his law practice under s. 3 "netting" – no moral judgment on deduction of expenses**.

Note: court rejected embezzlement as a new, unrecognized source of income under s. 3(a) "without restricting the generality of the foregoing," as was simply income from a business (of embezzlement).

Johnston v R 2011 TCC

Tax consequences of a Ponzi scheme

Facts: Ms. Johnston was an up investor. The tax situation: the fraudster (Mrs. Field, Buckman, etc) have income from business (their fraudulent embezzlement scheme). Ms. Johnston was an early investor. The early investors get a huge return on their money. Ms. J invested $10K and got back $1.3 million. The other investors got their money taken from them. CRA went after Ms. J for the $1.3 million – $10K of income. She fought this in court.

Held: Judge agreed with Ms. J – she did not have a "source" – her return from the ponzi scheme was a windfall similar to gambling and was therefore tax-free.

Victims: "down investors" – no deduction for losses

The embezzlers would issue information slips to down investors (T4 slips) – all of which was entirely fictitious. The ponzi scheme victims applied for tax relief for the money they paid in taxes in regard to the information slips they received. CRA still has not decided on this matter. The victims are still waiting for an answer, asking for a refund on the taxes they paid on the earnings that they did not actually receive.

If the victims do not get tax relief, they could apply for a remission order. Courts seem to say: there is no source here therefore there is no basis on which the courts would give relief. But an appeal to the government might be available via a remission order.

Neuman v Canada 1998 SCC
Successful income-splitting (dividends through separate entity corporation)

Facts: Corp (Melru), a holding company had different classes of shares for each family member. Neuman had all class G shares. Wife ruby had class F shares (paid for shares with her own funds). Ruby chose to pay dividends to her class of shares. CRA said because mr. neuman set it all up to split his income from his law partnership, the income should be attributed to mr neuman and not to ruby.

Issue: Should Neuman be taxed on this income that he diverted to his wife?

Reasoning: Court looked to s. 56(2) and found that the dividends would not have been the income to Mr. Neuman because it would have belonged to the corporation. Because it failed to satisfy s. 56(2)(4), the income splitting was permitted. Therefore Mr. Neuman wouldn't have been entitled to the income.

Boutillier v Canada 1999 FCA
Unsuccessful income-splitting (corporation not separate entity)

Facts: B is a mutual funds salesman who worked as an independent contractor. Worked on commission and also charged trailer fees (remunerate salesperson for monitoring customer's account and discouraging customer from selling the fund). B didn't want the trailer fees to be considered his 'income from business' so he incorporated a numbered company and had the trailer fees go to the numbered company which would pass the trailer fees to beneficiaries as allocated by trustees. B said he was transferring the opportunity to earn trailer fees to the company but CRA said he was transferring the fees itself.

Issue: Should Mr. B be taxed on the income or just the company? Yes

Reasoning: Court looked to s. 56(4): (a) Transfer of a right to income [from any source] (b) To a non-arms length person [family, companies owned by TP] (c) Would have been transferor's income [beneficial entitlement] (d) Unless property also transferred. Found that the right to income would have fallen to Mr B and he was beneficially entitled to the trailer fees, he transferred to non-arms length (corp he started). **Court considered:** the company was not providing any service to the clients (B was doing it); No employment contract between Mr. B and the company; He didn't tell clientele services would be provided for by company.

WHO IS SUBJECT TO INCOME TAX?

Thomson v MNR 1946 SCC
Must sever ALL significant residential ties with Canada

Facts: Left canada in 1930 to go to Bermuda and establish residence [pure farce]. Travelled up and down eastern seaboard nb and florida. Had home with servants in Canada vacant and available for his occupation at any time (this was a critical factor in determining his residency). He would still travel around the US and back to his home but spent approx. 160 days in canada. He claimed he gave up his Canadian residence and isn't taxable on income.

Issue: Was he a resident of Canada in 1940?

Reasoning: Court considered (a) intention of permanent severance of residential ties to Canada (b) regularity and length of visits to Canada (c) Dwelling place. Having a house available while out of the country was a significant residential tie to Canada. If individual leases dwelling place on arms-length terms the CRA may not consider dwelling to be significant residential tie to canada.

Ratio: To determine residence, the court will look at whether an individual severed all residential ties with Canada. Look to intention to be resident or stop being resident. Look to regularity and length of visits to canada Look to Residential ties outside canada.

Lee v MNR 1990 TCC

Immigration status does not affect residency status for tax purposes

Facts: L held a UK passport, employed full-time by a non-resident corp with all work done out of Canada. However, L married a Canadian who bought a house using a mortgage guaranteed by L. L would come into Canada to visit his wife, but each time he would have to leave within the prescribed time period for a "temporary visitor" stay (about 20 days). L paid no income tax anywhere else, so he was living his life income tax free.

Issue: Was L a deemed resident of Canada for tax purposes?

Held: Yes, L was a factual resident

Analysis: Even though L was a temporary visitor upon each entry into Canada, the lack of immigrant status does not preclude someone from being a resident for tax purposes. Most important factor is whether the individual establishes residential ties in Canada. Here, having a spouse and a residence with a mortgage he guaranteed made him a resident. ***ITA s. 114***: see section on "part-time residence." Lee became a residence when he married his wife and bought the house, which made him taxable on worldwide income for rest of the year.

Ratio: Residence is a question of fact and depends on the specific facts of each case; the more ties a TP has within Canada, the more likely they will be considered a resident

Canada v Reeder 1975 FCTD

Physical presence not necessary for a TP to be "ordinarily resident"

Facts: Reeder accepted a job with Michelin Canada and was sent to France for training. He sold his house and put his furniture into storage; couldn't sell his car but stored it in a garage. Upon arrival in France, he rented a furnished apartment, bought a car, and drove with Ontario DL. He kept a bank account in Canada where Michelin deposited pay. R tried to claim part-time residency under s.114 for March to November when he was in France.

Issue: Was Reeder considered to be "ordinarily resident" of Canada under s.250(3)?

Held: Yes, R was found to be ordinarily resident in Canada and had to pay tax for the entire year

Analysis: Old presumption was if an individual was abroad over 2 years, they would become a non-resident. No longer applies, as residency is now a question of fact in every case whether someone should be considered a non-resident for the purpose of going abroad. Here, **Reeder always intended to return to Canada** following the training period even though his length of stay in France was indeterminate in length. Also, he didn't collectively sever his secondary residential ties to Canada. *Note*: might get relief from double taxation if Canada had a tax treaty with France at the time

Ratio: If a TP goes and lives abroad but does not sever all secondary residential ties to Canada, they will be "ordinarily resident" in Canada and will be taxed on all of their worldwide income for the entire taxation year

De Beers v Howe 1906 UKHL

Facts: The company De Beers incorporated a company in South Africa. Had business operations in SA Board had some meetings in SA. Shareholders met in SA. Business operations were in SA. However, the company's articles said all the important decisions were made by the Board at their meetings in London, UK.

Common law test: A company resides for purpose of income tax where its real business is carried and the real business is carried on where its central management and control actually abides. Usually (de jure control – legal concept) where do the directors meet? The directors are usually the ones making the highest-level decisions.

Held: In this case, the articles said the big decisions were to be made in London, and they were made there. So the company was resident in the UK.

Where are the highest-level strategic decisions made? (de facto control – where somebody other than the directors can be calling the shots) i.e. where is the top level of control located?

Fundy Settlement v Canada 2012 SCC

Facts: Trust set up in Barbados. Trustee was a Barbados trust company. Beneficiaries were Canadian. So they thought they had moved the trust to Barbados.

Analysis: There was a departure from the usual rule. The high level decisions in this trust was being made by someone other than the trustee.

New test: Where does the trust's central management and control actually abide? ***De jure:*** where the majority of trustees make their decisions. By law, the trustees should be making the high-level decisions. ***De facto:*** where the highest level of decision-making occurs. But, in fact, trustees may be allowing the beneficiaries or another agent to make the high-level decisions.

Held: In this case, the beneficiaries in Canada were telling the trustees what to do, therefore the trust was resident in Canada

Granger v Gough 1896 UKHL

Merely soliciting orders does not equal "carrying on business"

Facts: Grainger was acting as an agent in England for Louis Roederer, a wine merchant operating in France. He canvassed orders for Roederer's wine and received commission for all orders from England. However, Roederer in France actually had discretion over actually filling or rejecting the orders. Was Roederer carrying on business in England?

Issue: No, for Grainger, since he wasn't carrying on business he didn't have to pay tax

Analysis: Important to look at where the contracts are made and where acceptance takes place. Distinction: trade with a country v. trade within a country. Employing an agent to solicit and transmit orders doesn't amount to exercise of trade in country. Here, Grainger never made a K to sell wine on behalf of Roederer in England. K was only formed when Roederer agreed to fulfill it. Therefore, an order given to a merchant for the supply of goods does not in and of itself create any binding legal obligations, and therefore no tax consequences.

Ratio: Criterion for carrying on business is where the contract is made and therefore where acceptance of the contract that creates binding legal obligations occurs.

Sudden Valley Inc v Canada FCA 1976
Offer must be made within Canada to "carry on business"

Facts: Residential development in Washington. Incorporated in USA. Tried to find buyers in BC, established an office in Vancouver where interested people would call in then go down to Washington to see the property. If people couldn't afford, people would take mortgages from Sudden Valley (Canadian resident purchaser paying interest and principal to SV). CRA said interest was part XIII income and Canadian residents should have been deducting and remitting withholding tax and Sudden Valley would be taxed on gross amount because they weren't really carrying on business in Canada. Sudden Valley relied on s. 253(b) and said they were soliciting orders from Canadians so carrying on business.

Issue: Is SV carrying on business in Canada or should there be withholding tax on interest? (No)

Reasoning: Court looked to where contracts were made and this was USA. Also distinguished between invitations to treat and soliciting orders (which is an offer).

The "soliciting of orders or offers" means BINDING offers (offers that are capable of acceptance). Roederer was getting a binding offer, but they still needed the acceptance to be from Roederer because Grainger had no authority to accept.

Comment: Nowadays this interest would be non-taxable; interest is exempt from tax (***ITA s. 212(3)(b)***)!

GLS Leasco Inc. v McKinlay Transport Ltd. 1986 TCC
Business activity v. passive income

Facts: GLS, an American subsidiary of Centra Inc., was a USA corporation that bought and leased transportation equipment in Canada, primarily to McKinlay who was also a subsidiary of Centra Inc. GLS wanted to be taxed under Part I "carrying on business in Canada" so they could deduct losses from profits on the basis of a non-capital loss carryover (i.e. offset 79-80 profits with 77-78 losses).

Issue: Was GLS carrying on business in Canada during the years in question?

Held: Yes, for GLS, in substance their profits arose from operations taking place in Canada

Analysis: GLS had very few indications of a physical presence in Canada, ie: use of an office at McKinlay to sign documentation and use as a mailing address, bank account in Canada, 2 McKinlay employees helped GLS as required. However, as a "matter of fact", GLS was carrying on business in Canada, as: (a) All GLS contracts were executed in Canada (b) All GLS equipment was purchased in Canada (always owned it, just leased to McKinlay) (c) Had a branch office and bank account in Canada. Therefore, GLS owed tax under Part I, could deduct losses, and McKinley not responsible for past withholding taxes. **While perhaps not all the form of carrying on business in Canada was present, there was enough to amount to a substance in Canada.** ***So: where the substance of doing business in Canada is present (i.e: contracts, payments, deliveries, bank accounts, intent to do business in Canada), it will take precedence over a lack of form (ie: no offices/ official agents in Canada) and establish that business is being carried on in Canada as a matter of fact.***

INCOME FROM OFFICE AND EMPLOYMENT

Wiebe Door Services Ltd. v MNR 1986 SCC
Must consider whole scheme of operations for test

Facts: Wiebe operated a business installing doors and repairing overhead doors in Calgary through the services of many door installers and repairers. Each installer had a specific understanding that they would be running their own business and no deductions would be made by W for withholding tax. CRA then assessed Wiebe and held he incorrectly forgot to deduct/remit EI and CPP contributions. Wiebe appeals, claiming the persons in question should all be classified as ICs rather than EEs.

Issue: Were the individual door installers independent contractors? Yes, for Wiebe

Analysis: Tax Court used "Integration Test" and found that the workers were an integral part of the business. ie: nobody more integral to a door installation business than door installers. However, SCC held that the Tax Court missed the point, as the "integration test" had to be examined from the point of view of the EE. If a court examines the "integration" test from the point of view of the ER, it will always be easy from the perspective of the larger enterprise to assume that every contributing cause is purely for convenience…way too inclusive. Instead, **the "total relationship" test is more accurate to focus on the whole operational scheme.** Some factors the court used to determine the relationship in this case, all of which pointed to IC:
(a) Termination on completion of a "specified job or task" rather than providing for the disposal of personal services to the master ER (ie: "specific results" test)
(b) Payment of remuneration
(c) Right to hire others/power to delegate
(d) Length and nature of the engagement
(e) Whether it is an exclusive/full time engagement
(f) Right to benefits and deductions at source/T-4
(g) Legal liability for defective work

Ratio: To determine whether a person is an EE or an IC, apply the fourfold test, weigh all relevant factors, and ask: "is the person who has engaged himself to perform these services performing them as a person in business on his own account"?

Cavanagh v. The Queen 1997 TCC
TA is an IC and gets to deduct business expenses

Facts: Cavanagh was an accounting tutor (ie: TA) for a course at York University; the university issued a T-4 setting out his income from employment, thinking he was an EE. He then filed an employment tax return, but then changed his mind and re-filed as a self-employed worker in order to deduct his traveling (ie: car/gas) and business (ie: stationary) expenses.

Issue: Was Cavanagh an EE or an IC? – For Cavanagh, he's an IC so he gets to deduct all of his expenses

Analysis: The Court applied both tests, both leading to the same conclusion:
(a) Lord Wright's Fourfold test = IC
- Control – York university and professors exercised minimal control over Cavanaugh with regard to supervision, location, and scheduling…he wasn't a lecturer, only a tutorial leader
- Ownership of tools – all his own, not provided by the university
- Chance of profit – some
- Risk of loss – some, but depended on how many students he had and drop-out rate

(b) Lord Denning's Integration test = IC
- Work was integrated into York's work in that York was there to teach and C tutored/marked
- However, from EE's point of view (Wiebe), C's work was not an integral part of the business, as York could've hired somebody else and C was free to hire somebody else

(c) "Specific results" test = IC
- Relationship finished after a specific task, ie: finished marking and tutorials were over
- After this, C ended any relationship with York. C would have to go back and re-solicit another K or renegotiate a new relationship, as he didn't have tenure

Ratio: The issuance of T-4 is not determinative of whether a worker is an EE or an IC; instead, it is for Courts rather than the ER to determine whether income is income from employment

Curran v MNR 1959 SCC
Signing bonuses intended to induce a new EE to join is taxable as income

Facts: Curran, a highly regarded geologist, was an EE of Imperial Oil and received $250,000 from Brown, a substantial SH of another company, as an "inducement payment" to leave IO for another company. C claimed the money represented a capital receipt and not income, as the agreement was to provide compensation for loss or relinquishment of a source of income. C also claimed that if the payment came from a 3rd party (i.e. SH of the new ER), and not from the new ER itself, it couldn't be caught by s. 6(3).

Issue: Was the inducement payment income or capital? If income, was it taxable under s.6(3) of the ITA?

Held: Yes, for MNR, payment classified as income from employment and therefore taxable under s.6(3)

Analysis: SCC found that the compensation was a "payment for services to be rendered by the EE." Payment was to induce C to become manager of the new company. Even though the payment didn't specifically fall under the s. 6(3) definition, the payment from the ER was still considered remuneration, and thus was income from a source (employment). Result of the decisions is that Brown couldn't deduct the "inducement payment" as an expense; rather, C was taxed on the compensation.

Ratio: Where a signing bonus-style payment is made to induce a person into a subsequent employment agreement, and not to acquire the rights of the EE against the current ER or strictly as compensation for loss of a future pension, the payment is categorized as income.

Comment: this case stands for proposition that C received income from employment under s. 5 under Bellingham's surrogatum principle; however, SCC held that it was income from an unenumerated source under s. 3

Sorin v MNR 1964 AB
Secondary location from residence used for cat naps is not taxable

Facts: Sorin, who lived with his brother, was a partner running a hotel with a bar; his duty was to manage the bar and rent out the rooms. He stayed at the hotel until 4am to close up the bar; took afternoon naps in a room used for storage. MNR charged S with a benefit for use of the room at half the normal rate for the year

Issue: Was the room used by S "lodging" under s.6(1)(a) and thus a taxable benefit?

Held: No, for Sorin…receives the benefit tax-free

Analysis: Under s. 6(1)(a), "lodging" would be a taxable benefit, but no meals served at hotel, so no benefit. EE was not getting any enjoyment from staying at the hotel, and would've rather spent time at home if his duties permitted him to do so…he was actually getting negative fun.

Ratio: If it can be shown that there was no benefit to the EE, and only a benefit to the ER, then it is not a taxable benefit

Canada v Savage 1983 SCC
Benefit only needs to be in relation or in connection with employ

Facts: Savage had a contract of service from his ER insurance company which included a $100 incentive for each insurance course voluntarily complete; available to all EEs to encourage self-upgrading. He did 3 courses and received $300 from ER for successfully completing these work-related courses. ER claimed the amount was an expense of doing business, indicating it was a "prize for passing LOMA exams"; as a result, S didn't include the $300 in his tax return. MNR reassessed (over $300 freaking dollars) and said it was income from office/employment. Savage argued it was a prize for achievement and since it was under $500, wasn't income

Issue: Was the payment income under a contract of service?

Held: Yes, for MNR…money received in respect of employment and the "benefit" was taxable as income

Analysis: SCC took a very broad view, holding that the Canadian ITA is broader than the UK statute. "Benefits of any kind whatever…in respect of…office or employment" are of the widest scope. Here, even though the incentive did not take "the character of remuneration for services", it was a benefit because it gave some advantage to the EE by:

a) EE received $100 extra pocket cash for each successfully completed course
b) Made her a more valuable EE, better at her job, and increased her opportunity for promotion

Note: had the ER merely been paying for the course, either in advance or as reimbursement, as opposed to offering a reward, there would be no taxable benefit

Ratio: Taxable benefits need not be for services rendered, but merely conferred on the TP in relation to or in connection with their employment in any way

Laidler v Perry 1965 UKHL

True gifts from ER to EEs are distinguishable from contractual expectations

Facts: ER used to give turkeys to all EEs as Christmas gifts; switched to 10 pound vouchers every x-mas.

Issue: Did the vouchers arise from employment, or were they merely personal gifts?

Held: For gov't, vouchers were taxable as a form of remuneration

Analysis: Sum was given to EEs in hope or expectation that the gift would produce good service in future. **Test:** has the practice become a contractual expectation? If they go from true gifts to contract expectations, they become taxable employment benefits. Here, vouchers were given year after year to promote loyalty, and EEs came to expect them as a regular practice that went with their service.

Note: turkeys would be OK today under s. 258 small gift exception, even as part of a gifting program…ER would deduct the turkeys as a business expense and EEs would receive them tax-free

Ratio: Where regular gifts are made to EEs by ERs in order to obtain future beneficial results for the business, the gifts are taxable as income.

Lowe v Canada 1996 FCA

If a trip is primarily for business (i.e. benefits ER), it is tax-free

Facts: Lowe was an account executive of Wellington Insurance Co., responsible for maintaining and developing rel'ts with independent insurance brokers and encouraging them to sell W's insurance. W didn't have its own sales force; relied on independent brokers who also sold other insurance. W paid for a business trip to New Orleans for L and his wife to promote W's insurance to brokers. Both L and his wife were expected to attend, as the brokers were all bringing their wives. Spent so much time with clients that they had only 1 hour to enjoy for themselves over 4 days. Tax Court treated the expenses of L's spouse as a personal benefit under s. 6(1)(a).

Issue: Was this portion of the trip's a paid holiday or a business trip?

Held: No, for L…trip was deductible as business expense and not a personal "benefit of any kind whatever"

Analysis: If the trip was pure business, 100% deductible; if pure pleasure, 100% taxable…here, it was mixed. "The Primarily Business Test": **was the principal purpose of this trip for business or pleasure?** Here, the primary purpose of the trip was business to benefit the ER. While the wife had no legal obligation to be present, any personal enjoyment of the trip by the spouse was merely incidental to what was **primarily a business trip** by both spouses for the purpose of advancing the ER's business interests. Since the majority of

the trip had been devoted to business expenses, no part of the trip expenses were to be regarded as a personal benefit.

Ratio: A trip (or part of a trip) may be regarded as a personal benefit under s. 6(1)(a) unless it is a mere incident of what is primarily a business trip

Canada v Huffman 1990 FCA

Reimbursement of employment expenditures is tax-free

Facts: Huffman was a plainclothes officer with the Niagara Regional Police Force who examined crime scenes for physical evidence (like Dexter); this caused big-time dry-cleaning bills. The CA between EEs and ER provided $500/year to plainclothes members for the purchase of such clothing because uniformed officers were provided with their work clothes at no cost to them.

Issue: Was the $500 clothing allowance a taxable benefit under s.6(1)(a)?

Held: No, for Huffman, allowance given to H tax-free and ER can deduct the expense

Analysis: Test: was there a material acquisition conferring an economic benefit on the individual TP? Here, while H was required to incur clothing expenses for his job, reimbursement of these expenses by his ER did not confer any personal benefit. TP spent more on the clothing than he received, so the $500 was therefore nothing more than a reimbursement (as opposed to an "allowance"…see s.6(1)(b))

Ratio: Benefits that reimburse expenses incurred by EEs at the order of the ER, which restores an EE to his/her pre-expense economic situation, is not a taxable benefit under ***s. 6(1)(a)***.

Ransom v MNR 1967 ExCt

"removal expenses" confer no benefit to EEs and aren't taxable

Facts: Ransom was transferred by his ER from Sarnia to Monreal, and in the process, lost money on the sale of his home in Sarnia because the market was saturated. To compensate Ransom, his ER paid him for the cost of moving expenses and any losses on the sale. On appeal, the Minister contended that the amount constituted salary, wages or other remuneration paid to Ransom under s.6(1)(a), or alternatively that the sum was paid as an allowance for personal expenses or for some other purpose under s.6(3)

Issue: Was the reimbursement payment a taxable benefit?

Held: No, for Minister…payment was reimbursement and did not form part of EE's income

Analysis: Cost of relocating when an EE is forced to move is in the same category as other traveling expenses. Ransom's financial position was adversely affected by reason of his employment relationship. Reimbursement was purely to put him back in his original position…no "net" benefit for Ransom. Court found that the payment for the capital loss was not taxable because:

(a) **Not payment by ER to EE under s. 6(3) deemed to be remuneration under s. 5**
- Ransom, by the production of evidence, rebutted the presumption of s. 6(3) that the payment was remuneration for services rendered
- Indemnity paid to Ransom in respect of capital loss sustained when selling was not:
  i) **Consideration for entering employment** – no, nothing to do with status as an EE
  ii) **Remuneration for services** – no, source of payment wasn't services
  iii) **Consideration for promises pre-or-post employment** – no evidence
- The payment was money disbursed by reason of but not in the course of employment and was quite different from remuneration for services performed by an employee

(b) **Not a benefit "of any kind whatever" under s. 6(1)(a)**
- Three categories of payment under this subsection:

i) **Remuneration** – not money for services performed by EE under s.6(3) above
ii) **Reimbursement** – not a benefit "of any kind whatever" as no benefit to Ransom
iii) **Allowance** – not an arbitrary amount paid in lieu of reimbursement under s.6(1)(b)

In sum, the payment by Ransom's ER "put nothing in his pocket"; it "merely saved his pocket". The payment made to compensate Ransom only served to make the EE whole

Ratio: Relocation payments which reimburse the EE for actual losses incurred on a sale of the EE's house are not taxable

Canada v Phillips 1994 FCA

EEs only reimbursed for moving expenses if no benefit to EE

Facts: P was moved by ER from Moncton, NB to Winnipeg; pursuant to a relocation agreement between the ER and the union, P received $10,000 payment to compensate him for increased housing costs in Winnipeg but no restrictions were placed on use of payment. i.e: a house in Winnipeg was $10,000 more expensive than in Moncton, so ER reimbursed him.

Issue: Was the reimbursement for the additional cost of housing a taxable benefit?

Held: Yes, for Her Majesty the Queen

Analysis: Similar to Savage, Phillips received the $10,000 payment in his capacity as an EE from the ER. While the Court endorses Ransom, it limits Ransom to cases concerning an expenditure as opposed to a capital loss. This purchase increased Phillip's net worth and was therefore taxable under s. 6(1)(a). The benefit was taxable unless can convince the Court it didn't confer an economic advantage. Here, the Court found that EE was indeed getting a benefit by:

a) Compensation had no conditions on use and gave Phillips more disposable income
b) Gained advantage over fellow EE's resident in the community with higher housing costs

Ratio: The ***Ransom*** principle does not extend to reimbursements for the increased cost of housing, as a more expensive house adds to the net worth of the individual.

Campbell v MNR 1955 TAB

Use of EE's vehicle without accounting for costs is a taxable allowance

Facts: Nurse had her own car and got a $50 allowance/month for transporting nursing home patients. She wasn't required to account for the expenses, show receipts, or return any surplus. This responsibility was not required under her K of employment; instead she did it voluntarily.

Issue: Was the allowance taxable under s. 6(1)(b)?

Held: Yes, for government, monthly payment were income as the allowance was paid on a periodic basis

Analysis: She voluntarily transported patients in her vehicle, which wasn't part of her ordinary duties. C then alternatively argued that if the allowance was included as income, she should be able to deduct the expenses… but since ER never obligated her to use the vehicle, expenses non-deductible. *Note:* she could've got a tax-free allowance if she did it on a per-km rather than per-month basis.

Ratio: Receipt of an allowance to compensate for the costs of *voluntary services rendered* is taxable as income and is not subject to deductions for the costs of the service.

Canada v Huffman 1990 FCA

Undercover policeman didn't get allowance for plain clothes

Facts: Huffman was only supposed to be reimbursed up to $500, but was paid an additional $79.57. CRA claimed this extra money was given an allowance for which he was required to account for.

Issue: Was the amount additional to that of submitted receipts taxable as an allowance under s.6(1)(b)?

Held: No, for Huffman, the amount was reimbursement rather than an allowance

Analysis: Three qualities to an allowance:
a) Limited predetermined sum of money paid to enable EE to pay for a certain expense
b) Amount is determined in advance
c) Once paid, allowance is at complete discretion of EE who isn't required to account for it
Here, obvious that the $500 isn't an allowance, rather it is a reimbursement.

Ratio: Reimbursement of an actual expense is not taxable

INCOME FROM BUSINESS AND PROPERTY

Graham v Green 1925 TCC
Businesses are planned while windfalls are luck

Facts: Graham bet on horses on a large and sustained scale, made income from it, and substantially it was his sole means of living

Issue: Are Graham's winnings profits or gains of a "vocation" and thus subject to income tax?

Held: No, for Graham, receives gambling wins as a tax-free windfall

Analysis: Casino operators and bookies have a system, have organized their efforts, and make money regardless of whether they win or lose. Their bookmaking is income from business, systematically making odds with a profit motive.

In contrast, gamblers don't organize their effort in the same way that bookies do. Gambling wins are pure windfalls relying on luck, and this income does not fall from a source. Unlike business income, gambling wins don't provide a service or produce anything. *Note: in the USA, gambling wins are taxable.*

Ratio: Gambling is not a source of income; rather, they are windfalls and irrational agreements with one side winning and the other side losing

Walker v MNR 1951 Ex Ct
Court can infer an intention to carry on business and make a profit

Facts: W owned race horses, traveled around to the races, got inside info and gained a lot through betting

Issue: Did these gambling activities constitute income from business?

Held: Yes, for MNR, profits from betting on horses due to extra connections were taxable as constituting income from business

Analysis: For the ordinary horse gambler, money made on casual bets for pure amusement are simply a hobby and are not taxable. Here, W had an interest in many horses, had inside info from jockeys as to the probable outcome of the races, traveled around to all races, and bet on most events. He couldn't afford to lose and his intention was to make a profit.

Ratio: Gambling winnings can constitute business income in certain fact situations

MNR v Morden 1961 Ex Ct
Source of income from business can change from year to year

Facts: From 1942-48, M gambled extensively; but for the years in question, gambling was occasional

Issue: Did these gambling activities constitute income from business or income from a hobby/pastime?

Held: For Morden, gambling wins were tax free

Analysis: It is possible to have a source of income one year and not the next (and vice-versa). Here, there was no evidence after 1948 that Morden's betting activities constituted an enterprise of a commercial character or that they were organized as a business

Ratio: Each case of gambling gain must be decided on its own facts; the test is whether the TP's object was to conduct an enterprise of a commercial character or whether it was primarily to entertain himself/herself

Leblanc v Canada 2006 TCC
Gambling must be extensively organized for it to be a business

Facts: 2 guys started buying provincial lottery tickets on sports, and made $5.5 million in winnings. System involved taking extremely long odds, lost 95% of the time, but got big winnings. They bet around 10-13 million/year and made $200,000-$300,000 a week.

Issue: Did these winnings constitute income from a business?

Held: No, for Leblanc

Analysis: Although betting was done on a large scale, they took the odds they were given, didn't have inside connections or a system, and bet on impulse.

Ratio: Courts focus on the organization of the TP's activity in determining if there is a business

Stewart v Canada 2002 SCC
Reasonable expectation of profit not necessary for a business

Facts: Stewart was an experienced real estate investor and bought property for rental revenue. He had to pay huge interest on loans (much higher than rental revenue) used to purchase the units, but he wanted to be able to deduct the losses over 10 years and net them out under s.3. Had no REOP; just had reasonable expectation of losses for many years, followed by capital gain. MNR disallowed the losses (deductions of interest expenses) because he had no reasonable expectation of profit and thus no source of income under s.9…entire scheme was devised for losses

Issue: Are the losses deductible?

Held: Yes, for Stewart…his rental activities constituted a source of income so he can deduct the losses

Analysis: Startup losses are usual for business, but losses incurred year after year can be like a tax shelter. SCC held that CRA abused its power in requiring the REOP test to restrict deductions of business and property losses on personal income tax.

Instead, a 2-stage approach should be used to determine whether a TP's activities constitute a source of business or property income under s. 9:

(a) Is the TP's activity undertaken in pursuit of profit? Or is it a personal endeavor?

- This stage assesses the general question of whether or not a source of income exists
- i.e. does the TP intend to carry on activity for profit, and does evidence support the intent?

- If the activity contains no personal element and is clearly commercial, no further inquiry is necessary…it's income from business under s. 9 and deductions for losses is available

(b) If it is not a personal endeavor, is the source of the income a business or property?

- This stage categorizes the source of income as either business or property under s.9(1)
- Here, Stewart was pursing profit and it the evidence showed it was not a personal endeavor
- Stewart argued that he would take losses for a decade or so, but then sell the property for a capital gain after it had appreciated in value (see factor 'e' below)
- SCC endorses this, saying it's OK to expect to make a capital gain in the long run
- Therefore, if an activity is undertaken in pursuit of profit, there is no need to prove REOP anymore

Ratio: Reasonable expectation of profit should only be used as a factor to demonstrate that an activity is a business when a personal element is involved, not as a required element

Groulx v MNR 1967 SCC

If price paid for property exceeds FMV, excess deemed taxable interest

Facts: Groulx owned a farm that he sold to a company for $395,000 (fair market value was $350,000). $85,000 was due immediately, balance was paid in installments with no interest charge unless there was a delay of payment (in order to have capital payments instead of interest income).

Issue: Can the part of the installment package reasonably be regarded as interest under s.16(1)?

Held: Yes, for MNR…evidence indicated that the interest was income from property

Analysis: Three things MNR established to be able to tax on the interest portion of the payments:
(a) Inevitable practice in this area that any balance of price should carry interest at 5%
(b) Difference between FMV and agreed-to price was hidden interest element
(c) G was experienced with real estate transactions, and bargained for interest being hidden in a higher purchase price

TS: speculators can still do this, but should be careful to stay within the range of FMV; if they sell it for higher than FMV, may lead CRA and the Court to find that the price included an interest payment

Ratio: Where a payment is structured in a way that subverts interest, under s.16(1), a portion of that payment can be assessed as interest and taxed as such

Imperial Oil Limited v MNR 1947 Ex Ct

As long as liability is incidental to business, deductible

Facts: Imperial Oil manufactured and marketed petroleum products, and also transported those products. After a crash at sea in 1927, IO paid $527,000 in damages and attempted to deduct it. This expense was incurred in 1930, as the agreement was determined and the fixed amount was settled in that taxation year…so loss was "incurred" in that year.

Note: since IO is a business, they report losses on an accrual basis when they had a legal commitment to pay; if it was an individual investor, they would use a cash basis to report income and would've paid the expense when it was actually paid.

CRA argued that the collision was not for the purpose of making income, so not a loss from business

Issue: Was the settlement tax deductible in the year the settlement was agreed to under s.18(1)(a)?

Held: Yes, for Imperial Oil…amount sought to be deductible was properly deductible under GAAP

Analysis: Transportation of petroleum was part of the business through which the income was earned. While expenditure was not to earn income, the expense was incurred in the course of earning income and was

therefore part of the process of earning income. Risk of collision between vessels is a normal and ordinary hazard of the operation. While amount of liability was large, there was nothing unusual in the collision itself. Unlike dividends, which are a distribution of profits already earned to shareholder, damages for the negligence of company servants is a loss that is part of the income earning process.

Note: deduction made in the year it was incurred, not the year the settlement was paid.

Ratio: An item of expenditure may be properly deductible even if it is not productive of any income at all and even if it results in a loss; as long as the liability is incidental to the business, it is a deductible expense

The Royal Trust Co v MNR 1957 Ex Ct

Accepted business practice + business purpose = deductible

Facts: Royal Trust paid admission fees and annual membership dues for some of its EEs to join social clubs and community organizations for the purpose of attracting business. Accountants testified that the amounts paid in dues were necessary deductions in computing income. CRA of course disagreed, arguing that the fees had not business purpose under s. 18(1)(a).

Issue: Were the social club membership fees a deductible expense for the company?

Held: Yes, for RT – expense were deductible under s. 18(1)(a)

Analysis: Court takes same approach as Imperial Oil by looking at s. 9 GAAP as the starting point. Next, go to s. 18(1)(a) to see if it prevents a deduction. Not necessary that it actually results in income, or that income is traceable to it; expense is simply deductible the year it is incurred even if it didn't result in income for the year. Here, there was evidence of a causal connection between expense and profit because of industry practice evidence from chartered accountant. Testified that it was good business practice for the company to pay for EE's social clubs. Socializing promoted business and was common practice in the industry. Therefore, since the expense were made for the purpose of gaining/producing income for the business through marketing, the initiation fees were not capital expenditures. Marketing didn't have to take place in the office; could occur at social clubs as well.

Ratio: It is sufficient that an expense be made in accordance with the principles of commercial trading and consistent with good business practice to make it deductible as a business expense under s.18(1)(a)

Benton v MNR 1952 DTC

Expenses to help earn income vs to assist personally

Facts: Benton was a 62-year-old single farmer with ailing health. He tried to claim a deduction for board and lodging and wages paid to a housekeeper as a personal expense of farm management in reporting the farm's taxable income.

Issue: Was the housekeeper's $780/week wage deductible?

Held: In part, $325 work wage was deductible and $455 personal wage was taxable

Analysis: Test: does the TP need the expense because of work, or do they have the need regardless? Here, MNR correctly apportioned part of housekeeper's wages for the farm work she did to help Benton earn income, but would have to keep a timesheet to record portion of time spent on the farm. Since B had a need for a housekeeper regardless, he could only deduct 50% of the expense.

Ratio: TPs must apportion expenses between actual business use and personal use, as under ITA s. 18(1)(a) expenses are only "deductible to the extent incurred for business purposes."

Leduc v Canada 2005 TCC

Can only deduct legal expenses if activity is normal part of income

Facts: Leduc, a lawyer, claimed $140,000 in legal expenses for hiring lawyers to defend him on sexual exploitation charges. MNR disallowed the deduction because they were personal in nature under s.18(1)(a). Leduc claimed that the expenses were incurred for a business purpose, ie: to save his reputation/career as a lawyer as he could lose his licence to practice if convicted (you would hope so). While he was also motivated by a desire to prove his innocence and stay out of jail, he argued that an ancillary intention to preserve his ability to earn income should be sufficient to allow a deduction.

Issue: Are Leduc's legal expenses incurred for a business purpose and therefore deductible?

Held: No, for CRA…expenses weren't paid in order to try and produce income from business

Analysis: Leduc's expenses were not normally incurred by other lawyers, and he would've had to pay the expenses no matter what his profession was. Also, no evidence that his career had suffered as a result of the charges and it was too remote to speculate whether an eventual conviction would affect his future practice. Other cases referred to were distinguishable because the charges faced by TPs were directly related to their work (ie: loss of a licence to work as a stockbroker).

Ratio: If criminal charges stem from an activity carried on in the normal course of business, then the legal expenses incurred to defend those acts are deductible; however, if the activity that led to charges is not a normal part of the production of income, they are not deductible

Symes v Canada 1994 SCC

If need arises because of parent and not business, it's too personal

Facts: Symes was a partner in a large Toronto law firm who hired a full-time nanny and deducted amounts. Claimed that the existence of the specific tax credit under s. 63 didn't affect her right to deduct the entire amount as a business expense, and that denial of a deduction would violate s. 15 of the Charter

Issue: Were the child care expenses deductible as a business expense?

Held: No, for MNR, as court splits down gender lines with McLachlin and L'Heureux-Dube JJ. Dissenting.

Analysis: Iacobucci J. for majority writes that the need for child care exists regardless of Syme's business. ie: fails a "business need" test. Rather, the expense was incurred to make her available to practice generally rather than for any purpose associated with the business itself. Also, no evidence that child care expenses were considered business expenses by accountants.

Ratio: Since s. 63 is available, majority decline to consider whether child care expenses are deductible as a business expense under s. 18(1)(a).

Scott v MNR 1998 FCA

If TP required by business to consume extra food/beverage, deductible

Facts: Scott was a self-employed foot and transit courier, traveling far every day with a heavy bag. He deducted modest amounts for the extra food and water he consumed for the job, which amounted to one extra meal per day for energy. He argued that if a courier in a vehicle can deduct fuel expenses, foot carriers should do the same.

Issue: Could Scott deduct extra food and water as an expense incurred for the purpose of business?

Held: Yes, for Scott…narrow exception for deduction of food/beverage allowed

Analysis: Expenses incurred to relieve a TP from personal duties and to make the TP available to the business are not considered business expenses. However, here, food was analogous to fuel that was already deductible. Therefore, only extra food and water Scott was required to consume beyond the average person's intake was deductible, and must be reasonable (i.e. can't drink Evian). *TS:* this would be a nightmare to apportion

Ratio: If a typically personal need can be characterized as a business need, it will be deductible from business income.

Cumming v MNR 1967 Ex Ct

Use of vehicle to and from hospital and home office is deductible

Facts: Cumming was a physician anesthetist rendering services to patients at the hospital and completing administrative duties at his home office. He traveled several times per day to and from the hospital during gaps in the schedule, as there was no office available for him to use at the hospital.

Issue: Were Cumming's vehicle expenses deductible as a business expense?

Held: Yes, for Cumming…25% of operating expenses allowed and 50% of capital cost use deductible due to depreciation/wear and tear on the car

Analysis: Looking at other anesthetists in Ottawa, they also deducted vehicle use to and from the hospital. Cumming's principal office was at home…going to the hospital was his way of earning income from his practice (similar to expenses incurred by a barrister traveling from office to the courts). Note: C must apportion use of car between personal and business before making deductions.

Ratio: Provided there is a base of self-employment, a TP may deduct commuting expenses and can apportion them on a reasonable basis.

MNR v Eldridge 1964 Ex Ct

Onus on TP to prove expenditures, whether they are legal or illegal

Facts: Eldridge carried on a very classy call girl operation in Vancouver; however, due to the cuming and going nature of her business, she alleged she kept no books of account or similar records. However, detailed records of her income and expenditures were found when she was changed under the Criminal Code

Issue: Are expenses from an illegal business activity tax deductible under s. 18(1)(a)?

Held: Yes, for Eldrige…could deduct expenses where she could provide receipts as evidence of an expense
Analysis: She had a lot of various expenses that were both deductible and not deductible:
(a) Rent for apartment deductible but not utilities
(b) Bribes to official not deductible only because she didn't keep receipts of liquor purchases
(c) Legal fees to defend girls from charges deductible because she kept the girls available for work and were part of the contract of employment
(d) Fees paid by cheque to the pimps hired to protect the girls were deductible
(e) Money she used to purchase all the issues of a newspaper that contained a story scandalous to her business was not deductible because no evidence would've been detrimental to her business

Ratio: Expenses incurred to earn income in illegal businesses are deductible if receipts are provided as evidence of the expenditures

65302 British Columbia Ltd v Canada 2000 SCC
Deducting fines not against public policy

Facts: TP corporation operated an egg producing poultry farm, and deliberately produced over the quota to maintain a major customer until it could purchase additional quotas at an affordable price. BC Egg Marketing Board then assessed the over-quota levy on the TP.

Issue: Are fines legally deductible as a business expense?

Held: Yes, for TP…not contrary to public policy

Analysis: Allowing TPs to deduct expenses for a crime would appear to frustrate the Criminal Code, but tax authorities are not concerned with the legal nature of an activity. Therefore, the same principles should apply to deduction of fines incurred for getting income. Otherwise, would introduce uncertainty into tax system's self-assessment process. ITA already specifies some fines/penalties that are not deductible (ie: bribes to public officials), and it's up to Parliament to include others if it wishes. Concurring J: criminal fines are not tax deductible, as they are meant to be a deterrent, but since this was an egg marketing board, it was OK

Ratio: Common law position is that statutory and non-statutory fines/penalties are deductible.

Canada v Bronfman Trust 1987 SCC
Interest payments deductible if borrowed funds directly

Facts: Phyllis Bronfman wanted payment out for her share in a trust; however, at the time, the market value of the portfolio was low, so T's decided to retain investments and borrow money to pay her. This way the portfolio was preserved and they didn't have to liquidate the trust's capital assets. T's then wanted to deduct the interest portion of the payment to the bank. CRA disagreed, arguing that the direct use of the loan was used to pay back B, not to earn income, so the interest payments shouldn't be tax-deductible. CRA admitted it would've been fine to pay out B and then borrow money to replenish the trust, as that would've constituted direct use of the funds rather than indirect use.

Issue: Is the interest paid to the bank only deductible when the loan is used directly to produce income? Or can TPs deduct interest payments if the loan indirectly preserves income-producing assets that might otherwise have been liquidated?

Held: For CRA, in this case the interest was not deductible

Analysis: Form v. substance: T's argued that substance of the transaction allowed for deductibility, but Dickson J. for the majority focused on the form of the transaction. Onus on TP to trace borrowed funds to an identifiable use that triggers the deduction. Therefore, if TP commingles funds used for a variety of purposes only some of which are eligible, he/she may not be able to claim the deduction, ie: uses equitable rule of tracing from trusts and applies it to tax law. If trust had sold the income-producing asset, paid B, and repurchased the same asset within a brief interval of time, court might've considered it a sham to conceal essence of transaction (ie: that money was borrowed and used to fund a payment to a B from the trust)

Ratio: Despite the fact that it can be characterized as indirectly preserving income, borrowing money for an ineligible direct purpose ought not to entitle a TP to deduct those interest payments

Singleton v Canada 2002 SCC

Interest payments deductible if direct link between loan and eligible use

Facts: Partner of Singleton Urquhart held $300,000 in a partnership capital investment account at the firm. He wanted to use money to purchase a house, following Bronfman, instead of borrowing money to buy the house, he sold the portfolio, bought the house with proceeds of sale, put mortgage on house, and replenished the funds in the capital account, thus making the mortgage interest tax-deductible. Following Dickson J's dicta in Bronfman, CRA said the transaction was a sham, as it was completed in one day and the borrowed money was used to finance purchase of the home.

Issue: Was the borrowed money used for the purpose of earning income from a business and deductible?

Held: Yes, for Singleton – loan and mortgage was genuine

Analysis: Test: following Shell Canada, Court notes that s. 20(1)(c)(i) has 4 elements:
(a) Interest must be paid in the year or be payable in the year sought to be deducted
(b) Amount must be paid pursuant to a legal obligation to pay interest on borrowed money
(c) Borrowed money must be used for purpose of earning non-exempt income from bus/property
(d) Amount must be reasonable, as assessed by reference to the first 3 requirements

Therefore, focus of the inquiry isn't the borrowing per se, but the TP's purpose in using the money. **The direct use to which the TP put the borrowed money is the main consideration of the court. Motive is irrelevant – if TP admits to using to structuring scheme for tax purposes, no factor.** Here, Singleton used borrowed funds to refinance the partnership capital account. Absent a sham, the TP need not demonstrate a bona fide purpose. Therefore, s. 20(1)(c) applied

TS: strict equitable tracing is not required; all that is required is a direct link between borrowing money and eligible use…if direct link is discovered, the interest is tax deductible.

Ratio: TP's motive or bona fide purpose is not relevant in categorizing whether the borrowed money was used for the purpose of earning non-exempt income from business or property; all that is needed is a direct link between the borrowed money and eligible use.