COMMENTS
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Deductibility of Expenditures: A Liberal and Fair Approach

Canadian Income Tax legislation has always contained expressed or implied limitations or restrictions respecting the deduction of "capital" expenditures. These limitations are an exception to the general rule of computing income for tax purposes, which is that an expenditure is deductible in the year incurred and to the extent it has been incurred to earn income, as implied in section 9 of the present *Income Tax Act*,[1] and specifically stated in paragraph 18(1)(a) of the Act. On the other hand, it is the scheme of the *Income Tax Act* to permit the deduction or amortization of certain types of capital expenditures made to acquire a capital asset of a depreciable or deteriorating nature to be used in the process of earning income from either a business or property.

The *Income Tax Act* does not provide (and has never provided) any specific definition[2] of "capital receipt" (or capital gain) or "capital expenditure".

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[1] R.S.C. 1952, c.148, as amended from time to time, esp. by S.C. 1970-71-72, c.63 (hereinafter referred to as the present Act).

[2] However, despite the general recognition that the *Income Tax Act* does not contain any definition of capital gain or expenditures, officials of the Department of National Revenue have recently contended that para.39(1)(a) does constitute a definition of "capital gain" and that the definition is to the effect that a capital gain includes any profit not otherwise required to be included in the computation of income of the taxpayer. Para.39(1)(a) reads as follows:

"(1) For the purposes of this Act,

(a) a taxpayer's capital gain for a taxation year from the disposition of any property is his gain for the year determined under this subdivision (to the extent of the amount thereof that would not, if section 3 were read without reference to the expression 'other than a taxable capital gain from the disposition of a property' in paragraph (2) thereof and without reference to paragraph (b) thereof, be included in computing income for the year or any other taxation year) from the disposition of any property of the taxpayer other than

(i) eligible capital property,

(ii) property, any amount receivable by the taxpayer for the disposition of which is required to be included in computing his income for the year by virtue of section 59, or

(iii) a life insurance policy within the meaning of section 138 (except an annuity contract), or

(iv) a timber resource property;"

The absence of statutory guidance with respect to "capital expenditures" obliged the courts to establish various tests which, until recently, have been considered to be almost statutory law.[3] For instance, Eugene Labrie[4] pointed out in 1965 that the fundamental test formulated by Viscount Cave in *British Insulated and Helsby Cables*[5] was being used so often that the dictum was almost considered to be a statutory pronouncement. Viscount Cave formulated the test for determining capital expenditures in the following terms:

> But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.[6]

Accordingly, unless the "capital" expenditure comprised a "depreciable" property (and was thus deductible within the provisions

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However, the interpretation of the nature of para.39(1)(a) as constituting a definition appears untenable since it implies that certain types of transactions when carried out by a resident of Canada would form part of ordinary income (as opposed to capital gain), but in the hands of a non-resident would comprise capital gain. The reason for this turns on the interrelationship of the provisions of s.3, s.39 and s.115 of the *Income Tax Act*. In the case of a resident earning income from any source, including trading profits wherever earned, this income must be brought into account for tax purposes within the provisions of s.3.

However, in the case of a non-resident, business activities are not brought into account unless either the business activities are carried out in Canada or the business activities comprise a sale of certain types of Canadian property known as "taxable Canadian property" within the provisions of s.115. Accordingly, where a resident engages, for example, in land trading on a speculative basis, the gain (within the criteria established in the past by the courts) would be a trading gain fully included in income under the provisions of para.3(a) and not a capital gain, only half of which is to be included in income pursuant to the combined provisions of para.3(b) and ss.38 and 39. Where, however, a non-resident carries on a similar business but outside of Canada and with respect to Canadian land, the theory put forward by certain tax authorities is that since the person is not carrying on a business in Canada, and thus is not to be taken into account for Canadian income tax under para.3(a), then it is deduced within the terms of para.39(1)(a) that the trading gain not otherwise included in income becomes a capital gain. In this view since the transaction is with respect to Canadian land, it is subject to Canadian tax as a capital gain, despite the fact that the gain is clearly on trading account and not on capital account within the extensive Canadian jurisprudence on the subject.

[3] As outlined below, the statutory basis for prohibiting the deduction of "capital expenditures" is set forth in s.18 of the *Income Tax Act*, *supra*, f.n.1.

[4] Labrie, *The Principles of Canadian Income Taxation* (1965, CCH Canada), 193.

[5] *British Insulated and Helsby Cables* v. *Atherton* [1926] A.C. 205.

[6] *Ibid.*, 213.

of the capital cost allowance system of the *Income Tax Act* and Income Tax Regulations), the application of Viscount Cave's fundamental test led to the result that some expenditures, at least prior to 1972, even if incurred to earn income, were not at all deductible in computing income. However, the amendments to the *Income Tax Act* brought in by Tax Reform in 1971 concerning eligible capital expenditures partly cured this inequitable result.[7] In addition, the Canadian courts have recently applied the fundamental test(s) for determining capital expenditures in a much more liberal and fair manner. In particular, the decision of the Supreme Court of Canada in *M.N.R.* v. *Algoma Central Railway*[8] originated the liberal trend which led to the decision of the Exchequer Court in *Canada Starch*,[9] extending the ambit of deductibility of expenses so as to include expenditures which previously would have been categorized as outlays on account of capital. The *Canada Starch* decision had an impact on subsequent related decisions such as *Bowater*,[10] *Elias Rogers*,[11] *Canadian Glassine*,[12] *Automatic Toll Systems*,[13] *Aluminium Company of Canada*[14] and *M.P. Drilling Limited*.[15]

Under the present Act, all expenditures incurred to earn income are deductible in one way or another. The importance of characterizing the expenditure remains, however, in light of the fact that eligible capital expenditures, *e.g.*, an expenditure to acquire goodwill, are not fully deductible: Only half of the amount is allowed as a deduction in the computation of the income of a taxpayer pursuant to paragraph 20(1)(a) and paragraph 14(5)(a) of the Act, and then at the modest rate of 10% per annum on the declining balance basis. In addition, the timing of the deductibility is still important, as a current expenditure would normally be fully deductible in the year incurred, whereas a depreciable capital expenditure would be written off over a period of years.

In addition to section 9, subsection 18(1) provides the rules for deductibility of an expense in computing the income of a taxpayer:

S.18 General limitations

(1) In computing the income of a taxpayer from a business or property, no deduction shall be made in respect of:

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[7] Para.20(1)(b) and s.14.

[8] 68 D.T.C. 5096 (S.C.C.); 67 D.T.C. 5091 (Ex.).

[9] *Canada Starch Company* v. *M.N.R.* 68 D.T.C. 5320 (Ex.).

[10] *Bowater Power Co. Ltd.* v. *M.N.R.* 71 D.T.C. 5469 (F.C. T.D.).

[11] *The Elias Rogers Co. Ltd.* v. *M.N.R.* 73 D.T.C. 5030 (F.C. A.D.).

[12] *Canadian Glassine Co. Ltd.* v. *M.N.R.* 74 D.T.C. 6089 (F.C. T.D.).

[13] *Automatic Toll Systems (Canada) Ltd.* v. *M.N.R.* 74 D.T.C. 6060 (F.C. T.D.).

[14] *Aluminium Company of Canada* v. *The Queen* 74 D.T.C. 6408 (F.C. T.D.).

[15] *M.P. Drilling Limited* v. *M.N.R.* 74 D.T.C. 6343 (F.C. T.D.).

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;

(b) an outlay, loss or replacement of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part;

Therefore, an expenditure will be fully deductible and on a current basis when:

1. it has been made for the purpose of gaining or producing income; and
2. it is not capital in nature.

Generally speaking, a current expenditure would be deductible in the year in which it is incurred. On the other hand, an expenditure giving rise to a lasting advantage would normally be considered as a capital expenditure in light of the test laid out by Viscount Cave, referred to above. However, in the *Tower Investment*[16] case, Collier J. of the Federal Court of Canada, Trial Division, concluded that advertising expenses incurred in one year could be spread and deducted over three years since the benefit to be derived from such an advertising campaign would extend over more than one year. The Court referred to the principle arising from section 9 of the *Income Tax Act* to the effect that general accounting and business principles should be relied upon in computing profit of a business (and applied the accounting theory of matching revenues and expenses), unless expressly prohibited or modified by provisions of the statute.

Before discussing the distinction made by the courts between current and capital expenditures, consideration should be given to the meaning of the words "for the purpose of gaining or producing income". An expenditure will be deductible only if it is regarded as having been incurred for the purpose of gaining or producing income. At one point, there was a school of thought advocating that an expenditure should be deductible only to the extent that a taxpayer could prove that it actually produced income.[17] This interpretation was rejected by the Exchequer Court in *Royal Trust* v. *M.N.R.*[18] where Thorson P., as he then was, expressed the following criteria for deductibility of an expense:

1. the expenditure incurred is usual and appropriate to the particular commercial enterprise being conducted as deterined by other similar expenditures in the same industries; and

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[16] *M.N.R.* v. *Tower Investment Inc.* 72 D.T.C. 6161 (F.C. T.D.).

[17] See Eugene Labrie's discussion of some of the different views as to the meaning of para.[18(1)(a)], *supra,* f.n.4, 159-170.

[18] *Royal Trust* v. *M.N.R.* 57 D.T.C. 1055 (Ex.).

2. the taxpayer's intention and purpose for incurring the expenditure is to realize a profit.

To the extent that this intention can be demonstrated, the actual results of the transaction are not of prime concern.

In addition to the above mentioned criteria, the Supreme Court of Canada in *B.C. Electric Co. Ltd.* v. *M.N.R.*[19] had postulated a *prima facie* presumption that any expenditure incurred in the course of carrying on a business is for the purpose of gaining or producing income: "The main purpose of every business undertaking is presumably to make a profit".[20]

The criteria established in the *Royal Trust* decision and the presumption arising from the decision of the Supreme Court in *B.C. Electric* has been followed regularly so that an expenditure will be disallowed only when it is shown to the court that the expenditure has been motivated by considerations other than profit, that the expenditure reduces artificially the income of the taxpayer[21] or that the expense would be unreasonable.[22]

Once it is established that the expenditure has been incurred "for the purpose of gaining or producing income", it must then be categorized either as a current or a capital expenditure. As was indicated, if it is a current expenditure, it will normally be fully deductible in the year in which it is incurred. However, in exceptional circumstances, the expenditure may be spread over more than one year, as was found in the *Tower Investment*[23] case and in *Canadian Glassine Co. Ltd.* v. *M.N.R.*[24] If the expenditure is of capital nature, it will be deductible either under the capital cost allowance rules[25] or the eligible capital expenditure rules.[26] In either case, the expenditure may also be restricted or entirely prohibited by specific provisions of the Act, such as the thin capitalization rules of subsection 18(4) and the restrictions for land speculators of subsection 18(2).

It is mainly with respect to expenditures incurred either to preserve a capital asset or in the course of operating an ongoing and

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[19] *B.C. Electric Co. Ltd.* v. *M.N.R.* 58 D.T.C. 1022.

[20] *Ibid.*, 1027 *per* Abbott J.

[21] See, for example, *Shulman* v. *M.N.R.* 61 D.T.C. 1213, [1961] Ex. C.R. 410; and *Susan Hosiery* v. *M.N.R.* 69 D.T.C. 5278 (Ex.).

[22] See s.67 of the Act and also *No.511* v. *M.N.R.* 58 D.T.C. 307, where the Court reduced an expense of $22,500 to $5,000 on the basis that the expense was unreasonable.

[23] *Supra*, f.n.16.

[24] *Supra*, f.n.12.

[25] Para.20(1)(a) of the Act and Part XI of the Income Tax Regulations.

[26] Para.20(1)(b) and s.14.

established business that the courts in recent years have broadened the concept of "current expenditure" to include expenditures which would have been thought to come within Viscount's Cave famous dictum. The breakthrough in this respect came from President Jackett (as he then was) in *Canada Starch Co.* v. *M.N.R.*[27] While dealing with an expenditure to settle an infringement of trademark, Jackett P. expressed the more liberal approach in the following terms:

> ... in distinguishing between a capital payment and a payment in current account, in my view, regard must be had to the business and commercial realities of the matter.[28]

Such a liberal and seemingly fair approach by the courts culminated in the decision of the Federal Court of Canada, Trial Division, in *Aluminium Company of Canada Ltd.* v. *The Queen.*[29] In that case, the Court was concerned with the deductibility of a payment of $1,447,000 by Alcan to its Jamaican subsidiary, Aljam, as a retroactive price adjustment on the price of alumina sold by the Jamaican subsidiary to the Canadian company. The evidence revealed that such a retroactive price adjustment arose from a tax settlement between Jamaica and Aljam, which was agreed upon by the latter in order to maintain good relations with the Jamaican Government and therefore preserve a source of supply. Mr Justice Heald cited the Exchequer Court decision of *Canada Starch Co. Ltd.* v. *M.N.R.*[30] and concluded that the expenditure "was incurred in the process of operating a profit making organization and, as such, was an expenditure on revenue account".

Despite the fact that the ultimate goal may have been to preserve a source of supply, a capital asset, the Court nevertheless concluded that the expense was deductible. Such a conclusion is indeed evidence of the more liberal approach recently adopted by the courts in considering the deductibility of expenditures.

It is possible that the courts may modify this trend as a result of the new eligible capital expenditure rules. However, in view of the rather limited relief provided by these rules, taxpayers undoubtedly will continue their efforts to have expenditures categorized as being of a "current" rather than a "capital" nature.

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[27] *Supra,* f.n.9.
[28] *Ibid.,* 5325.
[29] *Supra,* f.n.14.
[30] *Supra,* f.n.9.
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