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Liberalized Expense Deductibility — Whither the Capital Outlay ?

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Some years ago Mr. Heward Stikeman called attention to a striking development in income tax jurisprudence — *The Vanishing Capital Gain.*[1] As he and other commentators have perceived, our tax tribunals, while paying lip service to the classical criteria for identifying the capital receipt, have in fact substantially expanded the scope of revenue receipts and correspondingly narrowed that of capital receipts, so that at one point it seemed that the tax-free capital gain might vanish altogether as a matter of case law, without any statutory capital gains tax. More recent decisions, however, have established that there still remains a definite, though restricted, place for the capital gain, which has not and probably will not vanish completely without legislative intervention.[2] The focus of discussion has now shifted from analysis of the existing case law on capital versus revenue receipts to a debate on the merits of imposing a capital gains tax by legislation.[3]

The purpose of this article is to consider whether we are witnessing, by the superimposition of recent statutory amendments upon a more liberal jurisprudence, an analogous development on the deduction side of the income tax coin. The old restrictive judicial approach to deductibility of business expenses seems to have been

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1 Richard De Boo Limited (1956).

2 See, *e.g.*, *Irrigation Industries Ltd.*, 62 DTC 1131 (Sup. Ct. Can.), and *Valclair Investment Co. Ltd.*, 64 DTC 5014 (Ex. Ct.).

3 See, *e.g.*, Robertson, *Capital Gains — to Tax or Not to Tax,* 13 Can. Tax J. 355 (1965).

discarded by almost all of the recent decisions on expense deduction of the Supreme Court of Canada and the Exchequer Court, and a more reasonable approach to deductibility has gained a foothold even in the Tax Appeal Board.[4] It may now be said with somewhat greater confidence than a few years ago that the former and unlamented "profit-earning process" test of deductibility is either dead or rapidly dying;[5] and a more careful judicial regard for the actual language of paragraphs (a) and (b) of section 12(1) of the Income Tax Act, together with a more realistic view of the relation between business outlays and business revenues, has led at least our higher tax tribunals to recognize that almost any business outlay is made "for the purpose of gaining or producing income" within section 12(1)(a) and that the real issue, in most deductibility cases, is whether the expenditure is a capital outlay under section 12(1)(b).[6] The old view that paragraphs (a) and (b) were two sides of the same coin, or negative and positive ways of saying the same thing, has been rejected, and the annulment of the marriage between these provisions has led to an expanded range of deductibility.[7] Recent deductibility cases have tended to concentrate on the capital outlay question, and here too a more liberal approach can be detected.[8]

In addition to these case-law developments, the formerly impregnable citadel of the capital outlay has been assaulted as well by a number of recent amendments to section 11 of the Income Tax Act. Until last year, the most important of such amendments were section 11(1)(cb), on expenses of issuing shares or borrowing money; section 11(1)(*ia*), on convention expenses; section 11(1)(qb) & (qc), on tuition fees; and section 11(1)(w), on expenses of objecting to or appealing an income tax assessment. At a later point we shall consider the further additions to section 11 included in the 1965 amendments to the Act.

All of these amendments have proved welcome to Canadian businessmen and their tax advisers and have removed some of the

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[4] See, *e.g.*, *Evans*, 60 DTC 1047 (Sup Ct. Can.); *Royal Trust Co.*, 57 DTC 1055 (Ex. Ct.); *Sorin*, 64 DTC 62.

[5] See K. E. Eaton, *The Death of the "Profit Earning Process Test"*, 5 Can. Tax J. 271 (1957).

[6] See a recent analysis of the problem by Gibson J. in *Johnston Testers Ltd.*, 65 DTC 5069, 5074 (Ex. Ct.).

[7] See Harris, *The Annulment of a Marriage*, 9 Can. Tax J. 370 (1961).

[8] See, *e.q.*, *Johnston Testers Ltd.*, note 6 *supra*; *cf.* *B.P. Australia Ltd.* v. *Comm'r of Taxation*, [1965] 3 All E. R. 209 (P.C.), noted 13 Can. Tax J. 493 (1965).

anomalies and hardships that flowed from the combination of (a) a prima facie prohibition in section 12(1)(b) against deduction of capital outlays and (b) a restricted range of capital outlays that qualify for capital cost allowance under Part XI of the Income Tax Regulations. From this situation arose the notorious "nothings" — outlays that were not currently deductible because they were of a capital nature and that were not deductible in subsequent years because they did not qualify for capital cost allowance. The existence of these "nothings" has led to considerable criticism of our income tax system. Thus, Gwyneth McGregor has noted —

> A business expenditure that is made or incurred for the purpose of gaining or producing income is no less a cost of doing business because it is not attached to depreciable property; and it is difficult to see what possible justification there is for the continued existence of the nothings.[9]

Professor W. G. Leonard, who has written frequently on this subject, has pointed out that —

> All expired costs that were laid out for business purposes should logically be deductible from the revenue of *some* year or years in which the costs have contributed to the revenue-earning process.[10]

As yet, the income tax administration has not seen fit to accede to the many representations made to it over the years to introduce broad legislation that would sweep the "nothings" out of our tax closet. The (Carter) Royal Commission on Taxation has heard many recommendations along these lines;[11] and it is naturally hoped and expected by those who find the existence of these "nothings" to be unpalatable that when the Commission's long-delayed reports appears, it will contain simple and straightforward proposals (which the government could not afford to ignore) that will do away with the "nothings". It seems fair however, to point out that the "nothing" category has already been shrinking, through a process of both judicial and legislative attrition; this legislative attrition has even accelerated during the past year — when for the most part the federal government had been content to "hold the line" on tax reform, pending release of the Carter

[9] McGregor, *More Ado About Nothings*, 12 Can. Tax J. 268, 271 (1964).

[10] Leonard, in *Legal* vs. *Accounting Principles in the Courts*, Can. Tax Foundation, Proceedings 12th Tax Conf. 362, 371 (1958). See also Leonard, *Income Determination for Tax Purposes*, 7 Can. Tax J. 240 (1959); Leonard, *A Jumble of Alien Rules*, 8 Can. Tax J. 328 (1960); *Accounting* v. *Tax Income*, Can. Tax Foundation, Proceedings 16th Tax Conf. 350 (1962); A. K. Eaton, *Where Angels Fear to Tread*, 7 Can. Tax J. 432, 446-47 (1959).

[11] See Royal Commission on Taxation, Summary of Public Hearings 268-77 (CCH 1964).

Report. In this atmosphere, the significance of the recent statutory changes may not have been fully appreciated.

Judicial attrition of the "nothings" has mostly taken the form of narrowing the scope of capital outlays — which are prohibited deductions under section 12(1)(b) unless expressly permitted elsewhere in the Act. Thus, outlays made to maintain or preserve capital assets or to reduce expense or made in connection with an illegal activity, which were treated as "nothings" under the earlier case law, are now being held deductible.[12] To the extent that these former "nothings" are no longer held to be capital outlays, they are deductibe in full in the year in which made or incurred, and so the question of claiming capital cost allowance on the outlay does not arise. Occasionally, however, the "nothing" category has contracted because of a more liberal judicial interpretation of the capital cost allowance rules; as a result some capital outlays that were formerly treated as result some capital outlays that were formerly treated as "nothings" are now held to be depreciable, though still not currently deductible, for income tax purposes.[13]

Similarly, legislative attrition of the "nothings" has taken place almost exclusively by permitting current deduction of what might otherwise be capital outlays rather than by expanding the classes of capital outlay that qualify for capital cost allowance. An interesting exception, however, is found in the provisions of section 11(17), added in 1965, which permits a taxpayer to elect 10% straight-line depreciation of outlays that otherwise would qualify for current deduction under section 11(1)(aa), also added in 1965. These provisions will presently be discussed more fully.

1965 Amendments to Section 11

It is proposed now to consider some of the implications of the 1965 amendments to section 11 of the Income Tax Act that extend the deductibility of business outlays. Under section 11(1)(y), a taxpayer may deduct.

> ... an amount, that would not otherwise be deductible, paid by the taxpayer in the year to a person with whom he was dealing at arm's length for the cancellation of a lease of property of the taxpayer leased by him to that person.

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[12] See, *e.g.*, *Dole Refrigerating Products Ltd.*, 60 DTC 416; *Bedford Overseas Freighters Ltd.*, 59 DTC 1008 (Ex. Ct.); *Espie Printing Co. Ltd.*, 60 DTC 1087 (Ex. Ct.).

[13] See *Weinberger*, 64 DTC 5060 (Ex. Ct.), reversing 60 DTC 322; *Lions Equipment Ltd.*, 64 DTC 35.

As in the case of the other 1965 amendments to be considered, this amendment requires that the deduction be claimed in the year in which the amount is *paid*, even though the Act elsewhere contemplates use of the accrual method, under which the timing of recognition of expenses is related to when the expense is incurred rather than when it is paid. [14] It is not clear why these new provisions should make the cash method mandatory in accounting for these outlays. [15] Perhaps the Taxation Division would argue that these are artificial deductions anyway, allowed as a matter of legislative grace, and that it is much easier for the administration to keep track of them if they are accounted for on a purely cash basis; in fact, however, these outlays are not artificial but legitimate business expenditures, and the administrative problem is no greater here than for other expenses.

Unfortunately, section 11(1)(y) is subject to several further limitations, which render the scope of its relief quite narrow: (1) the payment must be made in an arm's length transaction, so that under non-arm's-length leases, even cancellation payments that are fair and reasonable in the circumstances do not qualify; (2) the payments must be made to cancel a lease and not a license, franchise, or other similar contractual arrangement that does not technically qualify as a lease, though the provision is broad enough to include leases of personal or movable property as well as leases of real or immovable property; (3) the property that is leased must belong to the taxpayer and not some third party, and thus payments to cancel a sublease made by the lessee to the sublessee may not be deductible under this provision; [16] (4) the cancellation payment must be made by the lessor to the lessee and not vice versa. Because of the frequency of and economic justification for cancellation payments made to secure the early termination of leases and similar contractual arrangements, none of the foregoing limitations seem desirable; government revenues are amply protected by the provisions of section 12(2), which restrict any expense deduction to an amount that is reasonable in the circumstances.

Yet the fact that an outlay fails to meet one or more of the limitations in section 11(1)(y) does not necessarily mean that it is

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[14] See section 12(1)(a) of the Income Tax Act, and see generally Harris, *When to Deduct?*, 13 Can. Tax J. 536 (1965).

[15] The same is true of section 11(1)(w), added in 1964.

[16] In view of the very broad definition of "property" in section 139(1)(ag), a leasehold interest would seem to be property of the lessee, and it may be argued that a sublease is "a lease of property of the taxpayer" under section 11(1)(y).

nondeductible. Under the liberalized case law referred to earlier, many outlays of this nature are now being held to be currently deductible. Indeed, in defending the restriction of deductibility under section 11(1)(y) to payments by lessors, the former Minister of Finance stated that such payments by lessees are now being allowed;[17] but if this is the administrative practice, why not codify it in the Act ? In the present state of the case law, *some* cancellation payments by lessors and *some* cancellation payments by lessees are deductible, if they are not capital outlays under section 12(1)(b);[18] others would be capital outlays and nondeductible.[19] There seems to be no more justification for legislating in the one case than in the other. In contrast with the new legislation, which tends to be artificially narrow, there is scope under our case law for recognizing similarities and differences of principle; thus, our courts will apply the same general criteria of capital expenditure to cancellation payments by lessors and by lessees, to payments made to cancel leases, subleases, licenses, and franchises, and to situations where the parties do and do not deal at arm's length. Fortunately the new provision does not preclude deductibility under the case law; but the opportunity was missed to eliminate much of the remaining uncertainty in the case law and to do away with the former "nothings" in the area of contract cancellation payments; most of these "nothings" will still survive.

On another occasion I attempted to summarize the case law on deductibility of payments to cancel contracts, as follows —

> It is difficult to extract from the decided cases a clear-cut criterion for determining whether a payment made to cancel a contract is a capital one. It seems, though, that one or more of the following factors are being treated as relevant: (1) the total duration of the contract; (2) perhaps, the remaining term of the contract at the time it is cancelled; (3) whether the contract is central to the payor's business, in the sense that the business would be very different without the contract — or, as the courts sometimes unhelpfully put it, whether the contract is part of the payor's "fixed capital"; (4) what the payor is paying for; this is a question of the parties' intention, which would make relevant a consideration of matters such as the amount of the payment.
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> ...If a payment made [by the lessee] to obtain cancellation of a long-term lease is intended simply as an additional rental payment to give

[17] See Hansard, June 25, 1965, p. 2850.

[18] A cancellation payment made by a lessee was held deductible in *A. Leon Co. Ltd.*, 61 DTC 517.

[19] Thus, a payment by a lessee for the privilege of surrendering a long-term lease was interpreted as having been made for the purpose of partially going out of business and was held to be a capital outlay in *Mallett* v. *Staveley Coal & Iron Co. Ltd.*, [1928] 2 K.B. 405, 13 T.C. 772 (C.A.).

the lessor time, without loss of revenue, to find another lessee on equally attractive terms to the lessor, the payment seems to be of the nature of rent and should be deductible; if, on the other hand, the payment is designed to compensate the lessor for loss of an advantageous long-term investment, particularly where his chances of re-renting the premises on equally attractive terms appear doubtful, the payment could be said to have been made to get rid of an "onerous capital asset" and therefore to be on account of capital. [20]

This analysis seems to be supported by the Exchequer Court in *Johnston Testers Ltd.* v. *N. R.*, [21] where a licensee was held entitled to deduct a large sum paid by it to cancel a license that still had 15 years to run, on the ground that the payment was in lieu of, and based upon, the royalties that would have been payable if the license had run its course. Decisions of the Tax Appeal Board have not been uniform on deductibility of cancellation payments made by lessors; [22] cancellation payments *received* by lessors have frequently been held to be revenue rather than capital receipts. [23] Some cancellation payments made by licensors have been held not deductible, [24] and this hardship will not be relieved by section 11(1)(y). Thus the new amendment will not simplify the law or remove all the anomalies in it; all that can be said is that section 11(1)(y) will contribute in a small degree to the liberalizing tendencies already evident in the case law.

Section 11(1)(z) now permits a taxpayer to deduct

...an amount paid by the taxpayer in the year for the landscaping of grounds around a building or other structure of the taxpayer that is used by him primarily for the purpose of gaining or producing income therefrom or from a business.

This is a very useful provision, because hitherto landscaping expenses have been considered part of the cost of the land and therefore nondepreciable capital outlays. [25] Again, however, some unfortunate limitations are imposed: (1) the amount must have been paid in the year; (2) "landscaping" is not defined but might not extend to clearing, draining, or supporting land, to reclaiming land under water, or to protecting land against flooding or erosion; (3) the

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[20] Harris, in *Income Tax Workshop*, Can. Tax Foundation, Proceedings 18th Tax Conf. 138, 147 (1964).

[21] Note 6 *supra*.

[22] *Cf. Schafran*, 54 DTC 497, and *Dyment Ltd.*, 57 DTC 492, with *Shuchat*, 61 DTC 119.

[23] *Farb Investments Ltd.*, 59 DTC 1058 (Ex. Ct.); *Grader*, 62 DTC 1070 (Ex. Ct.); *MacDonald*, 64 DTC 91.

[24] *Mandrel Industries Inc.*, 65 DTC 5142 (Ex. Ct.) — an unsatisfactory decision.

[25] *Oriole Park Fairways Ltd.*, 56 DTC 537.

phrase "*around* a building or other structure" requires that there be a building or other structure and suggests that the landscaping must be in proximity to it, but it is not clear how far from the building the landscaping may go and still qualify under this provision; (4) the building or other structure must belong to the taxpayer, though, paradoxically, the land being landscaped need not; (5) the building must be primarily devoted to an income-earning use, so that where, for example, a portion less than 50% of the value of the building is devoted to an income-earning use and therefore qualifies for partial capital cost allowance under section 20(6)(e), no part of the landscaping costs would be deductible. There is not much chance for landscaping costs to be deductible apart from section 11(1)(z), unless, of course, the taxpayer is a dealer in land, so that the landscaping constitutes an addition to inventory cost.

Under section 11(1)(aa), a taxpayer may deduct

> ...an amount paid by the taxpayer in the year as or on account of expenses incurred by him in making any representation relating to a business carried on by him,
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> (i) to the government of a country, province or state or to a municipal or public body performing a function of government in Canada, or
>
> (ii) to an agency of a government or of a municipal or public body referred to in subparagraph (i) that has authority to make rules, regulations or by-laws relating to the business carried on by the taxpayer,
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> including any representation for the purpose of obtaining a licence, permit, franchise or trade mark relating to the business carried on by the taxpayer.

Section 11(17) permits a taxpayer who qualifies for a deduction under section 11(1)(aa) to elect instead to amortize the deduction equally over the ten-year period commencing in the year in which the amount in question was paid. If as outlay allowable under either of these provisions results in the acquisition of a patent, franchise, concession, or license for a limited period or of other depreciable property, the outlay is deemed by section 20(10) to have been granted as capital cost allowance and therefore is subject to recapture under section 20(1) on resale of the depreciable property; however, some strange results can be anticipated in attempting to combine section 11(17) and section 20(10).

Again there are some important limitations: (1) subject to the possibility but doubtful advisability of using section 11(17), the outlay must have been paid in the year in which the deduction is claimed; (2) if the representation is made to a senior level of government or its agency, the government may be anywhere, but if the representation is made to a municipal or public body or its agency, it must be in Canada — a particularly unfortunate and unnecessary limitation; (3) the representation must relate to a *business* carried on by the taxpayer, so that, for example, the costs of attempting to secure a change in municipal zoning for the benefit of an existing or projected rental-producing property of the taxpayer would normally not qualify, whereas similar costs relating to a taxpayer's place of business, if in Canada, would qualify; (4) the meaning of the terms "agency" and "public body" is not clear, so that it is debatable whether costs of making representations to a crown corporation such as a government-owned public utility would be deductible under this provision.

Notwithstanding these limitations, however, section 11(1) (aa) is startlingly broad in scope and should greatly expand deductibility in an area in which "nothings" have heretofore abounded. The full extent of this provision seems not to have been generally realized: it is easy to be misled by the specific reference in the paragraph to representations relating to licenses and the like into concluding that the listed categories exhaust the scope of the permissible deduction; but this is not the case: the listed items are merely included for greater certainty. So pervasive is government regulation of business today and so frequent (and sometimes expensive) are the contacts between business and the various levels of government and their agencies, bureaux, and departments, that it would be impossible to list all of the other circumstances to which this provision may extend. Yet a few instances may be cited to indicate its importance.

Lawyers and public accountants were somewhat pleased in 1964 when the addition of section 11(1) (w) to the Income Tax Act permitted taxpayers to deduct costs of objecting to and appealing an income tax assessment, thereby in many cases cutting in half the burden to clients of paying their professional fees in this somewhat restricted field. They should be even happier that their fees are now also deductible when they negotiate or dispute with income tax or other tax authorities — whether federal, provincial, or local — on tax matters affecting a client's business, regardless of whether an assessment has been issued and whether a formal objection or appeal has been or will be instituted. It has been particularly embarrassing in the past for the tax consultant to have to admit to his client in many cases that his own fees were not deductible.[26] The provisions of section 11(1) (aa) are probably broad enough to extend to the costs of research or other homework

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[26] The classical case on the former state of the law was *Smith's Potato Estates Ltd.* v. *Bolland*, [1948] A.C. 508, 30 T.C. 267 (H.L.).

preparatory to making a submission to government; though if research is done and an opinion is rendered but no representations ensue, the new paragraph will be of no help. Costs of making submissions to public utility boards and similar ratemaking bodies will now be deductible; and, for the first time,[27] business expenses incurred in attempting to bring about changes in legislation or governmental regulations (including the tax laws) may be deducted, if they involve representations to governmental bodies or public officials; but taxpayers will still encounter difficulties with expenses incurred in trying to influence public opinion to bring about a change in legislation or regulations.[28]

There is no requirement that the representations be successful for their cost to be deductible. It remains to be seen, however, whether expenses of "representation" can extend to the costs of seeking a long-term government contract or to bribes paid to public officials. Under the previous law, expenses of representation were and still are deductible if not of a capital nature, but most representations to governments and related bodies were treated as capital outlays. Consequently section 11(1)(aa) is of considerable interest, though an effort should be made to remove its ambiguities.

Under section 11(1)(ab) a taxpayer may deduct

> ...an amount paid by the taxpayer in the year for investigating the suitability of a site for a building or other structure planned by the taxpayer for use in connection with a business carried on by him.

Here again, (1) the amount must be paid in the year in which the deduction is claimed; and (2) the projected building must be connected with the taxpayer's business and not, for example, intended to be leased to another where the earning of rental income does not constitute a business of the taxpayer's. This, too, is a useful and welcome provision as far as it goes, since most such outlays have been treated as "nothings",[29] though in special circumstances the expenses of investigating a building site might have been depreciable under the previous law.[30] It should be noted that no building need actually be erected as a result of the investigation; if one *is* erected, there is no provision comparable to section 20(10), deeming the

[27] See *Arrco Playing Card Co. Ltd.*, 57 DTC 1227 (Ex. Ct.); No. 489, 58 DTC 95.

[28] See, *e.g.*, *Kitchener Hotels Ltd.*, 62 DTC 127; but *cf. Morgan* v. *Tate & Lyle Ltd.*, [1955] A.C. 21, 35 T.C. 406 (H.L.).

[29] *Newfoundland Light & Power Co. Ltd.*, 58 DTC 711.

[30] See Harris, in *Income Tax Workshop*, Can. Tax Foundation, Proceedings, 18th Tax Conf. 138, 152-53 (1964).

investigation expenses to be capital cost allowances for purposes of subsequent recapture.

Finally, the farmer has not been neglected, because by section 11(16),

> ... there may be deducted in computing a taxpayer's income for a taxation year from a business that is farming, amounts paid by him in the year for clearing land, levelling land or laying tile drainage for the purpose of carrying on the farming business.

The scope of the deduction here permitted seems broader than that permitted under section 11(1)(z) in relation to the landscaping of grounds, and it is not necessary here that the land be associated with any building. Yet (1) here, too, the amount must have been paid in the year; and (2) the deduction is confined to persons in the farming business. The new provision will be welcome to farmers, because this kind of outlay can be expensive and in the past has been held to be a "nothing".[31] The former Minister of Finance has declared that in practice the costs of open ditching are allowed as current deductions;[32] for the sake of certainty and completeness, however, this kind of outlay should also be included in the legislation.

Is the Capital Outlay Vanishing ?

Is the capital outlay then vanishing ? Do we need but a few well chosen words from the Carter Commission to put section 12(1)(b) into limbo ? Certainly one of the most knowledgeable authorities on this matter, the late Dr. A. K. Eaton, would have heartily approved. In his view,

> ... the only practical solution would seem to be, first, of all to establish in law the *general principle* of full deductibility for all capital expenditure in the taxation year in which they were incurred, and second to legislate exceptions to this general rule and *require* (not merely allow as at present) amortization of certain named items through capital cost allowances..."[33]

This recommendation seems to have much merit. Whatever integrity the system of capital cost allowance may once have had in postponing but not ultimately denying the deduction of expenditures that gave

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[31] *McDonald*, 50 DTC 149.

[32] Hansard, June 25, 1965, p. 2851.

[33] A. K. Eaton, note 10 *supra*, at 443. A somewhat more cautious approach is recommended in McGregor, note 9 *supra*, at 273, where it is suggested that current deduction be permitted of all capital outlays less than a certain amount, say $1,000, and that an arbitrary capital cost allowance class be provided for all the rest.

rise to a long-term advantage has been substantially eroded in recent years by the growing tendency to grant rapidly accelerated capital cost allowance as a tax incentive and by the recent amendments to section 11, which arbitrarily confer full current deductibility upon various kinds of capital outlay that in principle have little or nothing in common.

While we should continue to strive for, and obviously still need, considerable improvement in the law of expense deduction for income tax purposes, we should not ignore the substantial progress — both judicial and legislative — that has taken place in recent years. Certainly the capital outlay has far from vanished from our tax law; but it will be interesting to observe, while the proposals of the Carter Commission are being debated, digested, and translated into legislation, how liberally the 1965 amendments will be interpreted and applied in practice.