TAXATION

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I. INTRODUCTION

The following survey is not intended to be a comprehensive analysis, but rather to inform the reader as to the general concept and to illustrate some of the major tenants in relation to our tax system. It has been attempted to substantiate statements with case authority or reference to particular sections of the Income Tax Act. As tax is one of the fastest moving areas in our law today, it will be necessary for the reader to update any statements contained herein in order to ascertain if changes have been made either by statute or case law. In future articles on this subject, the author will deal more extensively with particular areas of our tax law and recent changes which have a wide import.

Generally speaking, federal income tax is imposed on individuals and corporations resident in Canada. The amount subject to tax is their total world income. In the case of non-residents only their Canadian income is taxed by federal authorities.

II. RESIDENCE

The concept of "resident" is a nebulous one and a difficult one to define.

A. *Individuals*

There have been statutory modifications superimposed upon the common-law concept of residency as it applies to individuals, so as to deem a person a resident of Canada if he sojourned in Canada for a period of 183 days or more in a taxation year.[1] In addition, a person is resident in Canada if, at the relevant time, he was "ordinarily resident" in Canada.[2] This latter concept seems to imply that physical presence is not essential in certain circumstances in order for a person to be resident for tax purposes. In a factual situation not involving "a sojourn of 183 days or more" or "ordinarily resident" the common law of residence applies. A distillation of the cases indicates that the prime test promulgated by the courts centres around the

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[1] CAN. REV. STAT. c. 148, § 139(3)(*a*) (1952) *as amended* [hereinafter cited Income Tax Act]. For the convenience of the reader, and in view of the numerous amendments to the Income Tax Act, §§ are cited from the C.C.H., CANADIAN INCOME TAX ACT (38th ed. 1969).

[2] Income Tax Act, § 139(4).

concept of where a person's ordinary or habitual mode of living indicates his residence to be.[3] Such factors as where the individual's family is located; what "ties" he has established in the form of bank accounts, club membership, employment and so on; the reason for his being physically located in a particular area (*i.e.*, was this a temporary transfer by his company for a specified purpose?); have been used by the courts in ascertaining whether or not a person is resident. There is no one criterion which can be applied that will answer in every case the question of whether a person is resident in Canada. In each fact situation many factors must be considered none of which is in itself the sole test. Mr. Justice Rand in *Thomson v. Minister of National Revenue*[4] states:

> The graduation of degree of time, object, intention, continuity and other relevant circumstances, shows, I think, that in all common parlance "residing" is not a term of invariable elements, all of which must be satisfied in each instance. It is quite impossible to give a precise and inclusive definition. It is highly flexible, and its many shades may vary, not only in the contexts of different matters, but also in different aspects of the same matter. In one case it is satisfied by certain elements, in another by others, some common, some new.

B. *Corporations*

The common-law concept of residency of corporations has been substantially modified by statute.[5] Under the statutory modifications, a corporation shall be deemed to be resident in Canada throughout a taxation year if it was incorporated in Canada after April 26, 1965 and, if it was incorporated prior to April 27, 1965, it was incorporated in Canada and carried on business in Canada. For practical purposes, this deemed residency covers most of the corporate situations. However, there are certain factual situations which do not fall within the above definition. In these cases, the common law as it relates to the residency of corporations applies.[6] The common-law concept of central management and control is the dominant theme in this area. Where the corporation's "real control" is exercised is where its residence will be. Such "real control" is normally exercised from the place in which the directors reside and hold their meetings.

It is clear that both individuals and corporations may have more than one residence at the same time. Therefore, by showing that an individual or corporation is in fact resident in one country will not preclude him from being found to be a resident in another country. The liability for tax on income of residents of Canada is found in section 2(1) of the Income Tax Act which states that "an income tax shall be paid as hereinafter required

[3] Thomson v. Minister of National Revenue, [1946] Can. Tax Cas. Ann. 51; Beament v. Minister of National Revenue, [1952] Can. Tax. Cas. Ann. 327.

[4] [1946] Sup. Ct. 209, at 224, 2 D. Tax Cas. 812, at 815.

[5] *See* Income Tax Act, § 139(4a).

[6] *See* De Beers Consol. Mines, Ltd. v. Howe, [1906] A.C. 455; Unit Constr. Co. v. Bullock, [1960] A.C. 351 (1959); Crossley Carpets (Canada) Ltd. v. Minister of National Revenue, 21 D. Tax Cas. 522 (Tax App. Bd. 1967).

upon the taxable income for each taxation year of every person resident in Canada at any time in the year." The word "person" includes a body corporate as well as the heirs, executors and other legal representatives of a person.[7]

C. *Non-Residents*

Non-residents who carry on business in Canada are liable for income tax on the profit derived therefrom. A non-resident is deemed to have carried on business in Canada if he produced, grew, mined, created, manufactured, fabricated, improved, tacked, preserved, or constructed anything in Canada or solicited orders or offers to anything for sale in Canada through an agent or servant.[8] Whether or not a non-resident is carrying on business in Canada is a question of fact. Some factors to be considered in ascertaining whether or not business is being carried on are as follows:

(1) Is there an identifiable trading centre in Canada—this could be an office, plant, or even mailing address which is habitually used;

(2) Are goods or stock in trade maintained in Canada;

(3) Are commercial contracts habitually made in Canada on behalf of a non-resident;

(4) Is any manufacturing or major altering of the stock in trade carried on in Canada.

If tax is exigible upon income earned in Canada by a non-resident, there is a withholding tax of fifteen per cent on every amount paid or credited to the non-resident.[9] The onus is upon the payor to withhold this fifteen per cent tax and remit it to the Canadian authorities. Failure to do this may result in the payor being liable for payment of the tax.

III. Computation of Income

The sources of taxable income for residents of Canada are enumerated in section 3 of the Income Tax Act. These include: (a) income from a business, (b) income from property, and (c) income from offices and employments. Section 3 states that it is the world income of the Canadian resident which is taxed. Therefore, if income arises from any of the above sources outside of Canada it will be taxed by the Canadian authorities. Double taxation is avoided by the use of tax treaties. In the situation where income was earned by a Canadian resident in a country other than Canada and with whom Canada does not have a tax treaty the possibility of double taxation on such income is a real one. Canada has tax treaties with the following countries: United States, The United Kingdom, Australia, Denmark,

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[7] Income Tax Act, § 139(1)(*ac*).
[8] Income Tax Act, § 139(7).
[9] Income Tax Act, § 106.

Finland, France, Ireland, Japan, The Netherlands, New Zealand, Norway, South Africa, Sweden, Tobago and Trinidad and West Germany.

A. *Business Income*

The word "profit" is used to describe what is taxable in relation to business income. This connotes gross receipts minus expenses incurred to earn those income receipts. Normally, businesses are required to file on an accrual accounting basis; however, professional businessmen, farmers and fishermen are allowed to file on a cash basis. Accompanying the return must be a statement of profit and loss which reflects the current year's income tax return.

Included in the definition of "business" for income purposes is the concept of "an adventure or concern in the nature of trade" [10] which has the effect of broadening what will be considered to be taxable income from a business. This concept is borrowed from English tax law, and under it will be included activities which in the normal sense will not be considered trading but are considered to be "in the nature of trade." There is a great body of law surrounding the interpretation of these words and the facts of a particular situation will govern as to whether or not the activities concerned fall within the extended statutory definition.

It is particularly important in Canada to ascertain what constitutes income from a business due to the fact that capital gains are not taxed. If the profit is not a capital gain, it will be taxed as income from a business and the graduated personal rates will apply. The following criteria have evolved from various reported cases:

(a) *Isolated transactions*—If the transaction or activity is an isolated one, it is more likely to be classified as a capital gain than a recurring type of activity. However, the fact that it is an isolated transaction does not *per se* mean that it will be classified as a capital gain rather than a business activity. [11]

(b) *Intention*—Intention is also an important criterion in ascertaining whether an activity arises from a business or is a capital gain. If profit is realized upon the sale of an asset it is the intention of the owner at the time the asset was purchased which is of critical importance. If it was the intention of the purchaser to acquire this asset for investment purposes, the sale of the asset will result in a capital gain. If, however, the intention of the purchaser was of a speculative or trading kind, the profit realized upon the sale of that asset will be taxed. The so-called "doctrine of secondary intent" has arisen whereby the courts have imputed speculative or resale intent even though there is a primary intent of investment. If this secondary intent is in fact imputed by the courts to a particular transaction, the profits resulting from the sale will be taxable. [12]

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[10] Income Tax Act, § 139(1)(*e*).

[11] Taylor v. Minister of National Revenue, 10 D. Tax Cas. 1125 (Exch. Ct. 1956).

[12] Regal Heights Ltd. v. Minister of National Revenue, [1960] Sup. Ct. 902.

If a number of persons come together in order to purchase the asset and there is a trading intent evident in the partner who undertakes the prime responsibility in relation to the management and eventual sale of the asset, his intention will attach to the passive members of the partnership, and the gain realized upon sale will be taxed in their hands. [13]

(c) *Related Business Activity*—The closer the activity in question is related to the normal business activity of the taxpayer the more likely the gain realized will be taxed. If you have a real estate salesman or company attempting to stipulate that a particular block of land was not purchased in their normal course of business activity but was solely an investment, they will have a much higher onus of proof to satisfy than would a widow who has had no previous real estate business experience.

(d) *Subject Matter*—There are certain types of subject matter the purchase of which give rise to almost a prima facie presumption that they were acquired for trading purposes. The purchase of thousands of casks of brandy [14] or millions of yards of linen [15] was held to result in a taxable gain when sold due to the fact that in the court's opinion the only reason that such quantities of that type of material would be purchased was for the purpose of resale.

(e) *Organized Effort*—If the taxpayer purchases an asset and expends money or labour in order to make the asset more saleable, the courts may impute to him an initial resale intention dating from the time the asset was purchased, and hence when it is in fact sold, any profits would be taxable. [16]

(f) *Objects of a Corporation*—Where the taxpayer is a corporation and the question of whether or not the income arises from a business activity must be answered, the objects of the company may provide some indication as to whether the particular activity involved is of a business nature or not. The courts, however, are more concerned with what is, in fact, the business of the company, rather than what they might be able to do under their objects [17] because of the very wide and all encompassing type of objects which are normally used in corporations today. Their impact is less forceful where the court may discern what in fact the business of the company is. However, where this is unclear, the objects may be of more signficance in ascertaining whether a profit was from a business activity.

B. *Business Deductions*

The amount which is taxable as a result of income produced from a business is the "profit." Profit connotes gross receipts minus expenditures

[13] Minister of National Revenue v. Lane, 18 D. Tax Cas. 5049 (Exch. Ct. 1964).
[14] Cape Brandy Syndicate v. Inland Revenue Comm'rs, [1921] 1 K.B. 64 (1920).
[15] Martin v. Lowry, [1927] A.C. 312 (1926).
[16] Commissioners of Inland Revenue v. Livingston, 11 Tax Cas. 538 (Court of Session, Scotland 1926).
[17] Sutton Lumber & Trading Co. v. Minister of National Revenue, 7 D. Tax Cas. 1158 (1953).

outlaid in order to produce that income. In order to ascertain whether or not an expenditure is deductible for tax purposes one must ask four basic questions:

(a) *Commercial Practice*—If the expense is the type which is usually associated with that type of business and considered normal, in the sense of being usual, the initial step towards deductibility has been taken. As Mr. Justice Thorson stated in *Royal Trust Co. v. Minister of National Revenue*: [18] "Thus, it may be stated categorically that in a case under the *Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of section 12(1)(*a*) of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of section 12(1)(*a*) and, therefore, within its prohibition." [19]

(b) *For the Purpose of Gaining or Producing Income*—Having ascertained that the expense involved passes the commercial practice test, the next step is to ascertain if the expense was laid out for the purpose of gaining or producing income. The Income Tax Act states that no deductions shall be made for an outlay or expense except to the extent that it was made by the taxpayer for the purpose of gaining or producing income. The present wording of the statute allows expenditures to be deducted which were formerly prohibited under the wording of the Income War Tax Act. [20] The wording under the Income War Tax Act stated that in order for an expense to be deducted it must have been "wholly, exclusively and necessarily" laid out to earn income. The present wording is wider and hence allows more deductions. In reading jurisprudence on deductibility, one must be careful in assessing the value of cases relating to the Income War Tax Act.

Under older jurisprudence, it was thought that income must flow as the result of the expenditure. This view is no longer held. As Mr. Justice Thorson stated: "The view that an item of expenditure is not deductible unless it can be shown that it earns some income is quite erroneous. It was never necessary to show a causal connection between an expenditure and a receipt. An item of expenditure may properly be deductible even if it is not productive of any income at all and even if it results in a loss." [21]

(c) *Capital Expenses*—Having passed both the commercial practice test and the test that the expense is made for the purpose of gaining or producing income, a third test must be passed. No deduction may be made for a capital expense. [22] The classic test of a capital outlay is that proposed

[18] 11 D. Tax Cas. 1055 (Exch. Ct. 1957).
[19] *Id.* at 1060.
[20] Income Tax Act, § 12(1)(*a*).
[21] Imperial Oil Ltd. v. Minister of National Revenue, [1947] Can. Tax Cas. Ann. 353, at 371 (Exch. Ct.).
[22] Income Tax Act, § 12(1)(*b*).

by Viscount Cave in *British Insulated & Helsby Cables Ltd. v. Atherton*: [23] "[W]hen 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 expenditure as properly attributable not to revenue but to capital." [24] Ascertaining whether or not a particular expenditure is deductible has been a very troublesome question. The controversy in Canadian tax jurisprudence surrounding capital expenditures is due partly to a misquotation of the test stated by Viscount Cave. [25] Generally speaking, the more recent decisions tend to broaden the content of deductibility. [26] However, the confusion has a distressing habit of periodically reviving [27] and the facts of each case will be the determining factor.

(d) *Reasonableness*—If all the above tests have been satisfied one final test remains as to deductibility. This has to do with reasonableness. No expense which is unreasonable will be allowed as a deduction for tax purposes. [28] It is important to note, however, that only that portion of the expense which is unreasonable will be disallowed if the expense is otherwise allowable. An apportionment may be made between the reasonable amount, which will be deductible, and the unreasonable portion, which will not.

C. *Repairs, Replacements and Improvements*

Situations often arise wherein expenses are made and the question is whether an expense was incurred for the purpose of repairing an existing asset, which expense would be deductible, or replacing an asset, which renders the expense non-deductible. It is usually a matter of degree as to whether or not the expense is for a repair or a replacement. There are, however, some guidelines. If it is a substitution of a new asset for an old one, this, of course, will be a replacement. If, however, the monies were expended only to put the asset back in the same condition as it previously was, this will be classified as a repair. If, however, some new innovation is incorporated into the asset, this may have the effect of a replacement and not a repair. Such things as replacements of motors, elevators and boilers are normally not deductible. [29]

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[23] [1926] A.C. 205 (1925).

[24] *Id.* at 213-14.

[25] *See* Minister of National Revenue v. Dominion Natural Gas Co., [1941] Sup. Ct. 19 (1940).

[26] B.C. Electric Ry. v. Minister of National Revenue, [1958] Sup. Ct. 133; Evans v. Minister of National Revenue, [1960] Sup. Ct. 391; Premium Iron Ores Ltd. v. Minister of National Revenue, [1966] Can. Tax Cas. Ann. 391.

[27] Farmers Mutual Petroleums Ltd. v. Minister of National Revenue, 21 D. Tax Cas. 5277 (1967).

[28] Income Tax Act, § 12(2).

[29] *See* Minister of National Revenue v. Vancouver Tug Boat Co., 11 D. Tax Cas. 1126 (Exch. Ct. 1957); Canada Steamship Lines Ltd. v. Minister of National Revenue, 20 D. Tax Cas. 5205 (Exch. Ct. 1966).

D. *Expenses Specifically Allowed*

There are expenses appertaining to business and property income which are specifically allowed. These include: (a) Capital allowance,[30] (b) Depletion allowance,[31] (c) Interest on borrowed money used for the purpose of earning income,[32] (d) Bad and doubtful debts,[33] (e) Pensions and other similar contributions,[34] (f) Convention expenses[35] and (g) Scientific research.[36]

E. *Income From Property*

The second major source of income enumerated in section 3 of the Income Tax Act is income from property. Essentially, this covers such things as rental income, and returns on investments. Section 139 (1)(*ag*) defines property: "'Property' means property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatsoever, a share or a chose in action."

It is hard to envisage anything which in common parlance we would think of as being property which is not included in this definition. The deductions relating to property are very similar to those appertaining to a business, and, in fact, the word "profit" as used in section 4 applies to both business and property income. Whether the income arises from a business or property is a question of fact which must be determined in each individual case. For instance, if an individual owns one apartment block and derives rental income therefrom, it will in all probability be classified as income from property. However, if this same individual owns many apartment blocks he may be classified as carrying on the business of operating apartment blocks, and hence the income derived therefore would be from a business.

F. *Income From Office or Employment*

The third source of income as enumerated in section 3 is that relating to income from an office or employment. The taxing of this income is found in section 5 of the Income Tax Act. Remuneration from an office or employment includes "other benefits of any kind whatsoever . . . received or enjoyed by him in the year in respect of, in the course of, or by virtue of the office or employment."[37] This concept of benefits greatly widens the tax net as it relates to office or employment. Many of the so-called "fringe benefits" enjoyed by employees of corporations would be taxable

[30] Income Tax Act, § 11(1)(*a*).
[31] Income Tax Act, § 11(1)(*b*).
[32] Income Tax Act, § 11(1)(*c*).
[33] Income Tax Act, §§ 11(1)(*e*) and 11(1)(*f*).
[34] Income Tax Act, §§ 11(1)(*g*) and 11(1)(*h*).
[35] Income Tax Act, § 11(1)(*ia*).
[36] Income Tax Act, § 11(1)(*j*).
[37] Income Tax Act, § 5(1)(*a*).

under this provision. In ascertaining what type of "benefits" falls within this statutory enactment, it should be noted that only benefits arising from the taxpayer's position as employee are taxed in the hands of the recipient. For instance, a valid gift, not related to a person's occupation, does not fall within section 5. It is often very difficult to ascertain when a gift falls outside of section 5 and when a gift is given due to the fact that a person is an employee. In many cases, what appears to be a gift possesses an element of reward for services, and this element may be sufficient to stamp the apparent gift as income. The contrast between a personal gift and remuneration is well exemplified in the judgment of Lord Atkinson in *Calvert v. Wainwright*[38] which turns upon the assessability of "tips" given to a taxi driver: "The ordinary tip given in those circumstances would be something which should be assessable, but supposing at Christmas, or when the man is going for a holiday the hirer says: 'You have been very attentive . . . here is a £10 note', he would be making a present, and I should say it would not be assessable. . . ."[39]

It is often very difficult to determine whether or not a person is an employee. A good expression of the problem is to attempt to ascertain whether an amount, received by an individual, is received under an express or implied contract for *service* which would result in it being classified as remuneration to an employee or is it received under an express or implied contract for *services* which would result in it being classified as income from a business or profession. The question depends on whether or not a master-servant relationship exists between payor and payee. This is a question of fact which must be determined according to the evidence adduced. This concept is rather pointedly brought out in *Abrahams v. Minister of National Revenue*[40] where, despite an admission by counsel for the Minister of National Revenue that the taxpayer was not an employee, President Jackett found otherwise. He stated:

> I might make this comment, however, that a discussion of these issues assumes an air of fantasy and unreality when all the evidence points to the conclusion that the appellant directed the operations of the sales organization that I referred to earlier as an employee of the company while the appellant takes the position and the respondent concedes, that he did so as an independent contractor. In these circumstances, it would seem that this might be a case where the evidence and the admission made by the counsel for the Minister cannot stand together, in which event, the admission should be taken as being made under a misapprehension and it is the duty of the Court to have regard to the real facts as shown by the evidence.[41]

One of the best statements of the criterion relating to a determination as to whether an individual is under a master-servant relationship is found in *Di Francesco v. Minister of National Revenue*[42] where Mr. Fordham,

[38] [1947] 1 K.B. 526.
[39] *Id.* at 528-29.
[40] 20 D. Tax Cas. 5453 (Exch. Ct. 1966).
[41] *Id.* at 5462.
[42] 34 Tax App. Bd. Cas. 380 (1964).

quoting from Halsbury's *Laws of England*, states:

> A servant (employee) acts under the direct control and supervision of his master, and is bound to conform to all reasonable orders given him in the course of his work; an independent contractor, on the other hand, is entirely independent of any control or interference, and merely undertakes to produce a specified result, employing his own means to produce that result . . . . To distinguish between an independent contractor and a servant, the test is whether or not the employer retains the power, not only of directing what work is to be done, but also of controlling the manner of doing the work.[43]

The evaluation of benefits is often extremely difficult. The best general statement relating to this area is found in the English case of *Wilkins v. Rogerson*[44] where an employer arranged with a tailor to supply each of his employees with a suit of clothes as a Christmas present. The cost to the employer of the taxpayer's suit was fourteen pounds fifteen shillings. On appeal the employee conceded that he had received a taxable benefit but maintained that its value in terms of money's worth was the price which he could have sold the suit in the open market if he had sold it immediately after he had received it. It was agreed this price was five pounds due to the fact that it should be classified as a second-hand suit the moment it was delivered. On appeal, the court held that the five-pound value was the measure of the benefit rather than the cost to the employer providing the suit. The court said in part:

> The only controversy was whether he was to pay tax on the cost of that prerequisite to his employer or on the value of it to him, and it appears to me that this prerequisite is a taxable subject-matter because it is money's worth. It is money's worth because it can be turned into money and, when turned into money, the taxable subject-matter is the value received. I cannot, myself, see how it is connected directly with the cost to the employer . . . . The taxpayer has to pay on what he gets. Here he has got a good suit. He can realise it only for £5. The advantage to him is, therefore, £5. The detriment to his employer has been considerably more, but that seems to me to be irrelevant . . . ."[45]

G. *Deductions re Income from Office or Employment*

It is of critical importance to ascertain whether or not income is derived from office or employment or from property or business in relation to deductible expenses. Deductible expenses for income derived from office or employment are very much curtailed in that the Income Tax Act, after including employment income as taxable income, states "minus the deductions permitted by paragraph (*i*), (*ib*), (*q*) and (*qa*) of sub-section (1) of section 11 and by sub-section (5) to (11) inclusive, of section 11 *but without any other deductions whatsoever*."[46] Therefore, no deductions whatsoever are

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[43] *Id.* at 384.
[44] 39 Tax Cas. 344 (Ct. of App., England 1960).
[45] *Id.* at 353.
[46] Income Tax Act, § 5(1)(*b*) (emphasis added).

allowed against employment income except those specifically enumerated in section 5. The type of deduction enumerated in section 5 relates to such things as contributions to pension plans, legal expenses relating to collection of salary, clergymen's residences, teachers' benefit funds and employees' travelling expenses. It is obvious that this type of expense allowed under section 5 does not have the same breadth of application as the expenses allowed in relation to business or property income.

H. *The Arms Length Concept*

In order to stop artificial tax minimization amongst members of a family, the Income Tax Act has provisions by which persons or corporations which are related to one another are prevented from taking advantage of this situation in their business dealings so as to avoid tax liability. Such dealings are said to be "not at arms length." If a taxpayer carrying on business in Canada has purchased anything from a person with whom he is *not* dealing at arms length at a price in excess of the fair market value, then the fair market value is deemed to have been paid for the purpose of computing the income of the business. [47] Similarly, if a taxpayer carrying on business has sold anything at less than fair market value, the fair market value shall be deemed to have been received in computing the income of the business. [48]

Arms length is defined in section 139(5*a*), 139(5*b*) and 139(6). The following persons are deemed *not* to be dealing at arms length: (a) persons connected by blood relationship, marriage or adoption, (b) a corporation and the person or persons who control it either directly or indirectly, (c) two corporations controlled by the same group of related persons.

I. *Taxation of Trusts*

A trust is taxed for income purposes as a separate person. Of course, it does not have the personal exemptions that an individual has; however, the income accruing to a trust is taxed on a separate individual base. A trust has an option with respect to the amount on which it will be taxed. It is taxed only on the amount of income which it retains during the taxation year, and any amounts which are in fact distributed to the beneficiaries of the trust will be taxed in the beneficiary's hands. It may, therefore, be seen that in a discretionary trust if the trustee elects to distribute part of the income to the beneficiaries and retain part of the income in the trust the most advantageous tax position may be obtained. Due to the graduated rates of tax, the overall effect of tax on the total income will normally be less if a partial distribution is made. This, of course, will not be true if the beneficiaries to whom the income is passed are in a very high tax bracket.

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[47] Income Tax Act, § 17(1).
[48] Income Tax Act, § 17(2).

J. *Personal Corporation*

A personal corporation is entirely the creature of the Income Tax Act. A personal corporation is one which was controlled by individuals resident in Canada and which derived at least one-quarter of its income from investments and did not carry on an active financial, commercial or industrial business.[49] Normally, a corporation is taxed as a separate entity on its income. However, a personal corporation is not taxed as a separate entity, and the income which it generates is taxed in the hands of its shareholders. At the end of the corporation's taxation year there is a dividend deemed to have been distributed to its shareholders.[50] For tax purposes, the dividend is not deemed to have been distributed in the proportion of the shareholdings but rather in the proportion of the capital contributed to the corporation. It must be emphasized that in all other aspects a personal corporation is the same as any other incorporated body. It is only for tax purposes that a difference arises.

K. *Taxation of Partnerships*

A partnership is not taxed as a separate entity but the income of the partnership is allotted to each partner who must then pay tax on his allocation, whether or not he has in fact received or withdrawn the income.[51]

L. *Computation of Taxable Income of Individuals*

In computing an individual's income, one must, of course, account for income received from all the sources previously mentioned, *i.e.*, business, property, office or employment. From this figure, the taxpayer may deduct certain specific sums such as pension plan contributions, professional dues, union dues, registered retirement savings plan contributions, alimony or separation allowance. The amount remaining after the above deductions are made is the net income of the individual. From this net income, the individual may deduct his personal exemptions, medical expenses, charitable donations and business losses from other years applicable. The sum remaining after the deductions is his taxable income, which is the amount on which tax liability is calculated.[52]

The personal exemptions referred to above are in respect of marital status, the age of the taxpayer and dependents. The philosophy underlying these exemptions is that for every taxpayer there is a portion of his income which is entirely free of tax. The basic exemption for each individual is 1,000 dollars with the marital exemption being 2,000 dollars. In order to qualify for the marital exemption, the taxpayer must be legally married and supporting his spouse. The so-called "common-law marriage" does not with an increase in the amount of taxable income. The tax is calculated on

[49] Income Tax Act, § 68.
[50] Income Tax Act, § 67(1).
[51] Income Tax Act, § 6(1)(*c*).
[52] Income Tax Act, § 2(3).

qualify for the marital exemption. One further qualification is that the wife must not have earned a total income of over 250 dollars during the taxation year. If the spouse had an income of over 250 dollars, the taxpayer may claim only the basic exemption, and any income earned between 250 and 1,250 dollars will proportionately reduce the amount of the marital exemption.

The Income Tax Act provides for an exemption of 300 dollars for each child or grandchild fully dependent upon the taxpayer if such child or grandchild was qualified for family allowance and under twenty-one years old. If a dependent is twenty-one years of age or over and mentally or physically infirmed or in full-time attendance at a school or university, the exemption may also be claimed. If the child or grandchild otherwise qualifies but does not qualify for family allowance the exemption claimed is 550 dollars.

A taxpayer may also deduct an amount expended up to the maximum of 550 dollars for the maintenance of the parent or grandparent who is dependent upon the taxpayer for support by reason of mental or physical infirmity or a brother or sister under twenty-one or if older, dependent by reason of mental or physical infirmity, or who is in full-time attendance at a school or university. A person whose income exceeds 950 dollars is not a dependent.

There is an exemption of 500 dollars for every taxpayer who attains the age of seventy during the taxation year. This exemption also applies to a taxpayer who is sixty-five years of age and did not receive old age security during the year.

M. *Medical Expenses*

A taxpayer has the option of deducting the standard 100-dollar deduction in relation to medical expenses and charitable donations or, in the case of medical expenses, of deducting all medical expenses in excess of three per cent of his net income. To qualify, these expenses must be paid to a medical practitioner, dentist or nurse qualified to practise under the laws of the place where the expenses were incurred or to a public or licensed hospital. One may also deduct the wages of a full-time attendant or the cost of residing in a full-time nursing home if he or she is confined to a bed or a wheelchair by reason of physical or mental illness. A totally blind person may deduct the renumeration of a full-time attendant in excess of three per cent of his income.

N. *Charitable Donations*

In lieu of the 100-dollar standard deduction mentioned previously, a taxpayer may deduct amounts given to an approved charitable organization in Canada up to ten per cent of his net income.

The tax to be levied on the taxable income is set out in section 32(1) of the Income Tax Act. It is a graduated rate, the percentage increasing the income received by the individual during the calendar year and is payable on April 30 following the calendar year end.

O. *Income Tax on Corporations*

Except for a personal corporation, a corporation is taxed as a separate and distinct entity. A corporation is taxed on its profits at an effective rate of twenty-one per cent on the first 35,000 dollars of profits and fifty per cent on the excess. This tax is payable by the corporation which must file a separate return within three months of the end of its fiscal period. A corporation's fiscal period may be any twelve-month period that the corporation elects but once a period is elected it may not be changed without the consent of the Department of National Revenue. A corporation need not choose a calendar year for its fiscal period.

Where two or more corporations are controlled by the same person or group of persons they are deemed to be associated for the purposes of the Income Tax Act. The result of being associated is that the lower twenty-one per cent rate may not exceed 35,000 dollars for the entire group of associated companies. The group may file an agreement with the Department of National Revenue allocating a portion of the 35,000 dollars between various corporations in the group.

P. *Undistributed Income of Corporations*

When money is taken from a company by individuals it is normally taxable to the individuals. The normal methods of obtaining money from a corporation are by way of salary or dividends. A corporation, however, may elect to pay a special tax on its undistributed income.[53] If such an election is made, the corporation may pay a fifteen per cent tax on all undistributed surplus held by it up to the end of the 1949 taxation year and to pay a fifteen per cent tax on the undistributed income earned thereafter equal to the dividends distributed from time to time during that period. The undistributed income remaining after the payment of this tax is called tax paid undistributed income. This tax paid undistributed income may be distributed to the individual shareholders with no further tax being applicable by the company declaring a stock dividend to the amount of the remaining sum. If this stock dividend is in redeemable shares, these shares may then be redeemed by the company and the money given to the individual. A stock dividend is not taxed as a dividend because the Income Tax Act's definition of a dividend specifically excludes stock dividends.[54]

IV. Returns, Assessment and Appeals

A. *Returns*

Every individual or corporation who has taxable income must file an

[53] Income Tax Act, § 105.
[54] Income Tax Act, § 139(1)(*k*).

income tax return. The individual must file by April 30 and the corporation must file within six months from the end of its fiscal period.[55] If the Minister of National Revenue issues a demand every corporation or individual must file a return whether or not he is liable to pay tax.[56] Upon the death of an individual, his executor must file a return within six months from the date of death. A trust must file a return within ninety days from the end of the calendar year and an estate within ninety days from the end of the fiscal year.

Employers are under an obligation to withhold and remit to the Department of National Revenue a portion of their employees' wages. This portion is calculated according to tables which are supplied to every employer.

B. *Assessment of Tax*

The Department of National Revenue is charged with the prime responsibility of enforcing the tax laws in Canada. This is done under a two-tiered structure comprising of the head office staff which is situated in Ottawa and various district offices in all major centres across the country. All taxpayers file their returns in Ottawa and the so-called "quickie" assessment is made of every return at that time. This consists of a computer checking such things as arithmetical calculations, deductions and exemptions, salaries reported by the employee against the salaries reported by the employer with respect to that particular employee, and investment income reported by the taxpayer against such things as a T-5 form which is submitted to the Department of National Revenue by institutions such as banks informing them of interest paid. Any extraordinary increase or decrease in income over income reported in previous years is checked at this stage. After this cursory assessment is made, there is issued to the taxpayer involved an assessment which is referred to as the original assessment. Upon this being done, the tax returns are returned to the various district offices which are closest to the locale of the taxpayer. So far as time and manpower permit, a more detailed assessment is made of certain taxpayers and his affairs are examined closely. If the Department of National Revenue feel that there has been some error made in the original assessment, they may issue a re-assessment. They may issue this re-assessment at any time within four years of the date of mailing of the original assessment, and if there is any allegation of fraud or misrepresentation on the part of the taxpayer this re-assessment may be issued at any time. In addition to this re-assessment power, the minister has the power to levy additional interest or penalties with respect to any underpayment of tax. If the minister feels that incomplete information was supplied to him or in the cases where no return is in fact filed the minister has the power to issue an arbitrary assessment[57] which levies income tax on an amount which is the closest estimate to be made by the minister from the

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[55] Income Tax Act, § 44(1).
[56] Income Tax Act, § 44(2).
[57] Income Tax Act, § 46(6).

information available.

C. *Objection to Assessment*

The taxpayer who feels that an assessment or re-assessment is wrong may object to his assessment. He does so by serving a Notice of Objection on the minister in duplicate within ninety days from the date of the mailing of the Notice of Assessment. The Notice of Objection must set out the reasons for the objection being made and the relevant facts of the particular case. It must be in the form prescribed and signed by the taxpayer. Upon receipt of this Notice of Objection, the minister reconsiders the assessment made and may confirm, vary or vacate the assessment. For practical purposes, there is no time limit in which the minister must act when he receives a Notice of Objection.

D. *Appeal Procedure*

A taxpayer may appeal an assessment under two circumstances:

1. Where a taxpayer has sent a Notice of Objection and has received no communication in the form of a confirmation, variance or vacation of the assessment; any time after 180 days has elapsed, the taxpayer may issue a Notice of Appeal. This Notice of Appeal must set forth the relevant facts of the case and reasons for appealing and may be signed by the taxpayer or his legal representative.

2. Where the taxpayer has received a confirmation, or variance and is still not satisfied, he may within ninety days from the date of mailing of such a confirmation or variance issue a Notice of Appeal. If, however, he does not issue the Notice of Appeal within the prescribed ninety days he has no further remedies.

The taxpayer may also choose the forum in which his appeal will be heard:

1. Tax Appeal Board—The taxpayer may issue his Notice of Appeal to be heard before the Tax Appeal Board. If this is done, there must be a fifteen-dollar filing fee accompanying the Notice of Appeal and there are no costs awarded to either party by the board.

2. As an alternative, the taxpayer may issue his Notice of Appeal to the Exchequer Court, where costs may be awarded to the winning party by the court.

If the taxpayer has elected to have his appeal heard before the Tax Appeal Board, either party may appeal the decision of the Tax Appeal Board to the Exchequer Court. This appeal is a trial *de novo*. Witnesses are called, and neither the taxpayer nor the Department of Revenue is bound by the evidence adduced at the Tax Appeal Board hearing. Additional witnesses from those called at the Tax Appeal Board may be called, and certain witnesses may be deleted which were in fact called before the Tax Appeal Board.

An appeal lies from the Exchequer Court to the Supreme Court of Canada. This applies whether or not the taxpayer elected to appear before the Exchequer Court in his original Notice of Appeal or arrived at the Exchequer Court by virtue of an appeal from the Tax Appeal Board judgment.

Before either the Tax Appeal Board or the Exchequer Court the taxpayer may appear in person or be represented by counsel. In the Tax Appeal Board, there is no prerequisite that the agent of the taxpayer be a lawyer; however, there is such a prerequisite in the Exchequer Court. The Tax Appeal Board or Exchequer Court may dismiss the appeal, vacate the assessment, vary the assessment or refer the assessment back to the minister for reconsideration or re-assessment. If the amount in controversy exceeds 500 dollars either party has an automatic right of appeal to the Supreme Court of Canada;[58] however, where the amount in controversy does not exceed 500 dollars, leave must be obtained to appeal to the Supreme Court of Canada.[59]

V. White Paper on Taxation

At the time of writing, there has recently been issued a White Paper on proposed tax changes. This is a major revision of our tax law, and it may well result in considerable changes in relation to areas commented on earlier. However, the comments are a reflection of the present law, and at the present time there is no indication as to what in fact will be enacted by legislation with respect to the ideas contained in the White Paper. Further, the effect of the ideas contained in the White Paper will be subject to the actual wording of any legislation which comes in the future; it, therefore, is impossible at this time to predict with any degree of certainty how the present law will change. It is, however, incumbent upon the reader to modify his thinking if and when legislation appears with respect to the proposed tax reform.

[58] Exchequer Court Act, CAN. REV. STAT. c. 98, § 82 (1952).
[59] *Id.* § 83.