TAXATION

*F.D. Jones**

I. INTRODUCTION

Subsequent to the previous survey written by the author in 1970 there has been a major overhaul of the Canadian Income Tax Act with the additional introduction of a capital gains tax. This new Income Tax Act came into force as of January 1, 1972. As the previous survey indicated, this 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 new tax system. Naturally there is no case authority in relation to this new Income Tax due, of course, to its recentness and indeed there will be no jurisprudence on this new Act until after taxpayers are required to file their returns pursuant to its terms and assessments made in relation to them. For individuals this will be April 30, 1973, with the exception of deceased persons whose executors are required to file an income tax return from January 1, 1972 until the date of death; for corporations this will depend on their fiscal period. In future articles on this subject, the author will deal more extensively with particular areas of the new tax law and jurisprudence relating thereto. Generally speaking, the same format will be followed in this article as was followed in the survey published in the *Ottawa Law Review*,[1] and references will be made to the statements contained therein when no substantial change has been effected by virtue of the new legislation. It is hoped that by following the same format the reader will be able to correlate the old jurisprudence and concepts which are retained in the new Act and which were explained in the aforesaid article with those of the new Act.

II. RESIDENCE

A. Individuals

The comments contained in the previous survey article with respect to the residence of individuals are equally applicable under the new legislation. The extended meaning of residence to include a sojourn in Canada of a period of 183 days or more is contained in section 250 of the new Act. As before, a person is resident in Canada if, at the relevant time, he was "ordinarily resident" in Canada.[2] The jurisprudence surrounding the concept of a residence will remain applicable in determining residence problems

---

**B.A., 1956, University of Alberta; LL.B., 1959, Dalhousie, LL.M., 1960, University of Toronto. Professor of Law, University of Alberta

[1] Jones, *Annual Survey of Canadian Law: Taxation*, 4 OTTAWA L. REV. 255 (1970)

[2] Can. Stat. 1970-71 c. 63, § 250(3) [hereinafter cited Income Tax Act]

under the new Act. This prime test centres around the concept of where a person's ordinary or habitual mode of living indicates his residence to be. The quotation of Mr. Justice Rand, in *Thomson v. Minister of National Revenue*,[3] is applicable under the new Act as it was under the old. This quotation is as follows:

> 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 conclusive 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 others, some common, some new.

B. Corporations

As was the case for individuals, the concept of residence of corporations has not been changed under the new legislation. A corporation is 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.[4] While this covers most situations where a corporation does not fall within these limits, the common law rules of central management and control apply.[5]

As was the case under the old legislation, both individuals and corporations may have more than one residence at the same time. The liability for tax on income of residents of Canada is found in section 2(1) of the Income Tax Act which states: "an income tax shall be paid as hereinafter required 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.

C. Non-Residents

By virtue of section 2(3) "a person who is not taxable under subsection (1) for a taxation year

> (*s*) was employed in Canada,
> (*b*) carried on a business in Canada, or
> (*c*) disposed of a taxable Canadian property,

at any time in the year or a previous year, an income tax shall be paid as hereinafter required upon his taxable income earned in Canada for the year determined in accordance with Division D." The main difference under the new legislation from the old is the inclusion of "taxable Canadian property"

---

[3] [1946] Sup. Ct. 209, at 224, 2 D. Tax Cas. 812, at 815.

[4] Income Tax Act § 250(4).

[5] *See* De Beers Consol. Mines, Ltd. v. Howe, [1906] A.C. 455; Unit Const. 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).

as being subject to income tax when disposed of by a non-resident. Taxable Canadian property is defined in section 248(1) as meaning: "Taxable Canadian property has the meaning assigned by subsection 115(1) except that, for the purpose only of section 2 the expression 'taxable Canadian property' includes a Canadian resource property (within the meaning assigned by subsection 66(15)), any property that would have been a Canadian resource property (within the meaning assigned by subsection 66(15)) if it had been acquired after 1971, and an income interest in a trust resident in Canada."

The above will have its main application in the capital gain area in which non-residents will be subject to tax on capital gains realized on Canadian real estate, Canadian business assets, shares of private corporations and certain shares of public corporations.

In addition, the rate of witholding tax on income paid to non-residents is to be increased to twenty-five percent effective January 1, 1976, but it is expected that this rate will be reduced to fifteen percent by tax treaties. A number of types of income which were not formerly subject to withholding tax are now subject. Items to be taxed include pension benefits, Canada Pension Plan benefits, retiring allowances, payments from a registered retirement savings plan, payments under an income averaging annuity contract and other annuity payments subject to tax in the hands of a Canadian resident. Discounts and accrued interest earned by non-residents on certain short term money market transactions with Canadians are to be subject to withholding tax. As was the case under the old Act the onus is upon the payor to withhold the appropriate amount under the withholding tax provisions and to remit it to the Canadian authorities. Failure to do this may result in the taxpayer being liable for payment of the tax.

III. COMPUTATION OF INCOME

Traditionally, the courts have found three sources of taxable income for residents of Canada, namely: (a) income from a business, (b) income from property, and (c) income from office and employment. However, as was stated by the author in a paper presented to the Twenty-third Tax Conference of the Canadian Tax Foundation,[6] it may well be that under the new legislation a broadening of the tax net might exist due to the additional emphasis on the word "source." Until we have some jurisprudence on the subject no definitive answer can be given. However, Mr. Justice Gibson in *Wood v. Minister of National Revenue*[7] states:

> In the result therefore, I am of the opinion and found my decision on the grounds that the profit from this transaction was income from a "source" within the meaning of the opening words of section 3 of the Income Tax Act as judicially considered by Noel J. in *George H. Steer v. Minister of National Revenue* whether or not it was profit from a "business" within the meaning of section 139(1)(*e*) of the Income Tax Act or "interest" within the meaning of section 6(1)(*b*) of the Income Tax Act. In doing so, I am adopting for this purpose the economist's concept of income as described above.

[6] *See* CONFERENCE REPORT 221 (1971)

[7] 67 D. Tax Cas. 5045, at 5052 (Exch Ct 1966)

It is seen, therefore, that an item could be taxed as income even though it was not from the three traditional sources enumerated above (*i.e.*, office or employment, business and property). The *Wood Case* was appealed to the Supreme Court of Canada.[8] However, the Supreme Court did not deal with the concept of income from a "source" but found that the transactions involved constituted an adventure in the nature of trade and hence found the profits taxable as being derived from a business. Taxpayers and their advisors should be aware, however, that the word "source" as used in the new legislation, could expand the base of taxable income depending on how the courts will interpret the wording of the new legislation.

A. Business Income

One of the most contentious issues under the old Income Tax Act was to attempt to delineate between what was a capital gain and an income gain. This basic dilemma has not in any way been resolved under the new legislation. Hence the mountain of literature and jurisprudence which has arisen over the years relating to this topic is still applicable. The concept of "an adventure or concern in the nature of trade" has been carried forth in the new legislation[9] as being included in the definition of "business." The interpretation of these words and this concept is as difficult under the new legislation as under the previous legislation and the following criteria which have evolved through jurisprudence and which were mentioned in the author's previous survey[10] are still of critical importance.

(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 court to a particular transaction, the profits resulting from the sale will be taxable.[12]

---

[8] 69 D. Tax Cas. 5073 (Sup. Ct. 1969).

[9] Income Tax Act § 248(1).

[10] Jones, *Annual Survey of Canadian Law: Taxation*, 4 OTTAWA L. REV. 255 (1970).

[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 the 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 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 those types of materials 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 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 significance in ascertaining whether a profit was from a business activity.

B. Business Deductions

As was the case under the old Income Tax Act the word "profit" is used with respect to the amount of income produced from a business to be

[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] Commissioners of Inland Revenue v. Livingston, 11 Tax Cas. 538 (Court of Session, Scotland 1926).

[16] Martin v. Lowry, [1927] A.C. 312 (1926).

[17] Sutton Lumber & Trading Co. v. Minister of National Revenue, 7 D. Tax Cas. 1158 (1953).

included in the tax base. Profit connotes gross receipts minus expenditures outlaid in order to produce them. Therefore, it is important to ascertain what deductions are allowable in determining the profit. Here again there is little or no change with respect to the previous situation. The criteria are as follows:[18]

(a) *Commerical 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*:[19] "[T]hus 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*) (now 18(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*) (now 18(1)(*a*)) and therefore, within its prohibition."[20]

(b) *For the Purpose of Gaining or Producing Income*—Having ascertained that the expense involved passes the commercial 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.[21] 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 the 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.[22]

---

[18] *See* Jones, *Annual Survey of Canadian Law: Taxation*, 4 OTTAWA L. REV. 255, at 260 (1970).

[19] 11 D. Tax Cas. 1055 (Exch. Ct. 1957).

[20] *Id.* at 1060.

[21] Income Tax Act § 18(1)(*a*).

[22] Imperial Oil Ltd. v. Minister of National Revenue, [1947] Can. Tax Cas. Ann. 353, at 371 (Exch. Ct.).

(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.[23] The classic test of a capital outlay is that proposed by Viscount Cave in *British Insulated & Helsby Cables Ltd. v. Atherton*:[24] "[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 a 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."[25] 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.[26] Generally speaking the most recent decisions tend to broaden the content of deductibility[27] however the confusion has a distressing habit of periodically reviving[28] 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.[29] 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.

Under the new legislation there has been a number of items added to the income base. The most significant of these is one-half of capital gains which will be dealt with in greater detail later. In addition scholarships, fellowships, and bursaries will be included with a 500 dollars exemption. Contributions which an employer has made on behalf of his employees toward an income maintenance plan or public medical care programme will be included in the employees' income. Unemployment Insurance receipts will be taxable and the contributions to the fund will be deductible. The calculation of tax is simplified somewhat by the use of a single rate schedule which indicates a top rate of sixty-one point one percent cutting in at 60,000 dollars. The new legislation prevents the deduction of certain expenses such

---

[23] Income Tax Act § 18(1)(*b*)

[24] [1926] A.C. 205 (1925).

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

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

[27] B.C. Elec. 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

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

[29] Income Tax Act § 67

as membership dues in clubs, yachts, etc. from business income but justifiable entertainment expenses will be allowed and two conventions a year will be allowed if held within the territorial scope of the organization. There is included a new standby charge for employees or shareholders of a corporation who have the personal use of an automobile which is owned or rented by the employer or the company. This value must be added to his income. The minimum amount to be included in his income is the "reasonable standby charge" for each month that the vehicle is available for the personal use of the employee shareholder less any amounts that he has paid the employer/corporation for such use.[30] If the automobile is owned by the employer/corporation the reasonable standby charge per month will be one percent of the capital cost of the vehicle. If the automobile is rented the reasonable standby charge will be equivalent to one-third of the rental incurred by the employer/corporation during the period that the car was available to the employee/shareholder. This sort of benefit was taxable under the old legislation but the addition of a formula to determine the minimum taxable value of the benefit is an innovation.

C. Expenses Specifically Allowed

There are expenses pertaining to business and property income which are specifically allowed. These include: (*a*) capital cost allowance,[31] (*b*) depletion allowance,[32] (*c*) interest on borrowed money used for the purpose of earning income,[33] (*d*) bad and doubtful debts,[34] (*e*) pension and other similar contributions,[35] (*f*) convention expenses,[36] and (*g*) scientific research.[37] The foregoing were all allowable under the old legislation. In addition there are two deductions found in the new legislation which did not appear in the old. The first relates to moving expenses and will apply to a taxpayer who:

(*a*) having ceased to carry on business or be employed at a location in Canada or

(*b*) having ceased to be a student in full time attendance at a university in Canada moves from one residence in Canada to another residence in Canada and commences to carry on business or be employed at the new work location.[38] For the provision to apply the new residence must be at least twenty-five miles closer to the new work location than was the old residence. The provision will also apply in the case of a person moving in order to commence studies as a full time student at an educational institution of university level.

[30] Income Tax Act § 6(1)(*e*).
[31] Income Tax Act § 20(1)(*a*)
[32] Income Tax Act § 65(1).
[33] Income Tax Act § 20(1)(*c*)
[34] Income Tax Act §§ 20(1)(*l*), 20(1)(*o*), 20(1)(*p*)
[35] Income Tax Act §§ 20(1)(*q*), 20(1)(*r*), 8(1)(*m*)
[36] Income Tax Act § 20(10).
[37] Income Tax Act § 20(1)(*t*)
[38] Income Tax Act § 62(1).

Moving expenses are defined[39] as including expenses incurred on account of:

(*a*) travelling costs (including a reasonable amount expended for meals and lodging), in the course of moving the taxpayer and members of his household from his old residence to his new residence,

(*b*) the cost to him of transporting or storing household effects in the course of moving from his old residence to his new residence,

(*c*) the cost to him of meals and lodging near the old residence or the new residence for the taxpayer and members of his household for a period not exceeding fifteen days,

(*d*) the cost to him of cancelling the lease, if any, by virtue of which he was the lessee of his old residence, and

(*e*) his selling costs in respect of the sale of his old residence.

The legislation also provides a deduction for amounts paid by a taxpayer in the year on account of child care expenses in respect of the taxpayer's children.[40] In most cases the deduction will be claimed by a woman.

Child care expenses are defined in section 63(3) as meaning expenses incurred by the taxpayer for the purpose of providing in Canada, for any child of the taxpayer, child care services including babysitting services, day nursery services or lodging at a boarding school or camp if:

(1) the child was ordinarily in the custody of the taxpayer and under fourteen years of age or over fourteen years of age if dependent by reason of mental or physical infirmity,

(2) the services were provided to enable the taxpayer to perform the duties of an office or employment or carry on a business either alone or as a partner actively engaged in the business, and

(3) the services were performed by a resident of Canada other than a dependent of the claimant or his spouse or a person under twenty-one years of age and connected with the claimant or his spouse by blood, marriage or adoption.

The most serious limitation on this seems to be that the services in order to be deductible must have been performed to enable the claimant to perform the duties of an office or employment or to carry on a business. This would preclude a university student from claiming child care expenses.

A new deduction is allowed the individual (and only the individual) with respect to an income averaging annuity as defined in section 61(4)(*b*). This income averaging annuity applies to such receipts as any single payment received by the taxpayer in a year from a superannuation or pension fund or

---

39 Income Tax Act § 62(3)
40 Income Tax Act § 63.

retirement fund or employees profit sharing plan or deferred profit sharing plan; a payment or payments made by an employer to the individual as employee upon or after retirement in respect of loss of office or employment; and capital gains. The concept will be discussed at greater length under the heading of *Averaging Provisions.*

D. Income from Property

The second historical heading under which income is taxed is that of property. Essentially this covers such things as rental income and return on investments. However the definition of property as contained in section 248(1) defines property as meaning, "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."

The deductions relating to income from property are similar to those relating to business and from a practical standpoint there is little differentiation in this area.

E. Income from Office or Employment

The third traditional source of income is from office or employment. 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."[41] As was stated in the previous survey on taxation[42] "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 under this provision. In ascertaining what type of "benefits" fall 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 (now section 6) . . . the contrast between a personal gift and remuneration is well exemplified in the judgment of Lord Atkinson in *Calvert v. Wainwright*[43] which turns upon the accessibility of "tips" given to a taxi driver: "The ordinary tip given in those circumstances would be something which should be accessible, 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 accessible . . . ."[44]

It is often very difficult to determine whether or not a person is an employee. One of the best statements of the criterion relating to a determination as to whether an individual is under a master-servant relationship is

[41] Income Tax Act § 6(1)(*a*).

[42] *See* Jones, *Annual Survey of Canada Law: Taxation*, 4 OTTAWA L. REV. 255, at 262 (1970).

[43] [1947] 1 K.B. 526.

[44] *Id.* at 528-29.

found in *Di Francesco v. Minister of National Revenue*[45] where Mr. Fordham, quoting from Halsbury's *Law 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 free 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."[46]

F. Deductions re Income from Office or Employment

It is in the area of deductions that the critical importance arises as to whether or not the income generated is from employment or property or business. 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 that except for the specifically enumerated deductions no other deductions whatsoever may be made from this income. This is in direct contrast to the "profit" concept which applies to business income and property income. In addition to continuing, with minor modifications, the specific deductions allowed in determining employment income which existed under the old legislation, the new Income Tax Act includes provision for a general deduction available to all employees of three percent of annual employment income up to a maximum deduction of 150 dollars, a deduction for Unemployment Insurance contributions made and a deduction or credit for Income Taxes paid to a political subdivision of a foreign country in respect of employment in that country.

The new Income Tax Act increases personal exemptions for all individual taxpayers effective January 1, 1972. The basic exemption is increased to 1,500 dollars from the former 1,000 dollars and the marital exemption from 1,000 dollars to 1,350 dollars.

Medical expenses will continue to be deductible in determining the taxable income of individual taxpayers to the extent that such expenses exceed three percent of net income. The limit on the amount of deductible charitable donations is increased to permit the taxpayer to deduct donations made to qualified charities up to an amount equal to twenty percent of his net income.

G. Capital Gains

There is not technically speaking, a capital gains tax imposed under the new legislation if one defines such as being a "tax on capital gains." Rather one-half of capital gains are included as ordinary income of the taxpayer. As stated previously, the thorny question of determining what constitutes an income item and a capital gain is not resolved in the new Act. Under the new legislation one-half of a realized capital gain, and in some circumstances a deemed capital gain, will be taken into the taxpayer's income. If,

---

[45] 34 Tax App. Bd. Cas. 380 (1964).
[46] *Id.* at 384.

for instance, a taxpayer is in the fifty percent bracket this will result in a twenty-five percent tax on the gain. The amount of the gain is the difference between the disposition price and the taxpayer's adjusted cost base. The concept of an adjusted cost base is new and basically means the initial purchase price or value on Valuation Day plus or minus certain adjustments to that price which will reflect additional amounts expended or a return of capital invested. For instance, if a person buys real estate for 10,000 dollars and over a period of five years expends 2,000 dollars per year on taxes, an additional 1,000 dollars will be added and at the end of the five year period his adjusted cost base would be 11,000 dollars. If he then sells it for 15,000 dollars his capital gain will be 4,000 dollars, one-half of which would be included in his income. Conversely, if a person purchases shares for ten dollars each and there was a distribution by way of a capital dividend this will reduce the adjusted cost and so increase his potential capital gain.

As might be imagined there was considerable difficulty in formulating a plan by which the new capital gains system could go into effect. The basic tenant was that there should be no retroactive tax of capital gains. With this in mind two valuation days were announced. For public trade stocks it was December 22, 1971 and for all other assets it was December 31, 1971. All taxpayers must value their capital assets as of those dates and any appreciation subsequent to those dates would fall under the new system and be taxed upon disposition or deemed disposition. However, any capital appreciation which had accrued up to those dates would remain non-taxable assuming that the taxpayer was not "in the business" of dealing with those assets. In addition, there was an election given to individual taxpayers but not to corporations as to how they would be taxed on their future capital gains. The first alternative available to an individual taxpayer was to have his assets valued on the tax-free zone method. In this method three figures are required, the initial cost, the value on Valuation Day and the disposition price. One is to choose neither the greatest of nor the least of those three figures and use that as his initial adjusted cost base. The taxable portion of the gain was the increase over the greater of his initial cost or the value on Valuation Day. For instance, if a person purchased a stock in 1965 for ten dollars and on December 22, 1971 it was worth twelve dollars and he sold it for fifteen dollars the capital gain insofar as the new legislation is concerned would be three dollars. It is seen, therefore, that the appreciation of two dollars, which occurred prior to the implementation of the system, remains non-taxable.

The other method available for individuals is the Valuation Day method. Only two figures are required if one chooses this method namely the Valuation Day value and the disposition price. The capital gain is the difference between the two figures. If a taxpayer does not elect he is automatically put on the tax-free zone method and if that is not desired a positive election must be made by the taxpayer in order to come under the Valuation Day method. Once a taxpayer has chosen the method by which he wishes to be taxed it applies to all of his capital assets and he is not allowed to choose one method for a particular asset and another for a different asset.

One-half of capital losses are available for deduction purposes. If one chooses the tax-free zone method it is the difference between the lesser of the original cost or value on Valuation Day and the disposition price. If one chooses the Valuation Day method it is the difference between the value on Valuation Day and the disposition price. The following table will illustrate the tax consequences of choosing one system or the other. Generally speaking, if one's capital assets had all appreciated prior to the implementation of the system it would be better to choose the Valuation Day method in that a hedge against potential losses is built into that system. If however one's capital assets are generally below their original cost on Valuation Day it would be advantageous to choose the tax-free zone method. If, however, as would be the case in most instances, there was a mixture, an individual must then view his capital assets from an overall point and decide on balance what the best system would be.

	Tax Free Zone Method					Valuation Day Method				
Cost	10	12	10	15	15					
Val. Day Value	12	10	15	12	10	12	10	15	12	10
Disp. Price	15	15	12	10	12	15	15	12	10	12
Gain (Loss)	3	3	0	(2)	0	3	5	(3)	(2)	2

It should be emphasized that these elections only apply to property held by the taxpayer before the commencement of the system.

The general rule is that taxable capital gains are to be included in income in the year in which the disposition of property takes place. There are, however, a number of exceptions to this general rule. In certain circumstances a deemed disposition is said to have occurred. These circumstances are as follows: (a) The death of a taxpayer, (b) The making of a gift by a taxpayer, (c) The giving up of Canadian residence, (d) The granting of an option to purchase or sell property, (e) The expiry of an option, (f) The redemption or settlement of a debt, (g) The seizure by a creditor of property on which a debt is secured, (h) The change and use of property from income-earning to personal use and vice versa.

In addition there may be circumstances in which the full taxable gain will not be brought into income in the year of disposition. For example, if a person sells a piece of real estate and the terms are such that the proceeds of the sale are not all due in the year of the sale, an appropriate portion of the gain may be deferred until later years when the proceeds become due under the terms of sale contract. In addition, there are a number of circumstances in which capital gains or losses which would otherwise be taken into account in the year are deferred until a later time. Where a taxpayer receives proceeds of disposition as a result of an involuntary disposition such as the destruction or expropriation of property and expends an amount in acquiring a replacement property within one year all cost incurred by the taxpayer in obtaining replacement property will be taken into account in determining any capital gains. There are certain circumstances in which a roll over of the adjusted cost base of an asset disposed of may be permitted with no tax consequences at the time the roll over takes place. As an example, a shareholder may transfer into a corporation in which he owns at least eighty per-cent of all the issued shares of all classes of the company immediately after the sale to the company without any tax consequence occurring at the time of sale. In essence, the corporation is put in the shoes of the taxpayer with the corporation's adjusted cost base being that of the individuals and hence any potential capital gains are not realized at that point in time but are carried forward to the corporation.

As mentioned previously, one-half of realized or deemed capital losses are deductible. The capital loss must first be used to offset any capital gain in that taxation year. If there is not sufficient capital gain to use up all of the capital loss, up to 1,000 dollars of the deductible loss may be used against other income in that year. If this is not sufficient to use up all of the deductible loss the same procedure is followed for the immediate preceding year. If there is still deductible loss not used the same procedure is used in subsequent years—that is the deductible loss is used to offset any taxable gains and any surplus up to 1,000 dollars is used against other income.

In the year of death there is an attempt made to provide a system whereby all deductible capital losses may be used firstly, against any deemed realizations of capital gains in the year of death and secondly, against other income in the year of death without the normal 1,000 dollar limitation applying.

As stated previously, a person who changes his residence from Canada to another country is deemed to have disposed of his assets at their fair market value at the time he leaves the country. Conversely, a person entering Canada to become a resident is deemed to have acquired the assets he then owns at their fair market value at the time of entry.

Certain exceptions to capital gains have been built into the system. Personal use property which is defined in section 54(*f*) as meaning property owned by a taxpayer primarily for his personal use or enjoyment which value is under 1,000 dollars is exempt from tax upon disposition. In addition there is a minimum adjusted cost base attaching to personal use property of 1,000 dollars. For example if a person acquired personal use property for 800 dollars and sold it for 1,500 dollars the capital gain would be 500 dollars half of which, namely 250 dollars, would be added to his income. The purpose of this is to alleviate the necessity of taxpayers generally having to keep detailed records of every capital asset which they own.

Another major exception to the normal capital gain rule applies to principal residents. A formula is built into the Act which states that the exemption allowed is:

$$\frac{\text{the number of years as principal residents}}{\text{the number of years owned by the taxpayer}} \times \text{the capital gain}$$

It is seen, therefore, that if the ordinary taxpayer purchases a home and it remains his principal residence throughout his ownership there will be no taxable capital gain on any profit made upon the disposition of this principal residence. Farmers have an election unavailable to other taxpayers. A farmer may elect to have the same formula enumerated previously apply or in the alternative he may take a flat 1,000 dollars per year for the number of years which it was his principal residence and deduct that from the capital gain.

Under the previous Income Tax Act there were what is referred to as attribution rules relating to income. In essence, what they were designed to do was to prevent income splitting amongst spouses and children under eighteen. If property as defined in the Act was transferred between spouses or to children under eighteen the income generated from that property would be taxed in the transferor's hands. Thus if a husband transferred an apartment block to his wife the husband was taxed on the profits realized on that apartment even though the wife was the owner thereof. The same idea is found in section 74(2) applicable to capital gains. Where a person after 1971 transfers property "directly or indirectly by means of a trust or any other means whatsoever to his spouse, or to a person who has since become his spouse, a capital gain from the disposition of the property or from properties substituted therefore shall, during the lifetime of the transferor while the transferor is resident in Canada and the transferee is his spouse, be deemed to be a capital gain of the transferor and not of the transferee."[47] The section does not provide that capital losses of the transferee are deemed to be capital losses of the transferor.

There is another type of property which is really a subdivision of personal use property called listed personal property. This is defined in section 54(*e*) as including:

(1) a print, an etching, a drawing, a painting, a sculpture or other similar work of art;

(2) jewellery;

(3) a rare folio, a rare manuscript or a rare book;

(4) a stamp; and

(5) a coin.

The gains and losses with respect to listed personal property are netted out treating this type of asset as a compartment within itself. Losses sustained on listed personal property cannot be applied against other types of

[47] Income Tax Act § 74(2)

capital gains nor against any other sources of income. However, any listed personal property loss that is not absorbed by listed personal property gains in the same year will be deductible in computing net gains realized on listed personal property in the immediately preceding year and in the five immediately following years.

As mentioned previously, there is a deemed disposition of all an individual's capital property in the year of his death. Special rules apply, however, to transfers or dispositions of property to a spouse or a trust for a spouse on or after the taxpayer's death. These rules apply where the death is on or after January 1, 1972 and both the taxpayer and the spouse or trust, as the case may be, were resident in Canada immediately before the death of the taxpayer.[48] Where the property is other than depreciable property of a prescribed class the proceeds of disposition to the deceased is equal to the amount of the adjusted cost base of the property to the deceased immediately before his death. The spouse or trust is considered to have acquired the property at a cost equal to the same amount. Any accrued capital gain or loss then passes to the spouse or trust without affecting the deceased's income. The spouse or trust will report any capital gain or loss should the property be disposed of.

In the case of a depreciable property of a prescribed class the deceased is deemed to have disposed of the property immediately before his death. The proceeds of the deemed disposition attributable to the taxpayer at his death will be an amount equal to the fraction when one takes as the numerator the undepreciated capital cost and the denominator the fair market value of the property and multiply that by the fair market value of all the property in the prescribed class. Again, the spouse or trust is considered to have acquired the property at a cost equal to the deemed proceeds. In the ordinary case where depreciable property passes on death there is a deemed disposition of the depreciable property at an amount midway between the undepreciated capital cost and the fair market value of the depreciable property at death.

H. Averaging

There are two types of averaging provisions which are new to the legislation. The general averaging provision is found in section 118(1) and its aim is to cushion the tax effect of significant increases in income. This general averaging provision applies automatically and will be applied by the Department of National Revenue as their computers will be programmed to have this averaging effect taken care of automatically. There is no election necessary by the taxpayer and the calculation can never increase the tax payable. The formula set out in section 118 permits taxpayers to average when their income is twenty percent more than the average of the four preceding years and ten percent more than the immediately preceding year. It is readily seen, therefore, that the averaging system will only apply

[48] Income Tax Act § 70(6).

to unusual increases of a taxpayer and will not be available to the normal steady increase of most taxpayers year by year. In bringing this averaging formula into use the formula will apply for the first time in 1973 using only the immediate preceding year as its base of calculation. This will gradually be expanded to the full four-year period as the time matures. It is important to realize, however, that the averaging formula will not take into consideration any years prior to the implementation of the Act. The formula will apply to individuals just entering the labour market on the basis that a minimum of 1,600 dollars income will have been assumed for the preceding years.

The other type of averaging which is commonly known as "forward averaging" envisages the use of the purchase of an income averaging annuity. The annuity may be for life or for a period of up to fifteen years. This is an election which must be made by the taxpayer and is not automatically applied. The following types of income receipts are eligible for the forward type averaging:

1. Capital gains.

2. Income from production of a literary, dramatic, musical or artistic work.

3. Income from activities as an athlete, musician or public entertainer.

4. A single payment received from a superannuation or pension plan such as a return of contribution on termination of employment or on the death of the employee.

5. A payment upon retirement of an employee in recognition of long service.

6. A single payment received from a deferred profit sharing plan upon retirement or withdrawal as a member of such a plan or upon the death of a member of such a plan.

7. A payment received under a death benefit plan for employees.

8. A return of premiums received from a registered retirement savings plan upon the death of the annuitant.

9. Proceeds from disposition of depreciable property.

10. Proceeds from the sale of inventory or certain accounts receivable on termination of a business.

11. Proceeds from disposition of certain special properties such as business goodwill.

12. Benefits received by an employee under a stock option plan.

It is interesting to note that the legislation is silent as to the exact terms of any annuity which could qualify under the income averaging annuity plan. Such clauses as acceleration clauses may possibly be built into the annuity although at this point in time it is uncertain. The statutory qualifications for the income averaging annuity are as follows:

1. The annuity must be purchased within sixty days after the end of the taxation year in which the amount was received.

2. It must be purchased by a single premium from a person authorized under the Laws of Canada or a Province to carry on an annuity business.

3. It must provide for payment to a purchaser of a series of equal amounts each year starting not later than ten months after the contract is purchased; these yearly amounts may be divided into monthly or other periodic payments throughout the year.

4. Payments may be for a specific number of years up to fifteen, or for the lifetime of the purchaser. A life annuity may not have a guaranteed term of more than fifteen years, and an individual age seventy years or over may not purchase an annuity of a guaranteed term greater than the difference between his age and eighty-five.

The general rules applicable to the averaging section are found in section 118(3).

Farmers and fishermen again have a special election under section 119 and may elect to average on a straight line basis on the basis of a block of five years. This must be elected by the taxpayer and does not apply automatically but such an election may be revoked by the taxpayer at any time before the Minister has assessed his tax for the year of averaging or thirty days following any assessment by the Minister of his tax for the year of averaging. This latter provision means that the revocation period could be several years after the election is made if there is some time lag in an assessment being made by the Minister. Sharecropping arrangements and income from a trust or estate to the extent that it can reasonably be regarded as having been derived from farming or fishing will also qualify for this block averaging election.[49] There is an interesting conflict between section 119(7) and 119(1) in that section 119(7) simply stipulates that rents which are dependent upon the lessee's gross production in the course of farming or fishing and income from a trust or estate to the extent that it can reasonably be regarded as having been derived from farming or fishing qualify for the block averaging election. However, under section 119(1) in order to so qualify, an individual's chief source of income must have been from farming or fishing. It is obvious that a hobby type farmer whose chief source of income is not from farming could have a sharecropping arrangement and usually does and it is equally obvious that a trust may not qualify under the chief source of income test but would qualify under section 119(7). If the usual statutory interpretation rules having to do with the specific overruling the general apply, in both of these latter cases there would be available a block averaging option.

I. Administrative Changes

There are some significant administrative changes in the assessment and appeal area under the new legislation. Previous jurisprudence had

[49] Income Tax Act § 119(7).

established that an innocent misrepresentation as well as a fraudulent misrepresentation allowed the Department of National Revenue to re-assess beyond the statutory four-year period.[50] The authority for this under the old Act was section 46(4)(*a*)(i). The comparable section in the new legislation is section 152(4) and there is a change in wording with respect to the powers of re-assessment. The new powers state that the Minister may assess at any time if the taxpayer has "made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud . . . . " It was intended by this section to alleviate somewhat the wide interpretation given the powers of the Minister under the old jurisprudence. It is submitted that it may not do as it was intended. The word "neglect" or "careless" does not connote any *mens rea* on the part of the taxpayer and could be likened to innocent misrepresentation. This must be read in conjunction with section 152(5) which starts out very strongly by saying that it applies notwithstanding anything in subsection (4) (which was the subsection previously mentioned). There shall not, after the expiration of four years, be included in any re-assessment or additional assessment an amount that was not included in computing his income of four years. However, subsection (*a*) of section 152(5) states that this refers to unreported amounts "in respect of which, the taxpayer establishes that the failure to so include did not result from any misrepresentation that is attributable to neglect, carelessness or wilful default or from any fraud . . . . " Therefore, the words "carelessness" and "neglect" are again present. We are thrown into the dilemma as to whether or not these words will be equated to innocent misrepresentation and the body of jurisprudence which has arisen surrounding this concept as being sufficient to extend the four-year period being applicable. It is arguable that no *mens rea* is required in order to constitute a "careless" or "neglectful" act and hence an innocent act may allow the Tax Authorities to re-open the taxpayer's affairs beyond the four-year period. Clarification will undoubtedly have to come through the courts.

Section 161(1) substitutes for a six percent rate of interest which was applicable on unpaid tax under the old legislation a rate to be prescribed by regulation which presumably will be more in line with the present interest rates. This same prescribed interest rate applies to installment payments which are not made and which should have been made by a taxpayer.

With respect to penalties under the previous legislation, section 56(1), which related to wilful evasion, has been substantially modified. Under the old Act every person that wilfully in any manner evaded or attempted to evade *payment* was subject to a penalty of not less than twenty percent and not more than fifty percent of the amount of tax evaded or sought to be evaded. Presumably an actual evasion would not have been necessary for this penalty to have been applied. The new statute under section 163(1) states that any person who has wilfully attempted to evade payment of tax by failing to file a return of income when required is subject to a fifty percent penalty. The wilful evasion only applies to the failure to file a return

[50] Minister of National Revenue v. Taylor, [1961] Can Tax. Cas. 211 (Exch. Ct.).

as it is required. The wilfulness is attributed to the failure of filing a return not to the information contained therein.

The far more common section used in relation to penalties under the old legislation was section 56(2) which is carried over intact under the new legislation as section 163(2).

One innovation is that the statute states if the Minister proposes to levy a penalty the onus of proof is on the Minister to justify the penalty assessment.[51] Because this is a statutory onus of proof it will be interesting to see whether or not the Crown must lead evidence prior to the taxpayer having any evidence before the court in penalty matters. If this is so it will mean a substantial change in the legal procedure from what is presently the case. There is a short-circuiting procedure which is new to the new legislation.[52] Under these new provisions it is possible for a taxpayer to have his appeal heard without the normal 180 day delay after filing a Notice of Objection. In essence, the Notice of Objection becomes the Notice of Appeal and is the only document filed before the court. In order for this short-circuiting to take effect it is necessary to have the consent of the Minister. There is an important administrative change embodied in section 172(3) which gives a statutory right of appeal in the following circumstances:

1. Where upon application any organization is refused registration as a Canadian charitable organization.

2. Where the Minister refuses to accept the registration of a retirement savings plan.

3. Where the Minister refuses to accept the registration of a profit sharing plan or revokes its registration.

4. Where the Minister refuses to issue a certificate of exemption.

This right of appeal is to the Federal Court.

There have been substantial changes in the investigation powers which existed under section 126 of the old legislation. Under the new legislation where the Minister has seized documents he shall either apply to a judge of a superior court or county court for retention of the documents or return the documents within 120 days from the date of seizure if no such application is made or if such an application is refused by the judge. In order for such an application to be successful the Minister must support by evidence to the satisfaction of the judge that reasonable and probable grounds have been established that there was a violation of the Income Tax Act and that the seized documents are required as evidence.[53] The taxpayer from whom any documents have been seized is provided with a statutory right of access to such documents at all reasonable times and also has a statutory right to copy the documents.[54]

---

[51] Income Tax Act § 163(3)
[52] Income Tax Act § 165(3)(*b*)
[53] Income Tax Act § 231(2).
[54] Income Tax Act § 231(6).

The inquiry provisions have also been modified. Where an inquiry is authorized the Minister must now go to the Tax Review Board for an order appointing a hearing officer. This is a change from the previous Act in which the Minister himself could appoint the hearing officer. The hearing officer so appointed by the Board shall have the powers of a commissioner under the Inquiries Act but has no power to punish any person except on application by the hearing officer to a judge of a superior or county court. It is also provided under the new legislation that any person appearing before such inquiry has a right to counsel.[55] Also, a person appearing before such an inquiry is entitled to receive a transcript of the evidence given by him. In addition, the person whose affairs are being investigated has a statutory right to be present throughout the inquiry and also to be represented by counsel.[56] The hearing officer, however, has the power to exclude the person whose affairs are being investigated and his counsel if the hearing officer considers them as being prejudicial to the effective conduct of the inquiry.

IV. CONCLUSION

The foregoing has been a brief survey of some of the aspects of the new income tax legislation. The reader will note that the area of corporate taxation and small business incentives and corporate distributions have not been covered. There are extensive changes in this area and they will be subject of a separate survey in forthcoming editions. Undoubtedly, as jurisprudence develops under the new legislation modifications of current thinking will have to take place. However, if one is able to grasp the basic concepts of the new legislation when individual cases are reported their meaning will have much more significance. It is hoped that this survey will have provided the reader with some of these basic concepts.

[55] Income Tax Act § 231(14)
[56] Income Tax Act § 231(15)