QUARTERLY Newsletter

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What the CRA is Saying

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The Canada Revenue Agency (the "CRA") releases its responses to queries from the general public on a regular basis. These responses give us insight into the CRA's approach to the law, including actual practices and policies of the government on tax matters. Some of these responses are summarized below.

Operation of a business incurring continual losses

The CRA was asked if the business losses incurred would be deductible or would be denied because of the absence of a reasonable expectation of profit.

A pharmacist earned business income from a pharmacy that had two sections: (1) a dispensary section involving the sale of medicine and other prescribed drugs generating income every year; and (2) a commercial section involving the sale of other products producing continual losses. The operation of the commercial section significantly increases the income of the dispensary section.

As noted by the Supreme Court of Canada and also by the CRA, the "reasonable expectation of profit" criterion is only applicable to determine if a taxpayer has a source of income when an activity comprises a personal element. Because the activity carried on does not comprise any personal element, the above criterion should not be applicable to deny him the deduction of his losses incurred in respect of the commercial section of his business. Note that the question of whether an expense incurred by a taxpayer is deductible from his or her business income is one of fact that can only be determined after a careful review and analysis of all legal documents and circumstances.

Purchase or Lease Contract?

The CRA was asked whether contracts signed by a corporate employer with another corporation to provide an employee with an automobile were purchase or lease contracts. This determination is important since the standby charge, which is calculated under the *Income Tax Act* (the "Act") and included in the employee's income, is calculated differently depending on whether the automobile is owned by or leased to the employer.

The CRA confirmed that the question of determining whether a contract was a purchase or lease contract had to be determined from the legal relationships created by the terms of the agreement. Subject to the application of the general anti-avoidance rule ("GAAR") and the finding that there is no sham in the above situation, the CRA considered that a re-characterization of the legal relationships created by the contract is only possible if:

1. the label attached to the transaction by the taxpayer does not properly reflect its actual legal effect; or
2. a particular provision of the Act provides that that the legal relationships must not be respected.

As confirmed by the Supreme Court of Canada, the economic realities of a situation cannot justify the re-characterization of a taxpayer's bona fide legal relationships. The term "sham" normally describes a transaction involving an element of deception to create an illusion whose purpose is to hide the true nature of the transaction, or a false pretence used by the taxpayer to create an appearance different from reality.

Even though the nature of the contract should normally be determined by the legal relationships created between the employer and the corporation, the CRA concluded that a more in-depth study would be required in this case to make that determination.

Lack of books and records

The CRA was asked whether losses claimed by a taxpayer should be disallowed due to a lack of supporting documents.

Two companies amalgamated to form Amalco, which claimed a non-capital loss on its return filed after the amalgamation. However, no books or records were provided to support the financial statements and tax returns.

The Act provides that the CRA is not bound by a return filed or information supplied by a taxpayer. It further requires a taxpayer to maintain books and records in such form and containing such information as will enable the taxes payable under the Act to be determined.

On an appeal of an assessment, the onus is on the taxpayer to "disprove" the assessment and the taxpayer is responsible for documenting his/her affairs in a reasonable manner. The courts have stated that documentary proof of tax claims is not an absolute requirement but, in fact, other forms of credible proof could be accepted. The CRA has also indicated in that unless there is other satisfactory evidence to support a claim, the CRA's practice is to disallow unvouchered expenses.

Based on the judicial authorities on the issue, the CRA's view is that, in the current situation, Amalco must be able to support the deductions claimed. If the CRA has informed the taxpayer of concerns arising from a lack of supporting documents and the taxpayer still has not produced sufficient and satisfactory proof of the loss claim, it would be reasonable for the CRA to disallow the loss claim.

Web page costs

The CRA was asked whether expenditures made by a taxpayer to develop a "Web page" on the Internet would be a capital or current expense.

The CRA stated that a Web page is an electronic creation that enables a taxpayer to advertise its business, sell products, or provide information about its business. A Web page is not permanent, and it may be modified, taken down, or rebuilt. Generally, software and labour costs would be the predominant costs of developing a Web page.

Generally, the question of whether an expenditure is on account of income or capital is made with reference to the purpose of the expenditure and whether it was made for the purpose of bringing into existence an asset of enduring value.

The CRA has stated that the tax treatment of Web page development costs would require an analysis of the different components of the various costs. For example, the CRA would consider the expected useful life of the Web page. Although a Web page may not be permanent (and can be modified, taken down, or rebuilt), some components of the development costs are likely capital in nature.

Further, the CRA has stated that computer software that is not systems software (i.e., applications software) is included in Class 12 of Schedule II of the Income Tax Regulations. The CRA has stated that, in its opinion, this would include the cost of application software purchased from third parties to be used to develop a Web page and the labour costs incurred to design and develop software to carry out the Web page functions.

Donation to a U.S. charity

The CRA was asked whether a Canadian resident corporation would receive the same tax relief in Canada for a charitable donation made to a U.S. charity that it would have received had it donated to a Canadian registered charity.

The Act permits a corporation to deduct, in computing its taxable income for a taxation year, the amount of gifts made in the year to specified institutions including registered charities, registered Canadian amateur athletic associations, municipalities in Canada, other certain entities, and charitable organizations outside of Canada that the federal government has made a gift. Amounts not deducted in the year the gift is made may be carried forward for up to five years and are limited to 75% of the corporation's income.

Under the Act, qualified donees can issue tax receipts for donations they receive from individuals or corporations. A qualified donee, as defined in the Act, includes a registered charity, which is a charitable organization, private foundation, or public foundation that is resident in Canada and was either created or established in Canada and that is at that time registered as a charitable organization, private foundation, or public foundation.

A qualified donee also includes a charitable organization outside Canada to which Her Majesty in right of Canada has made a gift in the year or in the 12 months immediately preceding that year. Accordingly, if the Canadian federal government made a donation to the U.S. charity, the Canadian resident corporation would receive the same tax relief for making a donation to the same U.S. charity as it would have received had it donated to a Canadian registered charity.

The Canada–U.S. Tax Convention (the "Treaty") also provides limited tax relief with respect to gifts made by Canadian residents to U.S. organizations. According to the Treaty, gifts made by a resident of Canada to an organization resident in the United States that is generally exempt from U.S. tax and that could qualify in Canada as a registered charity if it were created or established and resident in Canada, will be treated as gifts to a registered charity. Generally, a corporation may claim a deduction for the eligible amount of such gifts up to 75% of its income from U.S. sources. The CRA accepts that any organization that is exempt under the U.S. Internal Revenue Code will qualify for the purposes of the Treaty.

Therefore, if the organization is exempt under the U.S. Internal Revenue Code, a Canadian resident corporation may claim a deduction for the eligible amount of a gift to the organization, not to exceed 75% of its income from U.S. sources.