
The Significance of Commercial and Accounting Principles in Canadian Tax Cases

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INTRODUCTION

Commercial and accounting principles are relevant in determining “profit” for the purposes of the Income Tax Act.¹ These principles have also been referred to as “well-accepted principles of business (or accounting) practice,” “well-accepted principles of commercial trading,” “ordinary commercial principles,” and “well-accepted principles of commercial trading.” In *Symes v. The Queen et al.*, they were referred to as a “business test for taxable profit.”²

Most of the cases on these principles are considered in the context of determining income under subsection 9(1) and paragraph 18(1)(a) of the Act, but not exclusively so. In *The Queen v. The Bank of Nova Scotia*,³ the Federal Court of Appeal agreed with the trial judge in that case that

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

2 94 DTC 6001, at 6009 (SCC).

3 81 DTC 5115 (FCA).

generally accepted good accounting practices do not apply only to the calculation of profits under section 9 of the *Income Tax Act* but to all matters of account unless there exists some statutory impediment to the application of those practices.⁴

Thus it was held that a Canadian bank could determine its foreign tax credits by translating its foreign taxes into Canadian dollars using the same weighted average rate of exchange that was used to translate its foreign branch income into Canadian dollars, as opposed to calculating the foreign tax credit using the spot rate of exchange at the time the foreign taxes were actually paid.

Other applications of commercial and accounting principles in tax law are discussed below.

COMMERCIAL AND ACCOUNTING PRINCIPLES IN DETERMINING PROFIT

Subsection 9(1) provides that, subject to specific overriding provisions of the Act, a taxpayer's income for a taxation year from a business or property is the taxpayer's "profit" from that business or property for the year.

In the Supreme Court of Canada's decision in *Canderel Limited v. The Queen*, Iacobucci J explained the role of commercial and accounting principles in determining profit as follows:

- (1) The determination of profit is a question of law.
- (2) The profit of a business for a taxation year is to be determined by setting against the revenues from the business for that year the expenses incurred in earning said income. . . .
- (3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.
- (4) In ascertaining profit, the taxpayer is free to adopt any method which is not inconsistent with
 - (a) the provisions of the *Income Tax Act*;
 - (b) established case law principles or rules of law; and
 - (c) well-accepted business principles.
- (5) Well-accepted business principles, which include but are not limited to the formal codification found in G.A.A.P. [generally accepted accounting principles], are not rules of law but interpretive aids. To the extent that they may influence the calculation of income, they will do so only on a case-by-case basis, depending on the facts of the taxpayer's financial situation.
- (6) On reassessment, once the taxpayer has shown that he has provided an accurate picture of income for the year, which is consistent with the Act, the case law, and well-accepted business principles, the onus shifts to the Minister to show either that the figure provided does *not* represent an accurate picture, or that another method of computation would provide a *more* accurate picture.⁵

4 80 DTC 6009, at 6016 (FCTD).

5 98 DTC 6100, at 6110 (SCC) (emphasis added).

In *Canderel*, these principles were applied to permit a real estate developer to claim an immediate deduction for tenant inducement payments paid to attract tenants to its new office development. In particular, it was held that the matching principle did not apply to require such payments to be matched against future rental income and amortized over the term of the tenant leases. In *Ikea Limited v. The Queen*,⁶ the Supreme Court of Canada held that the matching principle did not apply to permit the taxpayer to defer income inclusion of tenant inducements received from its landlord.

The *Canderel* and *Ikea* cases deal with the application of accounting principles to determine profit for a year.⁷ As discussed below, commercial and accounting principles are also applied in determining whether (not just when) an amount is deductible in computing profit.

Paragraph 18(1)(a) provides that an outlay or expense is not deductible in computing income from a business or property except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property. In *Symes*, the Supreme Court of Canada said that subsection 9(1) and paragraph 18(1)(a) essentially cover the same ground. In other words, the concept of “profit” in subsection 9(1) generally prohibits the deduction of expenses that lack an income-earning purpose just as much as paragraph 18(1)(a), which specifically states this.

In *Symes*, commercial and accounting principles were considered by the Supreme Court of Canada in determining whether child-care expenses were deductible in computing profit from a business. A minority of the justices said that child-care expenses were deductible under these principles, but the majority concluded that, as a matter of statutory interpretation, the matter was exclusively dealt with under section 63 of the Act, which has a specific formula for deducting these costs.

In *Associated Investors of Canada Limited v. MNR*,⁸ commercial and accounting principles permitted an employer to deduct a loss suffered when prior-year advances to an employee were determined to be uncollectible and were written off.

EXPENSES OF A CAPITAL NATURE

Even if an expense is deductible in computing profit under subsection 9(1) and paragraph 18(1)(a), the deduction may be prohibited by paragraph 18(1)(b). Under paragraph 18(1)(b), no deduction is permitted in respect of “an outlay, loss or replacement of capital, [or] a payment on account of capital” except as expressly permitted under the Act.

6 98 DTC 6092 (SCC).

7 These are not the only cases. See, for example, *Toronto College Park Limited v. The Queen*, 98 DTC 6088 (SCC) (tenant inducement payments); *Canadian General Electric Co. Ltd. v. MNR*, 61 DTC 1300 (SCC) (foreign exchange losses); and *MNR v. Anaconda American Brass Ltd.*, 54 DTC 1179 (SCC) (inventory valuation).

8 67 DTC 5096 (Ex. Ct.).

In *Johns-Manville Canada Inc. v. The Queen*,⁹ the issue was whether a mining company could deduct the cost of land that it had purchased at the edge of an open-pit mine in order to permit the safe and economic extraction of ore from the ore body. The Supreme Court of Canada reviewed the UK, Canadian, Australian, and US jurisprudence on the classification of expenditures as either expense or capital and applied a “commonsense” approach to determining the question. In the court’s view, common sense dictated that the expenditures to purchase the land had to be made because otherwise the operations would of necessity be shut down. They were not once-and-for-all expenditures. They were not part of the assembly of the ore body and so were not entitled to depreciation or depletion deductions under the Act. The court concluded:

These expenditures are not disqualified by s. [18(1)(a)] and indeed that provision of the Act favours the inclusion of these expenditures in authorized expenses because there is no other provision made in the Act for these items which are, beyond contention, incurred of necessity by the taxpayer in conducting its mining operations according to good business and engineering practice.¹⁰

In *Johns-Manville*, deduction of the expenses was in accordance with good business and engineering practices. The next two cases discussed below indicate that principles enunciated in *Canderel* are also relevant in applying paragraph 18(1)(b).

In *BJ Services Company Canada v. The Queen*,¹¹ the Tax Court of Canada said that the approach established by the Supreme Court of Canada in *Canderel* in determining deductibility of expenses under section 9 is equally applicable in determining whether expenses are on account of capital. In Campbell J’s view,

[t]he primary objective is to create an accurate portrayal of [the taxpayer’s] income in accordance with well-accepted and established principles of business practice.¹²

Accordingly, the court held that expenses incurred to defend a hostile takeover bid were deductible against current income in accordance with well-established business principles, and there was no evidence presented to show that capitalizing these expenses would result in a more accurate portrayal of income.

In *65302 British Columbia Ltd. v. The Queen*¹³ (“the egg marketing case”), the issue was the deductibility of over-quota levies charged to a poultry farm by the British Columbia Egg Marketing Board. One of the Crown’s arguments was that the charge was a capital expense because it allowed the taxpayer to retain its quota, a capital asset. On this point, the Supreme Court of Canada referred to its earlier

9 85 DTC 5373 (SCC).

10 *Ibid.*, at 5384.

11 2004 DTC 2032 (TCC). See also *International Colin Energy*, *infra* note 29.

12 *BJ Services*, *supra* note 11, at paragraph 43.

13 99 DTC 5799 (SCC).

statement in *Canderel* that the focus is to portray the taxpayer's income in the manner that best reflects the taxpayer's true financial position and gives an "accurate picture" of profit. The court then analogized the expense to the cost of electricity to operate a factory. The fact that the risk that the quota would be revoked on non-payment of a fine was considered to be no more relevant to the analysis than the fact that the existence of a business would be in jeopardy if the electricity bills were not paid. In both cases, there was a current expense.

Commerciality

Commercial principles and the concept of commercial reality are also relevant in interpreting other provisions of the Act.

At one point, it was considered that if a taxpayer did not carry on an activity with a reasonable expectation of profit (REOP), the activity was not a "source of income," and if there was no source, a loss from that activity could not be deducted under section 3 against income from other sources. Thus, cases held, for example, that a taxpayer was not entitled to deduct its loss from rental property that was undergoing judicial sale proceedings, on the basis that no profit could reasonably be expected to be earned from the property once the proceedings were commenced.¹⁴ Bowman J clearly agreed with this view, and he said so in several judgments. In *Allen et al. v. The Queen*,¹⁵ for example, Bowman J said that, while the REOP principle could apply to deny losses from a hobby such as horseracing, collecting soft drink bottles, or renting out the basement of the taxpayer's home, the doctrine has no application where a genuine business exists. When the issue came before the Supreme Court of Canada in *Stewart v. The Queen*,¹⁶ the court agreed with Bowman J and held that the test for determining the existence of a business is determined by looking at the commerciality of the activity in question.

We are also reminded of the decision of Bowman J in *Reid et al. v. The Queen*.¹⁷ There, the issue was the deductibility of repair costs to a rental property that were incurred while the property was vacant, shortly before the owners moved in and used the property as a personal residence. On the question whether the deductibility of the expenses was denied under paragraph 18(1)(a) on the basis that they were not incurred for the purpose of earning income, Bowman J said:

It would be an absurd interpretation of the *Income Tax Act* and a distortion of commercial reality if every time a rental property became vacant the expenses of maintaining it became non-deductible. . . .

It runs counter to ordinary common sense and to the concept of fundamental commercial reality to say that such expenses, which are a necessary and ordinary cost of

¹⁴ See *Brill et al. v. The Queen*, 96 DTC 6572 (FCA).

¹⁵ 99 DTC 968 (TCC).

¹⁶ [2002] 2 SCR 645.

¹⁷ 95 DTC 308 (TCC).

operating a rental property, are not deductible simply because they were paid after the tenants who occasioned the expenses had moved out. To say that the expenses—or losses on one view of the matter—that were incurred as a direct result of the rental operation are not deductible is, in my view, an unrealistic and mechanical interpretation of paragraph 18(1)(a).¹⁸

In *The Cadillac Fairview Corporation Limited v. The Queen*,¹⁹ the issue was the deductibility of amounts paid by the taxpayer to release itself from a guarantee. Subparagraph 40(2)(g)(ii) denies a loss from the disposition of a debt, unless the debt was acquired for the purpose of earning income from a business or property. Where a guarantor pays an amount to a creditor under a guarantee, the guarantor is normally subrogated to the rights of the creditor and acquires a right against the debtor whose debt was guaranteed. As a practical matter, however, this debt is likely to be worthless. Bowman J observed that, on a narrow and mechanical reading of subparagraph 40(2)(g)(ii), it could be said that the payment under the guarantee and the guarantor's acquisition of the worthless debt could not be for the purpose of gaining or producing income. However, he stated,

[s]uch an interpretation in my view lacks commercial sense. A functional and more commercially realistic interpretation would subsume in the purpose of the acquisition of the subrogated debt the purpose for which the guarantee was originally given.²⁰

In *Cadillac Fairview*, the taxpayer's loss was found not to be deductible for other reasons. However, Bowman J's reasoning in interpreting subparagraph 40(2)(g)(ii) has been accepted in several other Tax Court of Canada cases.²¹

ACCOUNTING PRINCIPLES

In contrast to commercial principles, the role of accounting principles such as GAAP in the determination of income has been mixed. In many instances, the courts have found accounting principles to be only of "marginal assistance."²² In *Ikea*, the Supreme Court of Canada noted that the matching principle is not an overriding rule of law in determining income, even if it produces an "asymmetrical result" in the occasional case.²³

18 Ibid., at 310.

19 97 DTC 405 (TCC); aff'd. on other grounds 99 DTC 5121 (FCA).

20 Ibid. (TCC), at 407.

21 See, for example, *Daniels v. The Queen*, 2007 DTC 883 (TCC) (Hershfield J); *Proulx v. The Queen*, 2005 DTC 487 (TCC) (Rip J); and *Gordon v. The Queen*, 96 DTC 1555 (TCC) (McArthur J). See also *National Developments Ltd. v. The Queen*, 94 DTC 1061 (TCC) (Bell J).

22 *Ikea Limited v. The Queen*, 94 DTC 1112 (TCC), cited by the Supreme Court, supra note 6, at 6094.

23 *Ikea*, supra note 6, at 6100.

For example, while the cost of acquiring commercial density rights may appropriately be capitalized as a cost of a building for accounting purposes, such cost is really part of the cost of the land: density rights are concerned with what an owner can do with land.²⁴ The fact that the accounting treatment would have differed if there had been no building on the land—the cost would have been put in a suspense account and reviewed periodically—was found by Bowman J to “underline the difficulty, indeed futility, of attempting to find in accounting practices solutions to what are essentially legal issues.”²⁵

Further, accounting records themselves have been viewed with skepticism by the courts. In *Hickman Motors Ltd. v. The Queen*, the Supreme Court of Canada noted that

[t]he law is well established that accounting documents or accounting entries serve only to reflect transactions and that it is the reality of the facts that determines the true nature and substance of transactions.²⁶

Thus, although no revenue from a property was shown in the financial statements of a corporation that was wound up into its parent, other evidence showed that some revenue was earned to support a claim of capital cost allowance. Similarly, the unreliability of accounting records came into sharp focus in determining the amounts owing by a taxpayer,²⁷ travel allowances,²⁸ and fees paid to professional advisers in the context of a corporate merger.²⁹

INTEREST DEDUCTIBILITY

Commercial and accounting principles have also been applied in interpreting paragraph 20(1)(c). Under paragraph 20(1)(c), interest on borrowed money is deductible if it is paid or payable pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property.

In *Trans-Prairie Pipelines Ltd. v. MNR*,³⁰ the taxpayer was a pipeline company that paid the cost of construction of the pipeline through the issuance of common and preferred shares. Later on, it borrowed money under a bond issue and used part of the proceeds to redeem the preferred shares. The minister denied the deduction of part of the interest on the taxpayer’s bonds, on the basis that the borrowed money

24 *Sun Life Assurance Company of Canada v. The Queen*, 97 DTC 422, at 427-28 (TCC) (Bowman J). See also *Cadillac Fairview*, supra note 19 (TCC).

25 *Sun Life*, supra note 24, at 427.

26 [1997] 2 SCR 336, at paragraph 87.

27 *Jabs Construction Ltd. v. R.*, [1999] 3 CTC 2556, at paragraphs 33-37 (TCC) (Bowman J).

28 *2831422 Canada Inc. v. R.*, [2003] 1 CTC 2491, at paragraph 14 (TCC) (Bowman J).

29 *International Colin Energy Corp. v. R.*, [2003] 1 CTC 2406, at 2427 (TCC) (Bowman J).

30 70 DTC 6351 (Ex. Ct.).

was used to redeem the taxpayer's preferred shares and not, therefore, for the purpose of earning income from the taxpayer's business. In the Exchequer Court of Canada, Jackett P disagreed. In his view, interest on the borrowed money was deductible because, "as a practical matter of business common sense," the borrowed money went to "fill the hole" left by the redemption of the preferred shares.

In *The Queen v. Sherway Centre Limited*,³¹ the Federal Court of Appeal did not follow the mechanical definition of "interest" in earlier jurisprudence, which required the payments to accrue from day to day. Instead, the court concluded that participating interest payments that did not accrue from day to day were deductible under paragraph 20(1)(c) because

[t]o hold otherwise, that is, to construe this provision as narrowly as previous case-law has done and not allow the deduction would, in my opinion, be to ignore the new commercial realities that were not considered by the courts when their past decisions were rendered.³²

In *Gifford v. The Queen*,³³ the Supreme Court of Canada held that, where paragraph 20(1)(c) does not apply, interest is not deductible because, except in the limited case of a moneylender, interest is an expense "on account of capital" and, as such, is prohibited from deduction under paragraph 18(1)(b). In coming to this conclusion, the court rejected the approach used by Bowman J at trial,³⁴ which looked at the purpose for which the proceeds of the loan were used.

In our view, the commercial reality is that interest is no more an expense on account of capital than the over-quota fees or the cost of electricity discussed in the egg marketing case. We find it interesting that, in *Ikea*, the Supreme Court of Canada observed that, although a lease of business premises is a capital asset of the lessee, the payment of rent is obviously an expense on revenue account because it is incurred for the purpose of producing income and does not result in the acquisition of any capital asset. In all of these situations, the deduction of the expense was held to be necessary to provide an accurate picture of profit. In our view, the same analysis should be given to interest. Furthermore, as noted by the Supreme Court of Canada in *Gifford*, Bowman J's approach of allowing current deductibility of interest depending on the use of the borrowed money was "in accordance with general accounting principles and logic."³⁵

31 98 DTC 6121 (FCA).

32 Ibid., at 6124-25.

33 2004 DTC 6120 (SCC).

34 2001 DTC 168 (TCC).

35 Supra note 33, at paragraph 38.

CONCLUSION

Donald Bowman has been a major participant in the development of the law in this area. Of the decisions discussed in this article, he was the judge at trial in *Ikea*, *Gifford*, *Reid*, *Cadillac Fairview*, *Allen*, and other cases specifically identified above, and numerous other REOP cases referred to by the Supreme Court of Canada in *Stewart*. He was counsel for the minister in *Associated Investors* and counsel for the taxpayer in *Johns-Manville*. As counsel and trial judge, he indicated a willingness to interpret and apply the Act to take into account commercial realities in determining the income that should be subject to tax, an approach that found favour with the Supreme Court of Canada.

