The Matching of “Current” Expense Under Canada’s Income Tax Laws

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PRÉCIS
Depuis plusieurs années, Revenu Canada maintient que le principe comptable du rapprochement s’applique pour l’établissement du moment de la déduction des dépenses courantes à l’égard de l’impôt sur le revenu. Récemment, dans les affaires Canderel et Toronto College Park, la Cour d’appel fédérale a semblé suggérer d’élever ce principe au niveau d’un principe de droit. La Cour a soutenu qu’une dépense jugée comme étant de nature courante en droit doit néanmoins être « rapprochée » si elle a trait à des revenus futurs. En appel des décisions, la Cour suprême du Canada a rejeté la notion que le principe du rapprochement constitue une règle de droit. Cependant, elle a indiqué que le rapprochement peut s’appliquer aux cas où il procure une idée plus précise du bénéfice d’un contribuable.

Dans cet article, l’auteur conclut que le principe comptable du rapprochement ne devrait jamais être appliqué de sorte à reporter la déduction d’une dépense qui est jugée être de nature courante en droit. L’origine judiciaire du rapprochement est imparfait et n’est fondé sur aucune jurisprudence fiable. La règle simple, mais appropriée, selon laquelle toutes les dépenses courantes sont déductibles pour l’année durant laquelle elles sont engagées a été constamment confirmée par les autres tribunaux.

ABSTRACT
For several years, Revenue Canada has maintained that the matching principle of accounting is applicable in determining the timing of the deduction of current expenses for income tax purposes. Recently, in the Canderel and Toronto College Park decisions, the Federal Court of Appeal purported to elevate the matching principle of accounting to a principle of law. The court held that an expense that is determined to be current in law must nonetheless be “matched” if it relates to future revenues. On appeal of the decisions, the Supreme Court of Canada rejected the notion that the matching principle is a rule of law. However, the Supreme Court indicated that matching may apply in those cases where it yields the more accurate picture of a taxpayer’s profit.

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In this article, the author concludes that the matching principle of accounting should never be applied to defer the deduction of an expenditure that is determined to be a current expense in law. The judicial origins of matching are flawed and without reliable precedent. The simple but proper rule, that all current expenses are deductible in the year incurred, has been consistently confirmed by other courts of law.

BACKGROUND ON THE DEVELOPMENT OF MATCHING

It seems to me like saying that a man is entitled to charge supper in his expenses for Sunday night because, though he went supperless to bed, he orders something extra for his breakfast on Monday morning.1

Under general principles of taxation, a business expenditure is a capital expense if it gives rise to an asset or advantage with value (income-producing capacity) extending into taxation years beyond the year of expenditure.2 Otherwise, the expenditure is a current expense. If the expense is otherwise deductible,3 the distinction should be one of timing. Under general principles, the deduction of an expenditure appears to be justified when there is a realized decrease in the taxpayer’s wealth. Accordingly, a current expense should be deductible in the year in which it is incurred, whereas a capital expense should be deductible over time as the value of the asset diminishes (through depreciation or amortization), or when the asset is sold or otherwise ceases to exist in the taxpayer’s hands.4

The English and Canadian courts consistently confirmed that current expenses are deductible in the year in which they are incurred and that the availability of the deduction is not predicated on the tracing or matching of the expenses to revenues. In Canada, however, the case law has taken a strange turn. In the Associated Investors case, President Jackett of the Exchequer Court included a footnote indicating that, rather than being deductible in the year incurred, many current expenses are deductible in other years “in respect of which” they were made.5 Over the years, other Canadian courts adopted the Associated Investors footnote as authority for the matching of “current” expenses (determined as such in law) to future revenues under the matching principle of accounting. For example, in the Oxford Shopping Centres case, it was stated that the matching principle applies where an expense relates to future revenues; it does not

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1 The Naval Colliery Co., Ltd. v. The Commissioners of Inland Revenue (1928), 12 TC 1017, at 1049 (HL), per Viscount Sumner, in rejecting the proposition put forth by the taxpayer in that case that current expense incurred in one year could be deducted from related income in the previous year.

2 Assuming that it is not an expense incurred in acquiring inventory.

3 That is, that the expense is incurred for the purpose of earning income from a business or property.

4 See the discussion below under the heading “The Timing of the Deduction of Expenditure Under General Income Tax Principles.”

5 Associated Investors of Canada Ltd. v. MNR, 67 DTC 5096, at 5098 (Ex. Ct.).
apply to a so-called running expense, which is deductible only in the year in which it is incurred. The Canadian courts have defined a running expense as one that does not relate to particular revenues.

For several years, Revenue Canada has taken the position that the deduction of a current expense should be deferred and amortized if that is the treatment accorded by the matching principle of accounting.

Recently, the Federal Court of Appeal in Canderel held that the matching principle in accounting had been elevated to a legal principle, and that decision was followed by the court in Toronto College Park. Under the matching principle, according to the court, an expense that is determined to be current in law is subject to matching if it relates to a particular item of future revenue. In such case, the expense must be “matched” against the future revenue. Both decisions were set aside by the Supreme Court of Canada, basically on the grounds that the matching of the expenses in each case (compared to their immediate deduction) could not be shown to provide a more accurate picture of the taxpayer’s profit. According to the Supreme Court, the matching principle is a well-established business principle but not a rule of law. As a well-established business principle, it may be used in those cases where its application is consistent with the statutory provisions and established legal principles, and where it portrays the more accurate picture of the taxpayer’s profit for income tax purposes. For instance, the court indicated that the matching principle may apply where an expense is incurred principally for the specific purpose of earning a discrete and identifiable item of future revenue. Running expenses remain the exception, to which the matching principle does not apply.

The main point to be made in this article is a simple one. Once it is determined that a business expenditure is a current expense in law, it should always be deductible in the year in which it is incurred. There is no reasonable basis for the proposition that a current expense can be matched against future revenues.

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6 Oxford Shopping Centres Ltd. v. The Queen, 79 DTC 5458, at 5466-67 (FCTD), aff’d. 81 DTC 5065 (FCA). See also MNR v. Tower Investment Inc., 72 DTC 6161 (FCTD); and Canadian Glassine Co. Ltd. v. MNR, 74 DTC 6089 (FCTD), rev’d. 76 DTC 6083 (FCA).


8 The Queen v. Canderel Limited, 95 DTC 5101, at 5102 (FCA), rev’d. 98 DTC 6100 (SCC).

9 The Queen v. Toronto College Park Limited, 96 DTC 6407 (FCA), rev’d. 98 DTC 6088 (SCC). The issue in each case was whether tenant inducement payments (TIPs) made by a landlord in order to procure tenants were deductible in the year in which they were made, or whether they were required to be deferred and matched to revenues arising under the respective leases. In both cases, it was agreed that the TIPs were current expenses in law and not capital. In both decisions, the Federal Court of Appeal held that the TIPs had to be matched against the future revenues arising from the leases. On appeal of the decisions, the Supreme Court allowed the TIPs to be deducted in the years in which they were incurred.
MATCHING UNDER THE SCHEME OF THE ACT

As discussed above, the income tax system distinguishes between business expenditures that are current expenses and those that are capital expenses. Assuming that an expense is otherwise deductible (that is, that it is made for the purpose of earning income from a business), the distinction appears to be one of timing only.\(^{10}\) The Income Tax Act\(^ {11}\) contains no limitation as to the timing of the deduction of a current expense.\(^ {12}\) On the other hand, the Act contemplates that business expenditures with enduring value may be deferred and deducted only under specific rules found in the statute: if an expense is capital, a deduction is not allowed by virtue of paragraph 18(1)(b), except as expressly permitted by part I of the Act.\(^ {13}\) Expenses that are expected to provide utility over some number of years (namely, capital expenses with a limited useful life) are amortized under the capital cost allowance or eligible capital expenditure system.\(^ {14}\)

If the common law allows a current expense to be amortized against future revenues on the basis of the accounting principle of matching, the expense is effectively capitalized. The bizarre result is that in the first instance the legal status of an expense as “current” ostensibly avoids the limitation in paragraph 18(1)(b), but if matching applies, the expense is treated as capital and amortized (and the deduction is presumably in respect of obsolescence) in apparent contravention of that provision.\(^ {15}\)

\(^{10}\) At one time, the distinction between current and capital expenses had more extreme consequences. Before 1949, capital expenses were generally not deductible, although the minister in his discretion allowed straightline depreciation for some assets. Before 1972 and the introduction of the concept of eligible capital property, many intangible capital expenses were not deductible because they did not fall within the classes of depreciable property.

\(^{11}\) Income Tax Act, 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.

\(^{12}\) Paragraph 18(1)(a) prohibits a deduction except to the extent that the expense was made or incurred for the purposes of gaining or producing income from a business or property. In interpreting this provision, Mr. Justice Hall of the Supreme Court of Canada concluded in the *Premium Iron Ores* case, “The only qualification which Parliament imposed was that the outlay or expense be ‘made or incurred by the taxpayer for the purpose of gaining or producing income from the property or business of the taxpayer.’ No limitation as to time can be found in the section in question.” See *Premium Iron Ores Ltd. v. MNR*, 66 DTC 5280, at 5292 (SCC). See also *Mattabi Mines Ltd. v. Minister of Revenue (Ontario)*, [1988] 2 CTC 294, at 301 (SCC).

\(^{13}\) Specifically, paragraph 18(1)(b) prohibits a deduction for an outlay or loss of capital or a payment on account of capital, or an allowance in respect of depreciation, obsolescence, or depletion, except as expressly permitted by part I.

\(^{14}\) Some capital expenses are deducted under other provisions of the Act, as is the case, for example, for interest and financing expenses.

\(^{15}\) A similar dilemma is seen in the English Court of Appeal decision in *Gallagher v. Jones*, [1993] STC 537. In that case, it was agreed that the expenses in question, rental payments made under a lease, were current in law. However, the Court of Appeal held that the lease was a finance lease under accounting principles and that the deduction of the expense was precluded by that fact. (The footnote is continued on the next page.)
In my view, it is a shortcoming of the Act that many intangible capital expenditures, such as certain contractual rights, lasting advantages and benefits, and so on, do not fall within the classes of depreciable property and are not governed by other specific timing rules. Instead, these expenditures fall within the category of eligible capital expenditure by default and are amortized at low rates that may bear little relationship to the actual loss sustained over time. Before the advent of eligible capital expenditures, they were not deductible at all. This circumstance may help to explain the courts' development of the matching principle as it relates to “current” expense. Faced with expenses that appeared to be capital in nature but were incapable of fitting within an existing statutory scheme of amortization, the courts accepted the proposition that amortization based on the matching principle of accounting was an acceptable alternative. In effect, the courts created a judicial class of depreciable property based on the matching principle, namely, the “current” expense that relates to future revenue. Perhaps the courts should not be criticized for trying to provide just results in those cases where the expenses were, in essence, capital; but they must be taken to task for employing methodology that is clearly wrong in law and in principle. To hold that an expense must be amortized is tantamount to saying that it is a capital expense.

JUDICIAL PRINCIPLES GOVERNING THE TIMING OF THE DEDUCTION OF CURRENT EXPENSE

The General (and Correct) Rule

As noted above, it has been consistently upheld that a current expense is deductible in the year in which it is incurred and that there is no need to show any relationship between the expense and a particular item of revenue.

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15 Continued . . .

rental payments for income tax purposes was to be governed by the accounting treatment. As a result, part of the deduction that was allowed by the court for income tax purposes was the accounting depreciation of a capital asset, even though such deduction was not permissible under the taxing statute. See Graeme MacDonald, “Matching Accounting and Taxable Profits: Reflections on Gallagher v. Jones” [1995], no. 5 British Tax Review 484-98, at 488. As already noted, it is apparent that Revenue Canada looks to accounting principles, and in particular the matching principle, in determining timing issues that are essentially matters of capitalization. See IT-417R2, supra footnote 7.

16 Perhaps a more appropriate timing rule would be one similar to that found in subsection 18(9), dealing with prepaid expenses.

17 See, for example, Tower Investment, supra footnote 6, at 6165, where the judge allowed the amortization of advertising expenses based on the accounting matching principle. Although he held that the advertising expenses were current expenses in law, he was of the view that they were not so in the “normal” sense:

The advertising expenses laid out here were not current expenditures in the normal sense. They were laid out to bring in income not only for the year they were made but for future years.

I have therefore concluded that the treatment of the advertising expenses by the respondent in this case was proper and not prohibited by the Income Tax Act.
The House of Lords set out the general principle as follows:

[A] first principle of tax law is that the taxpayer, in ascertaining his profit, is entitled to debit his expenditure in the year of assessment. . . . [I]t is no grounds for refusing a deduction in one year that the expense may be recoverable in another. Put another way, the Crown is not entitled to anticipate a profit which may or may not be made. . . .

It has long been established that you are entitled to include in expenditure for the year all business expenses in that year. . . . whether or not they can be attributed to the production of goods in that year. It matters not that certain expenditures may have proved abortive, or may have been spent solely with a view to production and profit in some future year and have no relation at all to production during the year of account. This was settled as long ago as 1910 in Vallambrosa Rubber Co., Ltd. v. Farmer, 5 T.C. 529, a decision often followed and never questioned. 18

In Canada, the courts have similarly held that in computing the income from a business, a current expense “must be deducted by computing the profits for the period in which it was made, and not some other period.” 19

As for the general limitation found in paragraph 18(1)(a) (that expenses are not deductible except to the extent that they are incurred for the purposes of producing income from a business or property), there need be no specific relationship between the expenditure and any particular income. . . . [T]here is no need to demonstrate a causal connection between a particular expenditure and a particular income, and no need for the income to be generated in the same year in which the expenditure was made. . . . The only thing that matters is that the expenditures were a legitimate expense made in the ordinary course of business.

18 Duple Motor Bodies, Ltd. v. Ostime (1961), 39 TC 537, at 567 and 571 (HL). See also Vallambrosa Rubber Co., Ltd. v. Farmer (1910), 5 TC 529, at 535 (CT. Sess.); Albion Rovers Football Club, Ltd. v. Commissioners of Inland Revenue (1952), 33 TC 331 (HL); and Naval Colliery, supra footnote 1. In Ward & Co. v. Commissioner of Taxes, [1923] AC 145, at 148 (PC), the Privy Council stated that “much of the expenditure in each year—such as expenditure in the purchase of raw material, in the repair of plant or the advertisement of goods for sale—is designed to produce results wholly or partly in subsequent years; but, nevertheless, such expenditure is constantly allowed as a deduction for the year in which it is incurred.” In MacKenzie v. Arnold (HM Inspector of Taxes) (1952), 33 TC 363, at 368-69 (HCJ), it was held, “It is the expense which you incur in carrying on your profession or vocation in the year of assessment which may be brought into account against the receipts of the person taxed and you cannot bring into account the expenses which have been incurred in previous years. . . . The same principle, as it seems to me, is inherent in the decision of the Court of Session in the case of Vallambrosa Rubber. . . .” It was held that the taxpayer was entitled to bring into account the expenses in respect of the whole of the estate for each year, but only, of course, in respect of the year in which they were incurred. That seems to me to be, in effect, the same principle.”

19 J.L. Guay Ltée v. MNR, 71 DTC 5423, at 5427 (FCTD), aff’d. 73 DTC 5373 (FCA), aff’d. 75 DTC 5094 (SCC). See also Consolidated Textiles Limited v. MNR (1947), 3 DTC 958, at 960 (Ex. Ct.); The Royal Trust Co. v. MNR, 57 DTC 1055, at 1061 (Ex. Ct.); Wilson and Wilson Ltd. v. MNR, 60 DTC 1018, at 1024-25 (Ex. Ct.); and Rossmor Auto Supply Ltd. v. MNR, 62 DTC 1080, at 1082 (Ex. Ct.)
with the intention that the company could generate a taxable income some time in the future.\textsuperscript{20}

The Origins of Matching

The matching proposition is derived largely from the footnote in the Associated Investors case. It gained prominence on the basis of comments made in the Oxford Shopping Centres and West Kootenay cases. These cases are reviewed below. It is concluded that they are not reliable authority for the proposition that a current expense (in law) can be deducted in a year other than the year in which it is incurred.

Associated Investors: Not a Footnote To Stand On

The now famous footnote in President Jackett’s decision in the Associated Investors case is widely viewed as the judicial origin of the matching principle in Canada, as well as the so-called running expense exception to matching.\textsuperscript{22} It is interesting that neither the footnote nor the body of the decision mentions the matching principle. The decision simply affirms the general rule that an expense is deductible in the year in which it is incurred. The views expressed in the footnote do not appear to apply to the decision.

It is important to realize that at the time of the Associated Investors decision, no court had allowed the deduction of a current expense in a year other than that in which the expense was made or incurred. However, in the footnote, President Jackett rejected as a general principle that current expenses are deductible only in the year in which they are made or incurred. Instead, in his view, “many” expenses are deductible in the year “in respect of” which they were made:

\[\text{While certain types of expense must be deducted in the year when made or incurred, or not at all, (e.g., repairs as in Naval Colliery Co. Ltd. v. C.I.R, (1928) 12 T.C. 1017, or weeding as in Vallambrosa Rubber Co., Ltd. v. Farmer, (1910) 5 T.C. 529), there are many types of expenditure that are}\]

\footnotesize{\textsuperscript{20}Mattabi Mines, supra footnote 12, at 301. Similarly, in Premium Iron Ores, supra footnote 12, at 5286 and 5292, it was concluded that former paragraph 12(1)(a) (now paragraph 18(1)(a)) does not, in referring to “producing income from the property or business of a taxpayer,” limit the words quoted solely to the taxation year in which the deduction is being claimed. It is a clear indication . . . that the income thus referred to may be the income of the taxation year under review or of a succeeding year. . . .

The only qualification which Parliament imposed was that the outlay or expense be “made or incurred by the taxpayer for the purpose of gaining or producing income from the property or business of the taxpayer.” No limitation as to time can be found in the section in question.

\footnotesize{\textsuperscript{21}West Kootenay Power and Light Company Limited v. The Queen, 92 DTC 6023 (FCA). In Canderel, the Federal Court of Appeal also relied on the case of Commissioners of Inland Revenue v. Gardner Mountain & D’Ambrumenil, Ltd. (1947), 29 TC 69 (HL), which is cited in the Associated Investors footnote and is discussed in the analysis of that footnote in the text below.

\footnotesize{\textsuperscript{22}Associated Investors, supra footnote 5, at 5098.}
deductible in computing profit for the year “in respect of” which they were paid or payable [emphasis added].\textsuperscript{23}

President Jackett’s proposition does not appear to advocate the matching of current expense to future revenue, which is the form of matching that emanated from the subsequent Canadian matching cases. President Jackett’s view indicates that many expenses are deductible from income for the year in respect of which they are made. His statement appears to suggest a form of “time matching” of expenses to the year for which they were expended. This is not necessarily the same as matching to revenue.\textsuperscript{24}

No matter whether the \textit{Associated Investors} footnote dealt with time matching or revenue matching (or neither), it implies that a current expense may be deductible in a year other than that in which it is incurred. This view finds no support in the prevailing case law at that time. The examples of interest and the cost of inventory are cited in the footnote, but those examples do not advance the proposition. The interest rule is a statutory rule, and in any event our courts have held that interest is a capital expense. The inventory rules do not deal with current expense; rather, they deal with the cost of goods sold, which is deducted when the inventory is sold.\textsuperscript{25}

\textit{Authorities Provided in the Footnote}\n
The authorities put forth in the footnote do not support the proposition that a current expense may be deductible in a year other than that in which it is incurred. The \textit{Gardner Mountain} case is cited, but that case simply stands for the principle that revenue is included in the year in which it is realized and not the subsequent year in which it is actually received.\textsuperscript{26} In \textit{Gardner Mountain}, the taxpayer company acted as an agent for certain underwriters of insurance. As remuneration for its agency services, the company was entitled to receive commissions based on the net profits of each year’s underwriting. However, the accounts of the underwriting activities were to be kept open for some two years after the relevant year of commissions, in order that the net profits for that year (and therefore the commissions) could be ascertained with some certainty. The issue was whether the commission income was included in the underwriting

\textsuperscript{23} Ibid.

\textsuperscript{24} Interestingly, “time matching” (amortization over the years to which an expense relates) was rejected as a common law rule by the Federal Court of Appeal in \textit{Toronto College Park}, supra footnote 9, at 6410. The court held that unless prepaid expenses could be matched with particular revenues, they would not be required to be amortized, \textit{but for} subsection 18(9).

\textsuperscript{25} It is ironic that in a subsequent decision, Chief Justice Jackett (as he then was) held that the cost of inventory was not an “expense” deductible in computing profit. See \textit{Oryx Realty Corporation v. MNR}, 74 DTC 6352 (FCA). This view was confirmed by the Supreme Court of Canada in \textit{MNR v. Shofar Investment Corporation}, 79 DTC 5347 (SCC).

\textsuperscript{26} \textit{Gardner Mountain}, supra footnote 21. This case was also cited by DesJardins J of the Federal Court of Appeal in the \textit{Canderel} decision, supra footnote 8, at 5114, as authority for the matching principle as set out in that case.
year (year 1), that being the year in which the services were completely rendered and in which the company had an existing legal right to be paid, even though the amount of the payment was not fully ascertained and paid to the taxpayer until a subsequent year (year 3).

Both the Court of Appeal and the House of Lords held that the commissions were included in income in year 1. Viscount Simon stated the applicable principle as follows:

In calculating the taxable profit of a business on Income Tax principles . . . services completely rendered or goods supplied, which are not to be paid for till a subsequent year, cannot, generally speaking, be dealt with by treating the taxpayer’s outlay as pure loss in the year in which it was incurred and bringing in the remuneration as pure profit in the subsequent year in which it is paid, or is due to be paid. . . . [T]he net result of the transaction, setting expenses on the one side and a figure for remuneration on the other side, ought to appear . . . in the same year’s profit and loss account, and that year will be the year when the service was rendered or the goods delivered. . . . This may involve, in some instances, an estimate of what the future remuneration will amount to (and in theory, though not usually in practice, a discounting of the amount to be paid in the future), but in the present case the amount of the commission due to be paid on 31st March, 1941, [year 3] as part of the remuneration for services rendered two years before was already known before the additional assessment was made. The Crown is right in treating this additional sum as earned in the chargeable accounting period 1st April, 1938, to 31st March, 1939, [year 1]. . . .

This, as it seems to me, is the result of applying the well-known decision in the Woolcombers’ case (Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue), 12 T.C. 768, where the taxpayer had been engaged in combing wool on commission for the Government in the year 1917-18 and the commission was by a subsequent arrangement increased and paid to the taxpayer after the end of the trading year. Rowlatt, J., held that the total amount of commission must be included in arriving at the profits of the taxpayer for the year 1917-18. In other words, the taxpayer was treated as earning, by his work in that year, all the profits arising from the business of the year, even though there was no legal right to part of them until the agreement was afterwards made. It will be observed that the Crown’s contention in the present case does not go so far as the contention which prevailed in the Woolcombers’ case, for in the latter there was no legal right, at the time when the work was done, to receive the amount which was ultimately paid; here the Appellant Company had a legal right to be paid in futuro. The same principle is involved in the decision of this House in the case of Commissioners of Inland Revenue v. Newcastle Breweries, Ltd., 12 T.C. 927, at page 952. Another illustration of the same principle may be found in the case of English Dairies, Ltd. v. Phillips, 11 T.C. 597. The principle is to refer back to the year in which it was earned, so far as possible, remuneration subsequently received, even though it can only be precisely calculated afterwards [emphasis added].

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27 Gardner Mountain, supra footnote 21, at 93-94. In Canada, an amount is similarly included in income in the year in which it is receivable even if it is received in a subsequent year, although the quantum of the amount must be sufficiently ascertainable in the receivable year.
It is evident from the entirety of this text that Viscount Simon held the relevant principle to be as follows: when services are completely rendered or goods are supplied in a year and the taxpayer has an existing legal right to be paid, the revenues are included in income even though they are not received until after the year.

As to the timing of expenses (which was not in issue), Viscount Simon held that it would not be appropriate to include revenues on a receipt basis in a subsequent year (year 3) while reporting expenses on an “incurred” basis (year 1). Rather, both the expenses incurred in year 1 and the revenues earned in year 1 were to be reported in “that year when the service was rendered or the goods delivered.”

It is important to remember that the *Gardner Mountain* case dealt with the timing of revenues, and the timing of the expenses was not in issue. All five of the judgments given by the members of the House of Lords dealt solely with the issue of the timing of the company’s revenues, which were found to have been earned and realized in year 1. There is no basis to conclude that, had the Lords found that the revenues were realized and included in year 3, the expenses *incurred in year 1* would have been deductible in year 3.28

In the *Associated Investors* footnote, President Jackett also noted that *Gardner Mountain* was applied in the *Ken Steeves* case.29 However, in that case, the *Gardner Mountain* decision was cited only for the principle that revenue is included in income when it is receivable, and not in a subsequent year in which it is received.

Lastly, President Jackett stated that his general proposition (that many expenses were deductible in the year in respect of which they were paid or payable) did not apply to “running expenses,” which were deductible only in the year incurred. He referred to the *Naval Colliery* case30 as authority for this view.

*The “Running Expense” Case*

Before *Associated Investors*, there was no judicial authority that carved out “running” and “non-running” expense from the category of current expense. *Associated Investors* and the subsequent Canadian matching cases have viewed a passage in the English decision in *Naval Colliery* (reproduced below) as holding that only running expenses are, as a matter of law, deductible in the year in which they are incurred (whereas current expenses that are non-running expenses may be subject to matching). Interestingly, no English court has interpreted *Naval Colliery* in this manner, and the English jurisprudence does not appear to have made a legal

28 Yet that is the interpretation given to the case by DesJardins J, in *Canderel*, supra footnote 8, at 5114.

29 *Ken Steeves Sales Ltd. v. MNR*, 55 DTC 1044 (Ex. Ct.).

30 Supra footnote 1.
distinction between running and non-running expenses. Most significantly, no English court has suggested that a non-running expense should be matched to future revenue.

The *Naval Colliery* decision does not appear to support the distinction made in the Canadian matching cases. The facts of the case are straightforward. The taxpayer’s coal mine was damaged by a large flood. The company incurred expenses in pumping out the water from the mine and in rebuilding the mine pit props. The expenses were incurred in the taxation year following the year of the flood. The company attempted to deduct the expense in the flood year, on the grounds that the repairs became necessary in, and were attributable to, the flood year.

Rowlatt J denied the deduction because the expenditure was not incurred in the flood year. Assuming that it was a current expense, the expense was deductible only in the year in which it was incurred. This conclusion was affirmed by the Court of Appeal and by the House of Lords. In the course of his judgment, Rowlatt J provided a summary of the principle regarding the computation of profit:

Now one starts, of course, with the principle . . . that the profits for Income Tax purposes are the receipts of the business less the expenditure incurred in earning those receipts. It is quite true and accurate . . . that receipts and expenditure require a little explanation. Receipts include debts due and they also include, at any rate in the case of a trader, goods in stock. Expenditure includes debts payable; and expenditure incurred in repairs, the running expenses of a business and so on, cannot be allocated directly to corresponding items of receipts, and it cannot be restricted in its allowance in some way corresponding, or in an endeavour to make it correspond, to the actual receipts during the particular year. If running repairs are made, if lubricants are bought, of course no enquiry is instituted as to whether those repairs were partly owing to wear and tear that earned profits in the preceding year or whether they will not help to make profits in the following year and so on. The way it is looked at, and must be looked at, is this, that that sort of expenditure is expenditure incurred on the running of the business as a whole in each year, and the income is the income of the business as a whole for the year, without trying to trace items of expenditure as earning particular items of profit.

Now, looked at in that way, it seems to me that nothing can be brought in the way of expenditure in this year [the flood year]; there was not any; and looked at as expenditure, you cannot say that in the next year, when the expenditure was made, you ought to say that some of that expenditure is to be allocated to the previous year, because the damage happened in the previous year which made the expenditure necessary [emphasis added].

This passage appears to affirm the general rule that “expenditure” is deductible in the year in which it is incurred (it was evident that Rowlatt J

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31 There was some speculation that the expense may have been capital, in which case the deduction would have been denied in any event.

32 *Naval Colliery*, supra footnote 1, at 1027-28.
was speaking of current expense and not capital expense), that it cannot be allocated to another year, and that the deduction is not dependent on whether the expense is traceable to revenues.\(^{33}\) Rowlatt J appeared to use running expenses only as an example to illustrate the point that the timing of a deduction cannot be predicated on tracing to revenues. The fact that “running expenses of a business and so on, cannot be allocated directly to corresponding items of receipts” cannot restrict their deduction. Expenditure “cannot be restricted in its allowance in some way corresponding, or in an endeavour to make it correspond, to the actual receipts during the particular year.” That is why “of course no enquiry is instituted” as to whether the expenses helped to earn “profits in the preceding year or . . . profits in the following year.” And that is why “the income is the income of the business as a whole for the year, without trying to trace items of expenditure as earning particular items of profit.”\(^{34}\)

\textit{Oxford Shopping Centres: Only as Reliable as the Footnote}  
The \textit{Oxford Shopping Centres} case is the other landmark decision in Canada insofar as the matching principle is concerned.\(^{35}\)

In consideration of the City of Calgary’s undertaking to construct an interchange and to make certain street realignments and improvements adjacent to the taxpayer’s shopping centres, the taxpayer agreed to pay an upfront lump sum in lieu of any local improvement rates or taxes that might arise from the construction.\(^{36}\) For accounting purposes, the taxpayer treated the expenditure as a deferred charge and amortized it over a period of 15 years, but for income tax purposes, the taxpayer attempted to deduct the entire amount in the year in which the expenditure was made.

Thurlow J held that the expenditure was a current expense in law. However, it is apparent that in his view this finding did not fully resolve the timing issue, and further analysis was required. After quoting the \textit{Associated Investors} footnote in full, Thurlow J concluded:

\begin{quote}
I think it follows from this that for income tax purposes, while the “matching principle” will apply to expenses related to particular items of income, and in particular with respect to the computation of profit from the acquisition and sale of inventory (compare \textit{Neonex International Ltd. v. The Queen} [78 DTC 6339 at p. 6348], [1978] C.T.C. 485 at p. 497), it does not apply to the running expense of the business as a whole even though the
\end{quote}

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\(^{33}\) See also \textit{Mattabi Mines}, supra footnote 12, and \textit{Premium Iron Ores}, supra footnote 12.

\(^{34}\) The phrase “without trying to trace items of expenditure as earning particular items of profit [emphasis added]” in the first paragraph appears to refer to expenditure in general and not only to running expense. In the second paragraph, where Rowlatt J applies the principle set out in the first and holds that the expenditure in question cannot be deducted in the year before the year in which it was incurred, he speaks of the amount in question “looked at as expenditure [emphasis added],” again implying that the principle applies to expenditure in general and not only to running expense.

\(^{35}\) \textit{Oxford Shopping Centres}, supra footnote 6.

\(^{36}\) Although the court held that the outlay was not a prepayment of future taxes.
deduction of a particularly heavy item of running expense in the year in which it is paid will distort the income for that particular year. Thus while there is in the present case some evidence that accepted principles of accounting recognize the method adopted by the plaintiff in amortizing the amount in question for corporate purposes and there is also evidence that to deduct the whole amount in 1973 would distort the profit for that year, it appears to me that as the nature of the amount is that of a running expense that is not referable or related to any particular item of revenue, the footnote to the Associated Industries [sic] case and the authorities referred to by Jackett, P., and in particular the Vallambrosa Rubber case and the Naval Colliery case, indicate that the amount is deductible only in the year in which it was paid. All that appears to me to have been held in the Tower Investment case and by the Trial Judge and LeDain, J. in the Canadian Glassine case is that it was nevertheless open to the taxpayer to spread the deduction there in question over a number of years. It was not decided that the whole expenditure might not be deducted in the year in which it was made, as the earlier authorities hold. And there is no specific provision in the Act which prohibits deduction of the full amount in the year it was paid. I do not think, therefore, that the Minister is entitled to insist on an amortization of the expenditure or on the plaintiff spreading the deduction in respect of it over a period of years.37

The ratio descendi of Thurlow J’s decision is that a running expense that does not relate to particular revenues is deductible only in the year in which it is incurred. As to His Lordship’s comment on the application of the “matching principle,” it is unclear what specific expenses other than the cost of inventory would be subject to matching. Thurlow J interpreted the decision in Tower Investment38 and the finding of the trial judge and LeDain J in Canadian Glassine39 as holding that the taxpayer had the option of spreading the deduction in question over a number of years. He did not expressly categorize the expenses in question, but it is evident that he did not view them as running expenses, which in his opinion were deductible only in the year incurred. His statement has been interpreted as meaning that the matching of current expenses other than running expenses is optional.40 DesJardins J in the Canderel case held that the optional treatment applied to running expenses,41 but this cannot be a correct interpretation.

If, in addition to the cost of acquiring inventory, “expenses related to particular items of income” refers to expenses that are otherwise determined to be current in law, Thurlow J’s opinion that such expenses were

37 Oxford Shopping Centres, supra footnote 6, at 5466-67 (FCTD). The Federal Court of Appeal, supra footnote 6, upheld the decision of the Trial Division and agreed with reasons given by Thurlow J.
38 Supra footnote 6.
39 Supra footnote 6.
41 Supra footnote 8, at 5113.
subject to the matching principle was a novel one without reliable judicial precedent. Thurlow J purported to follow the rationale in the Associated Investors footnote, but it is clear, as already discussed, that the footnote cannot be regarded as authority for such a proposition.

**West Kootenay: Accrual of Current Expense**

In the Canderel decision, the Federal Court of Appeal cited a passage in the West Kootenay case as authority for its conclusion that the matching principle had become a legal principle:

> The approved principle is that whichever method presents the “truer picture” of a taxpayer's revenue, which more fairly and accurately portrays income, and which “matches” revenue and expenditure, if one method does, is the one that must be followed.

No authority is given in West Kootenay for this statement. In the decision, the court determined that the accrual method of computing profit was to be followed by the taxpayer because it best matched revenue with expenditure. Under the accrual method, the amounts in question were included in income in the year in which they were receivable in law. This finding cannot be reasonably viewed as authority for the matching of a current expense beyond the year in which it is incurred. Under the accrual method of computing profit, a current expense is deductible when incurred.

**The Status After Canderel and Toronto College Park**

The judicial origins of matching are flawed and should not be regarded as authority for the amortization of current expenses. However, one is left with the Supreme Court’s comments made in obiter in Canderel and Toronto College Park. The court indicated that the matching principle may apply in those cases where it provides the more accurate portrayal of a taxpayer’s profit, such as where an expense relates directly to specific revenues or benefits that will be realized solely in future taxation years. For reasons outlined in the next section of this article, I suggest that only in the rarest of circumstances could such an expense be considered to be on current account (it would inevitably be capital or represent the cost of inventory). If so, common law matching may have little practical consequence except in regard to inventory profit.

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42 In Tower Investment, supra footnote 6, and in the Trial Division in Canadian Glassine, supra footnote 6, the courts allowed the amortization of certain expenses based on the accounting matching principle. However, the sole judicial authority for this treatment was the footnote in the Associated Investors case.

43 Supra footnote 8, at 5102, quoting West Kootenay, supra footnote 22, at 6028.

44 As discussed later in this article, the accrual method of computing profit, though based on the matching principle, is normally acceptable for income tax purposes because it conforms with general income tax principles.

45 The issue of characterization was not addressed by the Supreme Court because the Crown conceded that the expenses in both cases were current.
THE TIMING OF THE DEDUCTION OF EXPENDITURE UNDER GENERAL INCOME TAX PRINCIPLES

The Canadian income tax system appears to be based on the principle that changes in a taxpayer’s wealth—assuming that they are attributable to a “source,” and subject to overriding policy concerns—should be included in the tax base when they are realized. Accordingly, the deduction of a business expenditure is justified in the year in which there is a realized decrease in the taxpayer’s wealth.

A capital expenditure is generally viewed as one that gives rise to an asset or advantage with value (income-earning capacity) extending into taxation years beyond the year of expenditure. This explains why a full deduction is not allowed immediately: a capital expenditure does not decrease wealth; it merely changes the form of wealth. If the asset or advantage has a limited duration, a decrease in wealth is sustained solely owing to the passage of time as its utility is exhausted or

46 Under our income tax system, the “ability to pay” norm is modified in at least two significant ways: only wealth that can be attributed to a source is taxed (the source concept), and liability for tax generally arises only when a change in wealth is realized (the realization principle).

47 In the discussion below, the source of the income is assumed to be a business and expenditures are assumed to be incurred for the purpose of earning the income. In other words, the only issue is timing.

48 The distinction between a capital and a non-capital outlay is simple to state in theory, but its application is not always obvious in practice. Over the years, the courts have come up with numerous tests to be used in making the distinction, but few are helpful and some, particularly those of the earlier decisions, appear to be irrelevant to the capitalization issue. See generally Francis Eugene LaBrie, *The Meaning of Income in the Law of Income Tax* (Toronto: University of Toronto Press, 1953), 259-364; F.E. LaBrie, *The Principles of Canadian Income Taxation* (Don Mills, Ont.: CCH Canadian, 1965), 187-216; and Neil Brooks, “The Principles Underlying the Deduction of Business Expenses,” in Brian G. Hansen, Vern Krishna, and James A. Rendall, eds., *Canadian Taxation* (Toronto: De Boo, 1981), 189-249, at 208-21. Brooks, in his review of the guidelines laid out by the courts, ibid., at 207 and 223, concluded:

As in most of the areas dealing with deductibility, the courts have made little effort to articulate and apply the underlying principle; instead they have developed a series of tests to be applied in distinguishing capital from current expenses. This has resulted in turning what would have been a troublesome area of law into a chaotic one.

In view of such judicial statements one might be forgiven for despairing in trying to make sense of the tests that the judges say they are applying in distinguishing between a current and a capital cost.

In *Johns-Manville Canada Inc. v. The Queen*, 85 DTC 5373, after reviewing the various judicial tests and other authorities on the distinction between capital and current expenses, the Supreme Court of Canada concluded, at 5381 and 5384, that the principles enunciated by the courts and the elucidation on the application of those principles [are] of very little guidance when it becomes necessary, as it is here, to apply those principles to a precise set of somewhat unusual facts.

The characterization in taxation law of an expenditure is, in the final analysis (unless the statute is explicit which this one is not), one of policy.
consumed. Under the Act, a deduction is normally allowed for capital cost allowance or on account of eligible capital expenditure as an approximation of, or (perhaps to state the point more accurately) as a surrogate for, the decrease in wealth over time.

The cost or expense of acquiring a capital asset with an indefinite life (non-depreciable capital property) is normally deducted when the property is sold or otherwise ceases to belong to the taxpayer, because that is when the value of the property is terminated as far as the taxpayer is concerned. For similar reasons, the cost of inventory is deducted when the property is sold.

An outlay that cannot be reasonably viewed as creating value extending beyond the year of expenditure is not a capital expense. The utility of such an expenditure is effectively consumed, and a decrease in wealth is realized, in the year of expenditure. This type of expense, of course, is referred to as non-capital expense or simply current expense. A current expense should always be deductible in the year in which it is incurred.

49 A loss in wealth that occurs solely because of the passage of time might be viewed as having been realized, in the sense that the loss is once and for all and cannot be reversed. Or at the very least, it can be considered the “next closest thing” to realization. Even if not realized in the traditional sense, decreases in wealth owing solely to the passage of time are justified because they are not subject to the usual constraints associated with a full accrual or mark-to-market system. See Joseph M. Dodge, The Logic of Tax (St. Paul, Minn.: West Publishing, 1989), 229-30. Such decreases in wealth differ from those that occur because of economic or market forces, or for any other reason. In the latter cases, a decrease in wealth is simply a “paper” loss, which is not necessarily once and for all and may be reversed.

50 A taxpayer’s decrease in wealth will rarely coincide with the deduction provided under the amortization schedules in the Act. For the sake of consistency and administrative efficiency, the statutory rules must employ arbitrary assumptions and estimates, and the statutory scheme of depreciation is often used for tax expenditure purposes. In some cases, the deduction of the expense is governed by other provisions of the Act.

51 Depreciation is not allowed before that time, because the asset is assumed to exist in perpetuity.

52 As outlined earlier in this article, the judicial authorities apart from the Canadian matching cases have consistently accepted this proposition. See also Dodge, supra footnote 49, at 5: “Current expense represents an immediate decrease in the taxpayer’s wealth. The fact that an outlay is an expense does not alone mean that it is deductible (personal consumption expenses . . . are not deductible). But characterization as an expense means that, if the outlay is deductible, it is deductible in the taxable year made.” To the same effect, see Brooks, supra footnote 48, at 206:

The difference between these two kinds of business expenses, in terms of legal consequence, is that current expenses can be deducted in the year that they are incurred, while capital costs must at least in part be deducted in future years.

A current expense is a business expense that brings to a business a utility or value that is consumed in the year that the expense is incurred. A capital cost is a business expense that brings to the business a value that is not consumed in the year that the expense is incurred.

The Royal Commission on Taxation (the Carter commission) concluded with respect to business expenditures, “All expenditures reasonably related to the gaining or producing of...
A judge-made rule that aspires to amortize a current expense is untenable because it purports to recognize the expense in a year other than that of the realized decrease in wealth. To suggest that a current expense in law must be amortized is to say that the expense is in fact capital.53

MATCHING TO RELATED REVENUE AS A GOAL OF INCOME TAX

Under the analysis provided above, an expense is allocated to (deductible in) the year or years in which the utility of the subject matter of the expenditure is or will be consumed, a determination that is normally made as of the time of expenditure. I suggest that it is not readily apparent that any central principle of our income tax laws generally requires, or should require, that expenses be matched with related items of revenue.54 It is not obvious that the timing of the deduction of an expense is ever sanctioned by a matching to revenue, although the timing rules (described above) may result in matching.55

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52 Continued...

income should be deductible at some time. They should be deductible when incurred unless they were applicable to inventory, to an item defined in a capital cost allowance schedule, or to property of an indefinite life such as purchased goodwill, land, and securities. Costs allocated to the first group should be deductible from the proceeds of sale, those of the second group should be amortized as permitted by the schedules, and for the last group, losses should be deductible on disposition or when there was a proven significant loss in value [emphasis added].” Canada, Report of the Royal Commission on Taxation, vol. 4 (Ottawa: Queen’s Printer, 1966), 283. The commission would have allowed a broader base of expenditures because it recommended a broader revenue base; however, this point does not affect its conclusions on timing. In Toronto College Park, supra footnote 9, the Supreme Court allowed the current deduction of TIPs, because the primary purpose of the TIPs was to achieve a benefit that was realized entirely in the year of expenditure. In Canderel, supra footnote 8, the court agreed that the TIPs in that case gave rise to several benefits, some of which were realized in the year of expenditure and some in future taxation years. On the basis of that finding of fact, it appears that the TIPs in Canderel were capital; however, as noted above, the court was not required to address the characterization issue because the Crown conceded that the expenses were current. Faced with the option of current deductibility or judicial amortization, the court allowed the former.

53 On the other hand, there are some expenditures, such as advertising expenses, that may be capital in nature in that they may create some form of value that extends into future taxation years, but these expenses are typically treated as current for income tax purposes. Presumably, the rationale for treating these expenses as current is that the quantum of wealth that extends into future years, if any, and its duration, are difficult, if not impossible, to estimate with any certainty; accordingly, for the sake of administrative efficiency, they are simply classified as current. See, for example, Premium Iron Ores, supra footnote 12, at 5292.

54 In the next section of this article, I discuss why the accounting principle of matching expenses to related revenue cannot be viewed as a principle of general application in income tax.

55 See also Alan Gunn, “Matching of Costs and Revenues as a Goal of Tax Accounting” (Summer 1984), 4 Virginia Tax Review 1-47; and Judith Freedman, “Defining Taxable Profit in a Changing Accounting Environment” [1995], no. 5 British Tax Review 434-44. It is recognized that policy concerns may justify matching to related revenues in some circumstances—say, in the case of certain tax shelter investments, or hedging or straddle transactions.
Consider an expenditure for an asset or advantage of limited life or duration. In order that a taxpayer be allowed to recover the cost of his or her investment (the expense), it must be allocated on a rational basis expected to reflect the taxpayer’s loss of the utility of the expenditure (the decrease in wealth). Under general principles, the allocation to a particular year should be based on the amount that the taxpayer spent (this year) for the expected utility of the asset or advantage in this or a later year.  

For example, suppose that you incur a capital expenditure of $300 at the end of this year (year 0), which is expected to have utility and income-generating potential for three years. At the end of year 1, you will have sustained a loss in wealth, namely, one year’s worth of utility, which cost you $100 of the initial $300 outlay (assuming, for the sake of simplicity, a straightline allocation of the cost per year of use). Under general principles, you should be allowed to deduct the $100 decrease in wealth in year 1. At the end of year 2, you will have exhausted another year’s worth of utility, for which you also paid $100, and the pattern continues through to the end of year 3, at which point your expenditure has been “used up” and your entire loss realized.

Under general principles, the deduction that is allowed in each year is based on the portion of the $300 outlay that was expended for its expected utility in that year; the timing of the deduction is not justified by a matching to revenues. In other words, the amount of the expenditure allocated to the year does not change if the flow of revenues changes. For example, if it turned out that revenues in year 1 were either higher or lower than anticipated, or that they did not materialize at all, your entitlement to the deduction would not change. Similarly, the deduction in year 1 would not change if by the end of year 1, it became apparent that the revenues for years 2 and 3 would be higher or lower than expected. Nor would it change if it became apparent that the expenditure would lead to revenues in years 4 and 5. The allocation of the expense is fixed at the time of expenditure and cannot be reallocated because of subsequent value shifts or fluctuations in expected revenues.

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57 A straightline method is not sustainable in theory because it ignores the time value of money.

58 Similarly, once it is determined that the value brought by an expenditure is or will be consumed in the year in which the expense is incurred (that is, that it is a current expense), the deduction is allowed to stand if it subsequently follows that the expenditure in fact contributes to future revenues.

59 If an income tax system were to take into account fluctuations in the value or duration of the expected revenues, presumably this would be achieved by accruing the annual changes in the present value of those revenues. The original allocation of the expenditure to each year would remain the same. Of course, once it is apparent that the income-generating capacity of an expenditure is lost (say, if the asset is destroyed or if it is no longer used in the business), an adjustment to the original allocation may be made at that
The matching issue is somewhat obscured by the fact that theories of cost recovery often assume that the amount of an expense (its value at the time of expenditure) reflects the present value of revenues that the asset or advantage will generate over its useful life. Therefore, it is sometimes assumed that the allocation of an expense for income tax purposes is justified as, or sanctioned by, an allocation to related revenues. But any matching to related revenues is a consequence of the allocation decision, not necessarily the cause of it. Support for this view may be found in the observations of the Supreme Court of Canada in *Mattabi Mines* and *Premium Iron Ores*, quoted earlier in the discussion of judicial principles applicable to the timing of current expense deductions.

**THE ACCOUNTING MATCHING PRINCIPLE AND ITS RELEVANCE TO INCOME TAX**

Under the matching principle of accounting, an expense that has a “cause and effect” relationship or a reasonable association with revenue is matched and reported in the same period as the revenue. In some cases, the expense will be closely identified with particular revenue so that it can be matched directly to that revenue. In other cases, “direct” revenue matching is not feasible and the expense is simply amortized over time (time matching) as an approximation of the matching of expenses to revenues.

The matching of expenses to related revenues is considered necessary in fulfilling the primary objective of accounting. That objective is to provide an accurate portrayal of a firm’s profit-making capabilities to investors and creditors, in order that they may make estimates or predictions of the firm’s ability to earn income and generate cash flows in the future to meet its obligations and to generate a return on investment. If
expenses and related revenues were reported in different years, users of
the financial statements for either of those years may be misled as to the
firm’s “true” income-earning capabilities.

These concerns are exclusive to financial reporting and are not relevant
to income tax reporting. An income tax system does not normally concern
itself with whether a particular year’s income provides an accurate mea-
sure of the firm’s profit-generating ability to investors and creditors: “The
government—which finances itself on a year-to-year basis—is not con-
cerned about the possibility of being misled as to the long-term prospects
of a given business.”

In order to meet its objectives, the matching principle in accounting
requires the making of reserves and the exercise of judgment in order to
take into account the possible financial effects of other years. The entire
issue of capitalization and deferral is seen as one of the most subjective
and contentious areas of accounting, and at times it is dependent on man-
agement choice. On the other hand, a goal of an equitable tax system,
arising from the need for fairness and administrative efficiency, is a set of
rules that are relatively precise and objective.

Furthermore, the accounting principle of matching is at times focused
on the balance sheet rather than the income statement. The accounting
objectives may lead to the conclusion that an asset should be reported
and, if it is, the expenditure in question is capitalized. Under the income
tax system, on the other hand, the capitalization of an expense is required
for the purposes of profit measurement only. There is no balance sheet
concern. Capitalization based on the accounting matching treatment may
be irrelevant for income tax purposes:

[T]axation requirements will obviously be centred on the profit and loss
account, so that the distinctions between revenue and capital which are so
vital for tax purposes may be lost in the accounting treatment.

In summary, it is apparent that the objectives of the matching principle
of accounting and the motives for its application are largely foreign to
income tax principles. If the matching principle is to be adopted by the

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65 Dodge, supra footnote 49, at 166. See also Gunn, supra footnote 55, at 12.
66 See Geoffrey Whittington, “Tax Policy and Accounting Standards” [1995], no. 5
British Tax Review 452-56, at 453. At times, management discretion may be used to
smooth or manipulate reported income, cash flow from operations, and other measures of
financial performance. See Gerald I. White, Ashwin paul C. Sondhi, and Dov Fried, The
Analysis and Use of Financial Statements (New York: Wiley, 1994), 395-424. It is also
possible that conservatism in accounting can dictate expensing for financial purposes in a
case where the outlay is capital in law.
67 Whittington, supra footnote 66. See also Freedman, supra footnote 55, at 437; and
Guay Ltée, supra footnote 19, at 5427.
68 See, for example, White, Sondhi, and Fried, supra footnote 66.
69 Freedman, supra footnote 55, at 437. See also Sue Green, “Accounting Standards and
Tax Law: Complexity, Dynamism and Divergence” [1995], no. 5 British Tax Review 445-51,
at 450; and Brooks, supra footnote 48, at 222.
income tax system, it must be justified independently and not under the accounting rationale. As discussed below, the results provided by matching are acceptable only where they conform to income tax policy and principles and the tax concept of income. There is no apparent justification for the matching of a current expense beyond the year of expenditure.

Matching and Accrual Accounting

Accrual accounting is based on the matching principle. The accrual method allocates cash flows to years other than those in which they occur. Revenue is reported when it is realized (in the accounting sense) and expense when incurred, rather than when cash is actually received or paid. Accountants attempt to match the revenue earned with the expense that was incurred to earn that revenue. Accrual accounting is viewed as providing a better indication of the firm’s present and continuing ability to generate income and cash flows than does the cash method of reporting.

Although the concept of accrual was borrowed from accounting, it is not apparent that accrual in tax (legal accrual) is justified as a matching of expenses to revenues. Instead, legal accrual appears to be appropriate because an accretion to wealth is realized once a taxpayer has an absolute and unconditional legal right to receive an amount, even if the amount is not due until after the year in question. Therefore, an amount is included in income when it is receivable in law. (Under a “pure” tax system, the amount would be discounted to take into account the time period between the realization of the right and the receipt of cash, and interest would be accrued in the interim.) Similarly, a decrease in wealth is realized when there exists an unconditional legal obligation to pay an amount. An expense is deductible when it is payable in law. Because the issue of whether an amount is unconditionally receivable or payable is based on legal principles and the construction of contracts, legal accrual often differs from accounting accrual.

Furthermore, other modifications to the accrual method have been made for income tax purposes, to conform to legal realization and the tax concept of income, which take precedence over the matching objective of accounting. An example is found in the treatment of contingent expenses and similar reserves. Under accrual accounting, a contingency existing at the time of a sale of goods or the rendering of a service is deducted immediately if the contingent event is likely to occur and the amount of

70 Rosen, supra footnote 63, at 97.
71 White, Sondhi, and Fried, supra footnote 66, at 116-19.
72 Paragraph 12(1)(b). See Sinnott News Co., Ltd. v. MNR, 56 DTC 1047 (SCC); MNR v. Colford Contracting Limited, 60 DTC 1131 (Ex. Ct.), aff’d. 62 DTC 1138 (SCC); and West Kootenay, supra footnote 21.
74 See generally Arnold, supra footnote 40, at 225-34.
the loss can be reasonably estimated. The upfront accrual of the contingency more accurately matches the expense to the related revenue arising from the sale or the rendering of the service.

Income tax is not particularly concerned with matching the expense to the upfront revenue. An immediate deduction of the expense is denied because the obligation is contingent and not absolute, so that a current loss is not realized. The loss (decrease in wealth) is realized only once the contingency is satisfied. It is realized when the taxpayer has an absolute and unconditional obligation to pay the amount.

The difference in tax and accounting objectives is also seen in the analysis of prepaid or unearned income. Under accrual accounting, a prepayment received for future services to be rendered is not fully included in income in the year of receipt. The prepayment is offset by the liability to perform the future services and is only included in revenue over time as it is “earned” (in an accounting sense). The revenue is matched with the corresponding expense incurred in rendering the future services.

Under income tax law, prepaid or unearned income is included when received if the recipient has an absolute legal right to the amount and is allowed to commingle it with his other funds and use it for any purpose. In other words, it is included if it has “the quality of income,” even though the recipient has not earned the income. The rationale is that the recipient has realized an immediate accession to wealth, the source of which is the taxpayer’s business (assuming that the amount is received in the course of the business). The obligation to perform the future services is not a measurable “liability” that offsets the immediate increase in wealth. However, a statutory reserve is normally available, which has the effect of deferring the prepaid income until the performance of the

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75 CICA Handbook, supra footnote 62, at paragraph 3290.
76 Paragraph 18(1)(e). See also Sinnott News, supra footnote 72; and Guay Ltée, supra footnote 19.
77 If it is virtually certain that the taxpayer will be legally obligated to pay the expense in the future, a current deduction might be warranted (in theory, on a discounted basis) on the grounds that there effectively exists an unconditional obligation to pay. But see The Queen v. Burnco Industries Ltd. et al., 84 DTC 6348 (FCA).
78 It is sometimes said that the amount is included in income if there is no condition precedent to the recipient’s legal entitlement to the amount.
79 Paragraph 12(1)(a). See also Robertson v. Minister of National Revenue (1944), 2 DTC 655 (Ex. Ct.); Diamond Taxicab Association v. MNR, 52 DTC 1100 (Ex. Ct.), aff’d. 53 DTC 1111 (SCC); The Queen v. Foothills Pipe Lines (Yukon) Ltd., 90 DTC 6607 (FCA); and Ikea Limited v. The Queen, 94 DTC 1112 (TCC), aff’d. 96 DTC 6526 (FCA), aff’d. 98 DTC 6092 (SCC).
81 A different analysis applies if the prepayment is considered a loan or advance. See the discussion in the text below.
services.\textsuperscript{82} It has been suggested that the purpose of the reserve is to bring the tax treatment in line with the accounting matching treatment,\textsuperscript{83} but the justification for this result remains unclear. The reserve could be justified as a method of income spreading, in order to alleviate the hardship that might otherwise result—the graduated nature of the income tax means that more tax may be payable when income is bunched in one year. Alternatively, the reserve could be justified under a competing income tax theory, to the effect that prepaid income should be treated as a loan to the recipient. Under this theory, the reserve mechanism is justified on the grounds that income is not realized until the loan is “repaid” by the performance of the future services.\textsuperscript{84}

\textbf{Matching and Inventory Accounting}

If one owned only one or two items of inventory, determining the cost of the inventory would not be problematic. In the case of very large inventories, this determination is not practical; consequently, the accounting profession developed a formula to determine the cost of inventory, or more precisely, the cost of goods sold (COGS) in the year.\textsuperscript{85} Because the flow of inventory is not normally traceable, the COGS is determined using an assumed inventory flow. This may include either the “last in, first out” assumption (LIFO), the “first in, first out” assumption (FIFO), or the average cost assumption.

In regard to the matching issue, inventory accounting attempts to allocate the expense (the COGS) to the year in which the inventory is sold. The accounting “matching” of the COGS is acceptable under income tax principles, because the expense is deducted in the year in which a decrease in wealth is realized.\textsuperscript{86} Like the purchase of non-depreciable capital property, the purchase of inventory changes only the form of wealth. The

\textsuperscript{82} Paragraphs 20(1)(m) and 12(1)(e).


\textsuperscript{84} See, for example, Robert H. Scarborough, “Payments in Advance of Performance” (December 1991), \textit{69 Taxes: The Tax Magazine} 798-820; and Daniel I. Halperin, “Interest in Disguise: Taxing the Time Value of Money” (January 1986), \textit{95 Yale Law Journal} 506-52, at 515-19. For a similar view, see also Arnold, supra footnote 40, at 144-45 and 195. Whichever view is correct, the point is simply that the income tax treatment must be justified under income tax policy and legal principles, and not by determining whether the treatment is in accordance with the matching principle of accounting. The deferral of prepaid income (where the reserve applies) might also be justified under a neutrality argument, assuming that the payer must defer the deduction of the expense (for example, under subsection 18(9), which was, however, enacted 28 years after the reserve).

\textsuperscript{85} The formula is: Cost of goods sold = beginning inventory + purchases during the year − ending inventory.

\textsuperscript{86} But as discussed in the text below, the “lower of cost or market” method of valuation adopted from accounting appears to be at odds with general tax principles.
sale of the inventory is the realization event, when the value of the inventory is terminated as far as the taxpayer is concerned.

For income tax purposes, some adjustments to the accounting treatment have been made where necessary. For example, the LIFO method of allocating inventory costs is not permitted for income tax purposes.\(^87\) The LIFO method is not appropriate because it has the effect of deferring the recognition of the inflation component of realized profits.\(^88\) There is no reason to differentiate between inventory profit on the one hand and other forms of profit on the other where the income tax system does not make allowances for inflation.

The main concern with inventory accounting, from a tax perspective, is that it allows a deduction for unrealized depreciation of inventory under the “lower of cost or market” (LCM) method of valuing ending inventory. Income tax does not normally allow a loss to be recognized before it is actually sustained or realized. By importing the LCM method, however, our income tax laws allow a loss to be recognized before realization.\(^89\) Proposed amendments to the Act will rectify this problem for inventory used in an “adventure or concern in the nature of trade.” Such property is to be carried at its original cost so that an unrealized loss cannot be deducted.\(^90\)

**Matching of Capital Expense**

As outlined earlier, a capital expenditure could be viewed as being “matched” to the year(s) in which a loss in wealth is sustained or realized.\(^91\) This time matching may or may not result in a matching to related revenues.

**Matching of Current Expense**

As already argued in some detail, a rule that purports to amortize or match a current expense against future revenues is untenable under fundamental income tax principles. If an expense is determined to be current in

\(^87\) *MNR v. Anaconda American Brass Ltd.*, 55 DTC 1220 (PC).

\(^88\) On the assumption that the most recently purchased items of inventory are sold first, the cost of inventory is adjusted upward in periods of rising costs, roughly by the rate of inflation. This adjustment has the effect of deferring the inflation component of the realized profit on the sale of the goods.

\(^89\) This was the issue in *Friesen v. The Queen*, 95 DTC 5551 (SCC), where the taxpayer wrote down a single piece of land inventory using the LCM method of accounting.

\(^90\) Proposed subsection 10(1.01), in Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act and Related Acts, December 8, 1997. However, the LCM method still applies to other inventory, so that “depreciation” is still allowed before a loss is realized. Interestingly, instead of denying the recognition of such unrealized loss, the proposed amendments require that the loss be reversed, so that unrealized gain is reported, when the value of the ending inventory goes back up. It is not apparent why the government chose this route rather than simply disallowing the LCM method for all inventory.

\(^91\) See the earlier discussion under the heading “Matching to Related Revenue as a Goal of Income Tax.”
law, the fact that it may be deferred under the matching principle of accounting should be irrelevant for income tax purposes.

**Matching and the “Bunching” of Income**

A proponent of accounting matching might argue that it avoids the “bunching” of income and loss in separate years. However, income tax laws can deal with this issue in clear and more objective ways. For example, an income tax system can employ loss carryover provisions, income averaging provisions, and reserves that spread out deductions or inclusions over time. It should be considered peculiar for a tax system to combat the bunching of revenue or expense by way of a subjective matching principle.

**MATCHING AND THE TRUER PICTURE TEST**

The Canadian courts have repeatedly confirmed the existence of the so-called truer picture test. The test holds that where two or more methods of reporting profit are otherwise acceptable, the method that most accurately reflects the taxpayer’s income for the year in question is the appropriate method for income tax purposes.92

In the *West Kootenay* case, as cited earlier, it was proposed that the truer picture could be found through matching:

> The approved principle is that whichever method presents the “truer picture” of a taxpayer’s revenue, which more fairly and accurately portrays income, and which “matches” revenue and expenditure, if one method does, is the one that must be followed.93

The test obviously refers to the truer picture of profit for income tax purposes, and not for accounting purposes. The tax concept of income is predicated on annual changes in wealth as they are realized in law. For income tax purposes, the “truer” picture must be that which most accurately reflects this concept of income for the year in question. That method is not necessarily the same as that which provides the truer picture in fulfilling the accounting objectives.94

The foregoing was essentially the analysis provided by the Supreme Court of Canada in the *Friedberg* case.95 The court allowed the taxpayer’s method of reporting gains and losses on futures contracts, because it was an appropriate measure of realized income for tax purposes; the losses were reported when incurred and the gains when realized. The court was

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92 See, for example, *MNR v. Publishers Guild of Canada Ltd.*, 57 DTC 1017 (Ex. Ct.); *West Kootenay*, supra footnote 21; and most recently, the Supreme Court decisions in *Canderel*, supra footnote 8, and *Toronto College Park*, supra footnote 9.

93 *West Kootenay*, supra footnote 21, at 6028.

94 To the contrary, see *Neonex International Ltd. v. The Queen*, 78 DTC 6339, at 6349 (FCA), where the court implied that income tax treatment should follow the method that provides the most accurate portrayal of profit in fulfilling the accounting objectives. See also *Gallagher v. Jones*, supra footnote 15.

95 *The Queen v. Friedberg*, 93 DTC 5507 (SCC).
not satisfied that the “mark-to-market” method proposed by the Crown was appropriate for income tax purposes, even though it might provide a better measure of income for other (namely, financial accounting) purposes:

While the “marked to market” accounting method proposed by the appellant may better describe the taxpayer’s income position for some purposes, we are not satisfied that it can describe income for income tax purposes, nor are we satisfied that a margin account balance is the appropriate measure of realized income for tax purposes.96

If an expenditure is a current expense in law, it means that its value has been effectively consumed during the year of expenditure. A decrease in wealth is realized in the year in which the expense is incurred, and not in future years when revenues might be realized. Accordingly, the immediate deduction of a current expense more accurately reflects the tax concept of income than does amortization.

PREPAID EXPENSES AND SUBSECTION 18(9): MATCHING OF “CURRENT” EXPENSES?

Subsection 18(9) was added to the Act in 1981 to deal with prepaid outlays or expenses made for services to be rendered in subsequent years, including prepayments of rent, interest, royalties, and insurance. It is generally assumed that subsection 18(9) codifies the matching of certain “current” expenses (determined as such in law) in accordance with the matching principle of accounting.

Under general principles, however, the prepaid expenses listed in subsection 18(9) would normally be capital. A prepayment for services to be rendered in future years creates an asset or advantage with value extending into those future years, namely, the right to be provided with the services without further payment. For example, if you prepay five years’ worth of insurance premiums, the asset or advantage is the right to insurance coverage under the insurance contract. As each year goes by, one-fifth of the utility of the insurance coverage is lost, so that a decrease in wealth is sustained. Under general principles, the expense should be amortized over the five years.

Of course, subsection 18(9) is intended to achieve such a result. The provision denies an upfront deduction for prepaid expenses and instead purports to amortize them over the years to which they “can reasonably be considered to relate.” However, subsection 18(9) works only if the prepayments for future services are otherwise current expenses, so that “but for” the provision, they would be deductible upfront when made. If the prepayments are otherwise considered capital (and they probably are), the provision is unworkable. It is apparent, however, that this anomaly does not present a concern to Revenue Canada, which basically applies the provision in the manner that was intended.

96 Ibid., at 5508.
THE PROPOSED MATCHABLE EXPENDITURE RULES

The Act contains various provisions aimed at tax shelters that restrict and/or defer the deduction of current expenses. Some of these rules, such as the limited partnership at-risk rules and the limited-recourse debt rules, apply to taxpayers that may never be called upon to honour their liability, or may have it limited or offset at some future time. Other provisions simply restrict the deduction of current expenses (typically where the resulting revenues are deferred) so that losses cannot be created to shelter other sources of income.

The Department of Finance’s most recent attack on tax shelters is found in the proposed “matchable expenditure” rules. The government was concerned about certain tax shelters in which investors “purchased” rights to future income and deducted the expenditures immediately (or at least before they received the revenues). The “purchase price” was normally used to pay business expenses that would otherwise be incurred by the “vendor” of the right, in consideration for the right to future income from the vendor’s business. In addition to addressing its policy concerns, the government feels that the new rules add certainty to the timing of the deduction of such “matchable expenditures.” This subject matter, essentially the carving out of rights to income, is not well developed in Canadian income tax law.

In general terms, matchable expenditures will have to be amortized on a straightline basis over the greater of 5 years and the economic life of the right to the future income, to a maximum of 20 years. However, the deduction in each year is generally limited to the revenues earned in respect of the right in that year, so that the expenditure may be “matched” on a dollar-for-dollar basis with incoming revenues. The matching is generally one-sided, in that a larger deduction is not allowed if the incoming revenues in a year exceed the amount that could otherwise be amortized (although such excess can be carried forward to the following year, generally to the extent that there is a shortfall in revenues in that year). Presumably, the government felt that revenue matching (and not just time matching) was required because the transactions were (or could be) structured to bunch the resulting revenue in later year(s) of the economic life of the “right.”

97 The new rules are found in draft section 18.1 of the December 8, 1997 notice of ways and means motion, supra footnote 90.

98 For example, in a typical scenario the investments would be used to pay sales commissions incurred in respect of the sale of rear-load mutual fund units, in consideration for distribution fees and the redemption fees paid upon the redemption of the units. Administratively, Revenue Canada had allowed the investments to be amortized over three years, on the basis of accounting treatment.

99 The Department of Finance suggested that before the introduction of the matchable expenditure rules, the timing of the expenditures was determined using the accounting principles of conservatism and matching. See the “Backgrounder” accompanying Canada, (The footnote is continued on the next page.)
CONCLUSION
Subject only to overriding policy concerns, a current expense should always be deductible in the year in which it is incurred. A rule that purports to match a current expense against future revenues is not sustainable under fundamental income tax principles. The matching principle of accounting cannot justify the capitalization of an expense that is determined to be current in law.

Department of Finance, *Release*, no. 96082, November 18, 1996. Given that the timing issue is one of characterization, this suggestion is surprising, and for reasons already given, I submit that it is incorrect. In regard to its reference to the matching principle, the department was presumably following the existing case law that endorsed matching. However, to my knowledge, the courts have not suggested that the accounting principle of conservatism is relevant to the issue of timing in income tax. Under general principles, and depending on the circumstances, a “matchable expenditure” appears to be a capital expense because it creates an asset or benefit with value that endures into future taxation years (a right to future income, or at the very least, income-earning capacity over an agreed future period). Uncertainty as to the timing or quantum of revenues to be received over the economic life of the right does not in itself render the expenditure a current expense. Note that the proposed rules do not apply to capital expenses.

99 Continued ...