# *Current Receipts and Expenses After Canderel, Toronto College Park, and Ikea*

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**PRÉCIS**

Dans les affaires récentes *Canderel*, *Toronto College Park* et *Ikea*, la Cour suprême du Canada a souligné les principes relatifs au moment de la déduction des dépenses courantes, au moment de l'inclusion de l'encaissement de revenus et à l'établissement du fait de savoir si des paiements incitatifs relatifs à un bail sont de nature capital ou de revenu. Les jugements de la cour sur chacun de ces sujets sont examinés et analysés dans cet article.

L'auteur souligne le cadre réglementaire pertinent relatif aux questions de temps et examine le sens du mot « bénéfice » dans le cadre de l'établissement du revenu. Il souligne ensuite l'évolution historique de la jurisprudence régissant la déduction des dépenses courantes, y compris l'élaboration du principe selon lequel un contribuable a le choix d'amortir les dépenses courantes dans certaines situations, et de celle régissant le moment de l'encaissement du revenu.

Dans le cadre d'un examen de l'élaboration de la loi relative au moment de la déduction des dépenses et de l'inclusion de l'encaissement de revenus, l'auteur examine l'élaboration de la méthode de « l'image la plus fidèle ». De plus, l'auteur examine, dans le cadre de l'imposition des paiements incitatifs relatifs à un bail, l'élaboration de la loi traitant du droit d'un contribuable à recevoir un paiement qui constitue un remboursement de capital et qui n'est pas, par conséquent, un encaissement de revenu.

Enfin, l'auteur analyse les décisions rendues par la Cour suprême dans les affaires *Canderel*, *Toronto College Park* et *Ikea*, ainsi que les commentaires et les conclusions de la cour à la lumière de la jurisprudence déjà soulignée.


* Of Fraser Milner, Toronto. I wish to thank Catherine A. MacNeill of Davies Ward & Beck for taking the time to assist me in writing this article. Any errors that remain are my responsibility.

## ABSTRACT

In the recent cases of *Canderel*, *Toronto College Park*, and *Ikea*, the Supreme Court of Canada outlined the principles relating to the timing of the deduction of current expenditures, the timing of the inclusion of income receipts, and the determination of whether tenant inducement payments are on account of capital or income. This article presents a review and analysis of the court's pronouncements on each of these issues.

The author outlines the relevant statutory framework relating to the timing issues and considers the meaning of profit for purposes of determining income. He then outlines the historical development of the jurisprudence governing the deduction of current expenses, including the development of the principle that a taxpayer has an option to amortize current expenses in certain situations, and the jurisprudence governing the timing of income receipts.

As part of a review of the development of the law relating to the timing of deduction of expenses and the inclusion of income receipts, the author reviews the development of the "truer picture" doctrine. Also, in connection with the taxation of lease inducement payments, the author considers the development of the law relating to the right of a taxpayer to receive a payment that is a reimbursement of capital and therefore not an income receipt.

Finally, the author reviews the decisions of the Supreme Court in *Canderel*, *Toronto College Park*, and *Ikea*, and analyzes the court's comments and conclusions against the backdrop of the jurisprudence previously outlined.


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## INTRODUCTION

In the recent trilogy of timing cases, *Canderel Limited v. The Queen*,[1] *Toronto College Park Limited v. The Queen*,[2] and *Ikea Limited v. The Queen*,[3] the Supreme Court of Canada has set out the principles that govern the timing of the recognition of income receipts and the timing of the deduction of income expenses. In *Ikea*, the court also discussed whether lease inducement payments received by a taxpayer were on account of income or capital.

In each of *Canderel* and *Toronto College Park*, the taxpayer built commercial rental premises and offered tenant inducement payments (TIPs) to prospective tenants to persuade them to enter into leases. In each case, the taxpayer deducted the TIPs in the year in which they were paid. Revenue Canada took the position that the taxpayer could not deduct the

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[1] 98 DTC 6100 (SCC).

[2] 98 DTC 6088 (SCC).

[3] 98 DTC 6092 (SCC).

TIPs in the year of payment; instead, the deduction of each TIP had to be amortized over the life of the lease to which it related.

The factual situation in *Ikea* was the converse of that in *Canderel* and *Toronto College Park*. The taxpayer was a tenant who had received a TIP from the landlord. The first issue in *Ikea* was whether the receipt was a non-taxable capital receipt or a taxable income receipt. The second issue was the timing of the recognition of income if the receipt were income.

Before the Supreme Court of Canada heard these cases, the tax community had hoped that the court would give clear and practical judicial guidelines on the timing issues. The court's decision in *Ikea* did that. Unfortunately, while the principles enunciated by the court in *Canderel* and *Toronto College Park* are quite understandable in the abstract, neither tax practitioners nor the courts will find them easy to apply in practice. Instead, the court's decisions on the deduction issue have invited additional litigation.[4]

During the early 1980s, it became standard practice in the real estate industry for tenants to receive lease inducements, which were treated as non-taxable receipts. The practice of treating lease inducements as tax-free receipts came to a halt with the introduction into the Income Tax Act[5] of paragraph 12(1)(x) for amounts received after May 22, 1985.[6] The taxation of lease inducement payments received before the effective date of paragraph 12(1)(x) has been the subject of considerable discussion and debate.[7] In addition, as a result of the Tax Court of Canada decisions in *Ikea*[8] and *IBM Canada Limited v. MNR*,[9] there was concern that all inducements would have to be included in income pursuant to section 9 and that the various alternatives provided by paragraph 12(1)(x) were no longer available.[10] It had been hoped by the tax community that the decision of

[4] As one colleague said, "It's a great case for the tax bar. We win and we get to litigate some more."

[5] 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.

[6] Section 6(6) of SC 1986 provided for grandfathering in certain situations. Paragraph 12(1)(x) requires that the amount of any inducement be included in income unless certain conditions precedent are satisfied and the taxpayer elects that the inducement shall reduce the capital cost of assets to it.

[7] For a more detailed discussion of the jurisprudence relating to the taxation of these receipts and the deduction of lease inducement payments, see Brian R. Carr, "Lease Inducement Payments," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 32:1-35.

[8] *Ikea Limited v. The Queen*, 94 DTC 1112 (TCC).

[9] 93 DTC 1266 (TCC).

[10] If the recipient were required to include the lease inducement payment in income, the introductory language of paragraph 12(1)(x) would not be satisfied and the right to make the various elections provided for by paragraph 12(1)(x) would not exist. See Jean Potvin, "Inducement Payments," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 65:1-24, at 65:5.

the Supreme Court in *Ikea* would give guidance as to the taxation of not only lease inducement payments received before May 23, 1985, but also similar payments that might not be subject to paragraph 12(1)(x). Unfortunately, the court dealt quite summarily with this issue.

In this article, I will review and analyze the judgments of the Supreme Court in *Canderel*, *Toronto College Park*, and *Ikea*. In carrying out this objective, I will consider the evidence and jurisprudence in the same manner as would counsel preparing the cases for trial and for appeal.[11] Specifically, I will review the uncontroverted facts and the jurisprudence in order to consider the evidence to be introduced to the court and the submissions on jurisprudence to be made to the court. Finally, I will consider the Supreme Court's decisions in the context of the previously discussed jurisprudence and the established facts.[12]

## BACKGROUND FACTS IN THE THREE CASES

### Canderel

In the early 1980s, approximately 90 percent of Canderel's business consisted of managing and developing commercial real estate, while the balance was industrial development and management. The development project in issue, Churchill Office Park (COP), was located in the fringe of the west end of Ottawa, where rents at the relevant time were about 30 percent less than in downtown Ottawa. The general concept was to provide rental premises in the area for private sector businesses, thus creating a business centre outside the downtown core. Because property tax and rent were lower in the area, it was anticipated that tenants could be drawn from existing downtown facilities. Canderel entered into a development agreement dated February 3, 1984 with another party to develop COP as a joint venture, under which Canderel assumed development responsibilities.

There were no commitments to lease when COP was commenced because in the Ottawa market at that time, prospective tenants generally required substantial completion before they entered into leases.

The construction of COP was started in March 1984 and ended in June 1985. When COP opened, only 2.3 percent of the building was leased.

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[11] These cases are of more than academic interest to me. I was counsel for the taxpayer in *Nesbitt Thomson Inc. v. MNR*, 91 DTC 1113 (TCC), in which the taxpayer was reassessed in respect of lease inducement payments that it had received. In addition, I acted for a taxpayer that had made payments similar to the TIPs made by Canderel and Toronto College Park, had deducted such payments as current expenses, and had been reassessed.

[12] When one takes a certain view of the jurisprudence, one anticipates that statements made will be obvious. At a March 24, 1998 meeting of the Tax Section of the Canadian Bar Association (Ontario), Roger Taylor of the Department of Justice, who was counsel in each of *Canderel* and *Ikea* before the Supreme Court of Canada, and Al Meghji of Bennett Jones Verchere, who was counsel for the Department of Justice in *Canderel* when it was argued before the Federal Court of Appeal, gave their views on the cases of *Canderel*, *Toronto College Park*, and *Ikea*. It was refreshing to me to hear their comments because their views were 180 degrees from mine.

Although Canderel had analyzed the market before starting construction, six to eight months after construction had commenced, Canderel's management realized that there would be problems finding tenants. As a result, Canderel began offering TIPs. This strategy proved to be successful.

In preparing its financial statements, Canderel capitalized the TIPs, but in computing its income for its 1986 taxation year, it deducted them. The minister disallowed the deduction, and Canderel appealed to the Tax Court of Canada.

**Toronto College Park**

In 1983, Toronto College Park Limited ("TCPL") owned a new commercial building located at 777 Bay Street in Toronto. The building was ready for occupancy, but no tenants had been secured. In 1983, TCPL suffered startup rental losses of approximately $5 million. In the same year, TCPL made two TIPs, which it deducted in computing its income for purposes of the Act. The first was a payment of approximately $3.5 million to Maclean Hunter Limited ("MHL"). The payment was described as being for leasehold improvements, although MHL had no obligation to use it for that purpose. The second payment, of approximately $1.7 million, was made to contractors who were employed by the Ontario Ministry of Government Services and was made for the benefit of the ministry. In preparing its financial statements, TCPL capitalized the payments.[13]

The minister reassessed TCPL on the basis that the payments were capital payments, which TCPL was not entitled to deduct in computing its income. TCPL appealed to the Federal Court—Trial Division.[14]

**Ikea**

Ikea Limited carried on the business of selling furniture and other related items through retail outlets that it owned or leased throughout Canada. By an agreement dated May 10, 1985 with West Edmonton Mall Shopping Center Limited, Ikea leased premises for 10 years for the purpose of carrying on its retail business with an option to extend the term of the lease for a further 10 years. By an agreement dated May 16, 1985, Ikea became entitled to receive $2,650,000 from West Edmonton Mall; the payment was received during Ikea's fiscal year ended August 31, 1986. The agreement placed no obligation upon Ikea to use the payment for a specific purpose, such as applying it against the cost of inventory or fixtures. Ikea was free to spend it as it saw fit. Ikea incurred costs in the amount of $825,189 in respect of "fixturing" of the premises in question.

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[13] This fact is not stated in any of the judgments, but it was agreed to by the parties in paragraph 15 of the agreed statement of facts as stated in paragraph 5 of *Toronto College Park*'s factum in the Supreme Court of Canada. Subsection 18(9) requires a taxpayer to amortize certain expenses. It was accepted by the Crown that subsection 18(9) had no application to the payment of the TIPs.

[14] At the time of appealing the reassessment to court, the taxpayer had the option of appealing to the Tax Court of Canada or to the Federal Court—Trial Division.

Ikea filed its tax return for its 1986 taxation year on the basis that the payment was a non-taxable capital receipt. In preparing its financial statements for its 1986 taxation year, Ikea

- offset the cost of fixturing ($825,189) by a portion of the lease inducement payment; and

- included in earnings for the year only $152,068, which was an amortized portion of the balance of the inducement payment after deducting the $825,189 that offset the cost of fixturing.

The minister reassessed Ikea on the basis that Ikea was required to include the payment in income in its 1986 taxation year.

## THE DEDUCTION ISSUE

### Relevant Legislation

In both *Toronto College Park* and *Canderel*, the issue was the timing of the deduction by a taxpayer of an expense that it had incurred and had a current obligation to pay. In neither case was the issue whether the disputed expenditures were of a capital or an income nature.

There is no specific provision in the Act that sets forth a general rule as to the timing of the deductibility of expenses. Paragraph 3(1)(a) requires a taxpayer in computing its income for purposes of the Act to include income from each business and property. Subsection 9(1) provides, "Subject to this Part [part I], 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." A general limitation on the deductibility of expenses is provided in paragraph 18(1)(a), which requires that in order for an outlay or expense to be deductible, it must be made for the purpose of gaining or producing income from business or property.

The relationship between subsection 9(1) and the provisions of subsection 18(1) was explained by Mr. Justice Iacobucci in the majority decision in *Symes v. The Queen et al.* as follows:

> In other words, the "profit" concept in s. 9(1) is inherently a *net* concept which presupposes business expense deductions. It is now generally accepted that it is s. 9(1) which authorizes the deduction of business expenses; the provisions of s. 18(1) are limiting provisions only.[15]

Although other provisions of the Act (for example, subsection 18(9) and several of the provisions contained in subsection 20(1)) require that certain deductions be made in specific taxation years, those provisions are not applicable to the facts in *Canderel* and *Toronto College Park*.

### Historical Judicial Interpretation of "Profit"

The term "profit" as used in subsection 9(1) is not defined. It has long been accepted that profit is a question of law for the courts and is not to

[15] 94 DTC 6001, at 6009 (SCC).

be determined solely in accordance with generally accepted accounting principles (GAAP).[16]

Before the decisions of the Supreme Court of Canada in *Canderel*, *Toronto College Park*, and *Ikea*, the latest pronouncement on the importance of GAAP in the computation of income was the following statement by Mr. Justice Iacobucci in *Symes*:

> Thus, in a deductibility analysis, one's first recourse is to s. 9(1), a section which embodies, as the trial judge suggested, a form of "business test" for taxable profit.
>
> This is a test which has been variously phrased. As the trial judge rightly noted, the determination of profit under s. 9(1) is a question of law. . . . Perhaps for this reason . . . courts have been reluctant to posit a s. 9(1) test based upon "generally accepted accounting principles" (G.A.A.P.). . . . Any reference to G.A.A.P. connotes a degree of control by professional accountants which is inconsistent with a *legal* test for "profit" under s. 9(1). Further, whereas an accountant questioning the propriety of a deduction may be motivated by a desire to present an appropriately conservative picture of current profitability, the *Income Tax Act* is motivated by a different purpose: the raising of public revenues. For these reasons, it is more appropriate in considering the s. 9(1) business test to speak of "well accepted principles of business (or accounting) practice" or "well accepted principles of commercial trading."[17]

While the courts have held that profit is not to be determined solely in accordance with GAAP, in any given case, one cannot ignore the application of GAAP.[18] One author has gone so far as to state that while GAAP are not determinative, the courts will not permit the filing of tax returns that are not consistent with GAAP unless there is statutory authority to do

[16] See *MNR v. Anaconda American Brass Ltd.*, 55 DTC 1220 (PC). See also the comments of Mr. Justice Urie in *Neonex International Ltd. v. The Queen*, 78 DTC 6339, at 6348 (FCA). The high water mark for the importance of GAAP may well have been *The Queen v. Metropolitan Properties Co. Limited*, 85 DTC 5128, at 5137 (FCTD), where Mr. Justice Walsh held, in part, as follows:

> 1. General Accepted Accounting Principles (GAAP) should normally be applied for taxation purposes also, as representing a true picture of a corporation's profit or loss for a given year.
>
> 2. By exception they need not be applied for income tax purposes if there is some section or sections in the *Income Tax Act* which justify or require a departure from them or do not correspond with what are commonly accepted business and commercial practices. . . .
>
> 5. The fact that there is nothing in the *Income Tax Act* to prevent such deductions from being treated as current expenses and deducted as such from income in the year in which they are made is not sufficient justification for departing from GAAP principles in dealing with them in this way.

[17] Supra footnote 15, at 6009.

[18] For a very detailed discussion and for a review of the history of the courts' approaches to the realization of GAAP, see Gary J. Webb, "GAAP and the Canadian Income Tax Act," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 10:1-50.

so.[19] Counsel in presenting issues involving the timing of deductibility must therefore be aware of the relevant GAAP and the well-accepted principles of business practice in order to determine what evidence to present.

At the same time, as indicated in Mr. Justice Iacobucci's comments in *Symes* above, the courts have been reluctant to unreservedly embrace GAAP.[20]

To understand that the test of deductibility is a legal one and not an accounting one does not, however, answer the question of when TIPs are deductible. A review of the jurisprudence is required to determine what legal principles are involved. It is amazing that more than 80 years after the introduction of the Act, this question remains a topic of debate.[21] It is perhaps even more amazing that the debate will continue following the Supreme Court's decisions in *Canderel* and *Toronto College Park*.

**Historical Development of Deductibility of Current Expenses**

Early case law developed the principle that expenses on income account were deductible in the year in which they were incurred. This concept is most picturesquely described in *Vallambrosa Rubber Co., Ltd. v. Farmer*,[22] in which the taxpayer operated a rubber plantation. As rubber trees do not yield rubber until they are approximately six years old, in any given year it is necessary for 6⁄7 of the taxpayer's property to be devoted simply to the process of cultivation. However, in calculating its income for the taxation year in question, the taxpayer deducted expenses that had been incurred for weeding the entire estate. The revenue authorities argued that the taxpayer should be restricted to deducting 1⁄7 of the expenses on the grounds that revenue would be realized only from 1⁄7 of the rubber trees to which the expenses were devoted. The Lord President dealt with this argument as follows:

19 See Potvin, supra footnote 10, at 65:18, where he states, "It appears clear that the courts are not prepared to adopt GAAP as the sole test for measuring profit, but it is only in rare circumstances that a court has been unwilling to accept GAAP in computing profit for tax purposes. There appears to be no case in which a court has permitted a taxpayer to compute income pursuant to subsection 9(1) in a manner that was inconsistent with GAAP. Where the problem lies, and the focus of *Canderel* and *Toronto College Park*, is in the method of computing profit for the purposes of subsection 9(1) where there are competing GAAPs."

20 See Webb, supra footnote 18. One author's theory for this state of affairs is that judges have little accounting background and are influenced by the reality of cash received and disbursed by a taxpayer. See Michael J. O'Keefe, "Generally Accepted Accounting Principles and the Computation of Income," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 4:52-57, at 4:55-56.

21 The burning issue of the significance of GAAP was the topic of discussion at the Conference on the Income Tax Bill (Bill 454) held in Ottawa, December 8-9, 1947. See *Conference on the Income Tax Bill: Report of Proceedings* (Toronto: Canadian Tax Foundation, 1948).

22 (1910), 5 TC 529 (Ct. Sess.).

> I think the proposition only needs to be stated to be upset by its own absurdity. Because what does it come to? It would mean this, that if your business is connected with a fruit which is not always ready precisely within the year of assessment you would never be allowed to deduct the necessary expenses without which you could not raise that fruit. This very case, which deals with a class of thing that takes six years to mature before you pluck or tap it, is a very good illustration, but of course without any ingenuity one could multiply cases by the score. Supposing a man conducted a milk business, it really comes to the limits of absurdity to suppose that he would not be allowed to charge for the keep of one of his cows because at a particular time of the year, towards the end of the year of assessment, that cow was not in milk, and therefore the profit which he was going to get from the cow would be outside the year of assessment. . . . [T]he real point is, What are the profits and gains of the business? . . . [W]hen you come to think of the expense in this particular case that is incurred for instance in the weeding which is necessary in order that a particular tree should bear rubber, how can it possibly be said that is not a necessary expense for the rearing of the tree from which alone the profit eventually comes? And the Crown will not really be prejudiced by this, because when the tree comes to bear the whole produce will go to the credit side of the profit and loss account. When the year comes when the tree produces the only deduction will be the amount which has been spent on the tree in that year; they will not be allowed to deduct what has been deducted before.[23]

The foregoing comment makes one nostalgic for the days in which the Act and accounting principles were much simpler. The rule enunciated by the Lord President was quite straightforward: if an expense is incurred in a year, it may be deducted in that year, notwithstanding that some benefit from the expenditure may accrue in future years.

An expense that could not relate to any particular item of income became known as a "running expense." In *The Naval Colliery Co., Ltd. v. The Commissioners of Inland Revenue*,[24] there was a national stoppage of the coal mining industry and the taxpayers were forced to close their mine from April 1 to July 2, 1921. The complete stoppage of work during that period resulted in severe damage to the mines, and a large amount of work in the way of pumping and of restoring pitprops had to be undertaken to recondition the mines. The work of reconditioning was commenced immediately after the end of the national stoppage on July 2, 1921.

The final accounting period for excess profit duty purposes was in each case the period from April 1 to June 30, 1921. In the accounts of each corporation for the period in question, the cost of the reconditioning of the mines was recognized, although no expenditure thereon was made until after the end of the accounting period. The issue was whether the cost of restoring the mines should be allowed as a deduction in computing for excess profit duty purposes the deficiencies for that final accounting

[23] Ibid., at 535.

[24] (1928), 12 TC 1017 (HL).

period. The decision was ultimately appealed to the House of Lords, which held that such expenses were not deductible in the final accounting period. However, the passage to which reference is most frequently made is the following from the decision of Mr. Justice Rowlatt of the King's Bench Division:

> 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.[25]

The Supreme Court of Canada in *Riedle Brewery Limited v. Minister of National Revenue*[26] accepted that continuing and recurring expenses may be deducted in the year in which they were incurred. In *Riedle*, the taxpayer proposed to deduct from its income for the 1933 taxation year certain sums that had been expended for the purposes of treating tavern patrons to beer produced by the taxpayer. Mr. Justice Kerwin considered section 6 of the Income War Tax Act and stated:

> Nowhere in the Act is there a statement of what deductions are allowable in computing the annual net profit or gain but, if in any particular case they are shown to have been in fact and in law "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income," then they should be allowed.[27]

Although section 6 precluded deductions in respect of expenses not laid out for the purpose of earning the income for the taxation year in question, Mr. Justice Kerwin held that expenses could be properly deducted even if it were shown that they were not actually referable to the particular taxation year:

> For instance, in the case of a manufacturing company employing travellers to solicit business, meticulous examination of the latter's expense accounts might easily disclose that *sums expended towards the end of one taxation period were not productive of orders or of the filling of the orders or of the payment for the goods supplied,—in the same period. That result should not prevent the company deducting such expenses in its returns under the Act*. The statutory provisions may be given a reasonable and workable interpretation by holding that, as long as the disbursements fulfil the requirements already discussed, the taxpayer expended them "for the purpose," i.e., with the object and intent that they should earn the particular gross income reported for the period [emphasis added].[28]

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25 Ibid., at 1027.

26 (1939), 1 DTC 499-29 (SCC).

27 Ibid., at 499-29 to 499-30.

28 Ibid., at 499-30.

The court allowed the deduction of such expenses because there could be little doubt that the expenses were necessarily a continuing and recurring aspect of the taxpayer's day-to-day operations.

In *Premium Iron Ores Ltd. v. MNR*,[29] the Supreme Court of Canada was asked to consider the deductibility of legal expenses incurred by the taxpayer in opposing tax claims made in the United States. The court recognized that paragraph 12(1)(a) (now paragraph 18(1)(a)) does not specify the time at which outlays or expenses that meet the test of having been made or incurred for the purpose of gaining or producing income must be deducted. Mr. Justice Hall commented:

> "The income" surely means the net receipts over disbursements in the taxation year *in the totality of the taxpayer's business as an on-going concern* other than capital expenditures, gifts and the like [emphasis added].[30]

Mr. Justice Hall went on to say:

> The references to advertising in some of the cases are most apt. The millions now spent by commercial companies on advertising in any given taxation year which admittedly is aimed at securing business in succeeding years could not, on an acceptance of the so-called rule in *Strong v. Woodfield*, be allowed. But such expenses are allowed without question and it is only common sense that they should be allowed. While it may be possible to isolate the receipts and expenditures of a salaried individual for a one taxation year period, it is impossible to do so with commercial or corporate enterprises whose business activities are continuous and where expenditures made in one taxation year may have no effect nor be intended to have any effect in producing the income of that year but are expected to produce income from the business operation of the taxpayer in subsequent taxation years within the meaning of s. 12(1)(a) of the *Income Tax Act*.[31]

In response to the argument that the legal expenses could not be deducted in the taxation year in question because it could not be said that they had been incurred to earn income in that particular taxation year, Mr. Justice Hall stated:

> To limit the expenditure, if it is to qualify as a deductible, to the income of the particular year in which it was made requires writing into s. 12(1)(a) of the *Income Tax Act* words which Parliament did not put there. 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* [emphasis added].[32]

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[29] 66 DTC 5280 (SCC).

[30] Ibid., at 5286-87.

[31] Ibid., at 5291-92.

[32] Ibid., at 5292. See similar comments of Madam Justice Wilson in *Mattabi Mines Ltd. v. Minister of Revenue (Ontario)*, [1988] 2 CTC 294 (SCC).

## The Rise of the Optional Matching Principle

The rule that developed in the foregoing jurisprudence that a taxpayer could deduct an expense in the year incurred, whether it produced a benefit in that year or in subsequent years, was not helpful to a taxpayer who could not use the deduction in the year in which it was incurred. Predictably, it was only a matter of time before a taxpayer took the position that it did not have to deduct a current expense in the year in which the expense was incurred if it could be matched to some future source of revenue. This argument, unfortunately, led to confusion as to the applicability of the "matching principle" to the deductibility of expenses. This confusion has been compounded because too often the phrase "matching principle" is bandied about without thought for its meaning.

Matching can be either period matching or income matching. With period matching, the expense is deducted during the period to which it relates. A typical example of period matching is prepaid rent. Prepaid rent is deducted in the year to which the rental of the premises relates and not in relation to any particular income generated.[33] With revenue matching, there is an attempt to deduct the expense incurred during the period in which revenues are received. The classic example of revenue matching is found in *Vallambrosa Rubber*, in which the tax authorities argued that only 1⁄7 of the expenses could be deducted in any particular year because that matched the revenues produced by 1⁄7 of the trees.

In addition, in some of the judicial comments, there has been some confusion in references to the matching principle. At times, judges have referred to the matching principle as meaning the requirement to compute income in accordance with GAAP that may require some form of matching, be it period matching or revenue matching (compulsory matching). At other times, judges have referred to the matching principle as meaning the discretion that a taxpayer has to match expenses to the year in which revenue arises (optional matching). In this article, unless otherwise stated, the matching principle refers to compulsory matching.

One of the first (and perhaps the most often cited) cases in which reference to the matching principle is made is *Associated Investors of Canada Ltd. v. MNR*,[34] a decision of President Jackett. However, as discussed below, although *Associated Investors* has been quoted frequently in cases considering the matching principle, it is arguable that the actual decision of President Jackett has nothing to do with the matching principle.

In *Associated Investors*, the taxpayer carried on a business that consisted of negotiating contracts with members of the public under which, in consideration of being paid a series of amounts over a period of time, the taxpayer agreed to pay a specified amount at some time in the future. In order to negotiate such contracts, the taxpayer employed a staff of

[33] Subsection 18(9) now requires prepaid rent to be matched to a period or amortized.

[34] 67 DTC 5096 (Ex. Ct.).

salesmen who obtained applications from members of the public and were paid for their services by way of commissions, the payment of which depended upon the receipt by the taxpayer of certain of the amounts payable to it under the contracts. It was held to be a necessary feature of the taxpayer's carrying on business that it make advances to each of its sales employees. These advances were ordinarily recovered by means of a setoff against the commissions that became payable to the employees. The particular issue involved $25,000 of the amount of an advance to an employee in excess of the commissions earned by that employee which could not be recovered. The taxpayer claimed a deduction of that amount in the year in which it was determined that the amount would not be recoverable.

The principal submission of the minister was that such advances were, in effect, deductions for bad debts and that no deductions for bad debts could be made except as specifically authorized by the provisions of what is now paragraph 20(1)(p) of the Act. The court held that the amount was deductible. With respect to the timing of the deduction that could be claimed, the minister argued that, if the advance constituted a deductible expense, it was properly deductible only in the year in which the advance was actually made, and not in subsequent years. President Jackett dealt with this submission by way of a footnote, which reads, in part, as follows:

> In my view, 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 deductible in computing profit for the year "in respect of" which they were paid or payable.[35]

In coming to the conclusion that the advances that had been made by the taxpayer could not have been deducted in the years in which they were made, President Jackett stated:

> The situation was therefore that, at the time that the advance was made, the appellant had exchanged its money for a "right" that was, from a businessman's point of view, of equal value. . . . The advance cannot, therefore, as of that time, be regarded, from a businessman's point of view, as having affected the appellant's profit from his business. . . . When, however, the chose in action depreciated in value, there was an effect on the appellant's asset position and accordingly, at that time, for the first time, the advance transaction resulted in the appellant having sustained a loss. . . . In my view, [the loss] must be . . . taken into account in computing the profit from the business for the year in which the appellant, as a "businessman," recognized that the loss had occurred. It cannot properly be taken into account in computing the profit for a previous year.[36]

On the basis of this statement, the decision in *Associated Investors* did not depend upon the application of the matching principle. Instead, it

[35] Ibid., at 5098.

[36] Ibid., at 5100-1.

depended upon the holding that the advances that had been made by the taxpayer were not losses until the year in which the taxpayer recognized that the losses had occurred. Consequently, the advances did not constitute an expense until the year in which the losses were recognized and did not in fact qualify as an expense until the taxation year in respect of which the deduction was claimed.

The first Canadian case to consider the right, but not the obligation, of a taxpayer to match was *MNR v. Tower Investment Inc.*[37] The minister had disallowed the deduction by the taxpayer of the cost of an advertising campaign carried on primarily in 1963 in order to attract tenants to a new apartment complex constructed by the taxpayer in its 1963, 1964, and 1965 taxation years. Although the actual outlays during the years 1963 to 1965 had been approximately $92,000, $59,000, and $2,000, respectively, it was held that the taxpayer was entitled to make deductions of approximately $7,000, $64,000, and $82,000 in respect of its 1963, 1964, and 1965 taxation years. Mr. Justice Collier commented:

> I do not find there is *any prohibition* in the statute against the matching system. In fact, it was held appropriate under the particular circumstances of the case by Kerr J., in *Sherritt Gordon Mines, Ltd. v. M.N.R.*, [1968] 2 Ex. C.R. 459 at p. 481 [68 DTC 5180, at 5193] [emphasis added].[38]

The expenses in *Tower Investment* were clearly running expenses and could not be matched to any specific stream of revenue. It is therefore a little hard to understand how some of the cases have taken the position that the matching principle (meaning the option to match expenses) cannot apply to current expenses that are running expenses.

In a dissenting judgment in *MNR v. Canadian Glassine Co. Ltd.*,[39] Mr. Justice LeDain endorsed the optional use of matching. In *Canadian Glassine*, Anglo-Canadian Pulp and Paper Mills Ltd. entered into contracts to construct steam and pulp pipelines from its neighbouring pulp mill to the paper plant of Canadian Glassine and to supply pulp and steam. Anglo-Canadian Pulp owned the pipelines and was responsible for their maintenance and repair. Canadian Glassine agreed to pay Anglo-Canadian $268,623 for the execution of contracts. Canadian Glassine amortized this expenditure over a period of 25 years, the initial period of the contracts, and claimed a deduction of $10,744.94 in each of its 1966, 1967, 1968, and 1969 taxation years (the years in issue). The minister disallowed the deduction, contending that it was a non-deductible capital outlay pursuant to what is now paragraph 18(1)(b). When the Federal

[37] 72 DTC 6161 (FCTD).

[38] Ibid., at 6163. The *Sherritt Gordon* case referred to by Mr. Justice Collier did not involve the deductibility of a prepaid expense or a deferred charge, but rather the question whether interest charges, incurred during construction, could properly form part of the capital cost of the property in respect of which capital cost allowance may be claimed.

[39] 76 DTC 6083 (FCA).

Court—Trial Division[40] allowed the taxpayer's appeal on the basis that the expenditure was a currently deductible expense, the minister appealed to the Federal Court of Appeal. The majority held that the expenditure was a capital expenditure and did not address the issue of optional matching. Mr. Justice LeDain concluded that the expenditure was a current expenditure and then considered whether the method that the taxpayer had employed in order to claim a deduction was acceptable for purposes of the Act. He referred to the *Tower Investment* case and concluded that the matching system used by the taxpayer was correct and that the taxpayer was entitled to apportion the whole of the expenditure over the period of 25 years.

It may well be argued that the decision in *Tower Investment* and the dissent of Mr. Justice LeDain in *Canadian Glassine* are at the heart of the confusion of the litigation that developed in the *Canderel* and *Toronto College Park* cases. Such cases import into the Act a concept that is not obviously there on the basis of the scheme of the Act. One could certainly argue that the Act contemplates two kinds of expenses only, current expenses that may be deducted in the year incurred and capital expenses that must be deducted pursuant to some specific provision of the Act (such as paragraph 20(1)(a)). By allowing a taxpayer to amortize current expenses, the courts were effectively permitting the taxpayer to treat those expenses as capital.[41] Joseph Frankovic raises this criticism in his discussion of the *Canderel* and *Toronto College Park* cases and states:

> 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.[42]

One might well take the position that in *Canderel* and *Toronto College Park*, the minister was only stating that if it was acceptable for a taxpayer to choose to match, the taxpayer should match if accounting principles warrant. Perhaps the fallacy is that there was never any basis in the Act to permit a taxpayer to choose to match.

### Specific Cases Considering Compulsory Matching

In light of the foregoing statements of law, it is surprising that the *Toronto College Park* and *Canderel* cases were ever brought to court, let alone to the Supreme Court of Canada. It appears that, after *Canadian Glassine*,

[40] 74 DTC 6089 (FCTD).

[41] This is what subsection 18(9) requires a taxpayer to do in the circumstances referred to therein.

[42] Joseph Frankovic, "The Matching of 'Current' Expense Under Canada's Income Tax Laws" (1998), vol. 46, no. 1 *Canadian Tax Journal* 1-28, at 4.

the state of the law was that a taxpayer had an option to match current expenses but was not required to do so. The surprise heightens when it is realized that the application of the matching principle to factual situations similar to the payment of TIPs had been considered by the Federal Court of Appeal in 1981 in *The Queen v. Oxford Shopping Centres Ltd.*[43] and *Cummings v. The Queen*.[44]

In *Oxford Shopping Centres*, the taxpayer operated a shopping centre and entered into various agreements with the local municipality as a result of which the municipality improved certain roadways so as to ease traffic congestion and to provide better access to the taxpayer's property. The taxpayer paid $490,050 to the municipality in lieu of any local improvement rates and taxes that might otherwise have been payable as a result of the improvements. The taxpayer deducted from its income for its 1973 taxation year the full amount of this payment, although for accounting purposes it set up the amount as a deferred charge to be amortized over 15 years commencing in 1974. The minister argued that the expenditure was a capital outlay and that, even if it were a deductible expense for the purposes of the Act, the matching principle required the taxpayer to amortize the deduction over the same 15-year period.

The trial judge, Associate Chief Justice Thurlow, held that the expenditure by the taxpayer was not a capital outlay. In dealing with the issue of whether the taxpayer was required to amortize the expenditure over the 15-year period, Mr. Justice Thurlow stated:

> [F]or 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 . . . *it does not apply to the running expense of the business as a whole even though the 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. . . . 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 [emphasis added].[45]

[43] 81 DTC 5065 (FCA).

[44] 81 DTC 5207 (FCA).

[45] *Oxford Shopping Centres Ltd. v. The Queen*, 79 DTC 5458, at 5466-67 (FCTD). The foregoing quotation has probably added as much confusion to the issue as any other. In his discussion, Mr. Justice Thurlow is referring to the matching principle in the compulsory sense and is commenting that this principle does not apply to running expenses. In *Tower Investment* and *Canadian Glassine*, the judges are referring to the matching principle in the optional sense.

A number of comments made by Mr. Justice Thurlow in the foregoing passage are relevant to the issues considered by the Supreme Court in *Canderel*, *Toronto College Park*, and *Ikea*.

In the opening sentence of the quoted passage, Mr. Justice Thurlow states that the "matching principle" will apply to expenses related to particular items of income. That statement is based on the following passage of Viscount Simon from *Commissioners of Inland Revenue v. Gardner Mountain & D'Ambrumenil, Ltd.*,[46] which was expressly referred to by President Jackett in the footnote to his decision in *Associated Investors*:[47]

> In calculating the taxable profit of a business . . . 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. In making an assessment . . . *the 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 [emphasis added].[48]

On first reading, the foregoing passage from the *Gardner Mountain* case endorses the matching principle. However, the court in *Gardner Mountain* did not consider the proper timing of deductions but determined the income of the taxpayer derived from underwriting commissions. Under the terms of the contracts, commissions receivable were not calculated until the second year following the year in which the underwriting services were provided. As a result, the taxpayer alleged that it was not necessary for underwriting commissions to be brought into income until the year in which the final balance was calculated. The court held that, on the proper construction of the commission contracts, the commissions became an account receivable in the year in which the services were rendered, and therefore rejected the taxpayer's argument. The decision in *Gardner Mountain* did not hold that income and expenses must be matched. Instead, it held that income realized in a particular taxation year cannot be ignored for the purposes of calculating income.

The principle enunciated in *Gardner Mountain* is more closely aligned to the realization principle described in the Supreme Court's decision in *Ikea* than to the matching principle. The decision in *Gardner Mountain* does not provide authority for the proposition that expenses incurred in one year but attributable to income received in subsequent years are not deductible in the year incurred.[49]

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[46] (1947), 29 TC 69 (HL).

[47] Supra footnote 35.

[48] Supra footnote 46, at 93.

[49] Madam Justice Desjardins of the Federal Court of Appeal in her decision in *Canderel*, infra footnote 87, took the position that *Gardner Mountain* does support the requirement to apply the matching principle.

Mr. Justice Thurlow's statement that the matching principle applies to the computation of profit from the acquisition and sale of inventory simply acknowledges the existence of an exception to the rule enunciated in *Premium Iron Ores* for inventory costs. This exception has been the subject of judicial observations in a number of cases, including *Associated Investors*[50] and *MNR v. Shofor Investment Corporation*.[51] The cost of inventory is not a deductible outlay or expense within the meaning of paragraph 18(1)(a), and jurisprudence that considers the tax treatment of inventory has limited application to the provisions of paragraph 18(1)(a).

In the foregoing quote, Mr. Justice Thurlow confirmed that the decision in *Tower Investment* and the dissenting decision in *Canadian Glassine* hold only that matching is permitted by the Act, and that these cases do not stand as authority that matching is required for purposes of the Act.

Finally, whatever the applicability of the matching principle (meaning compulsory matching) to the computation of income for tax purposes, Mr. Justice Thurlow clearly stated that

> it does not apply to the running expense of the business as a whole even though the 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.[52]

*Cummings*[53] is an even stronger case for the proposition that TIPs should be currently deductible. In *Cummings*, the appellant and other members of his family entered into a 60-year emphyteutic lease with Globe Realty Limited, a subsidiary of the Royal Bank of Canada, and agreed to erect a 15-storey office building. At the time the lease was entered into, the real estate market for office buildings in downtown Montreal was quite buoyant. However, shortly thereafter, there was a dramatic deterioration, and the Cummings family encountered difficulty in obtaining tenants for the building. At this stage, Montreal Trust Company, in its capacity as a real estate agent, introduced Domtar Limited to the Cummings family as a prospective tenant. Domtar was prepared to become a tenant of the building, but it already occupied major space in three other Montreal buildings. This difficulty was resolved by the Cummings's agreeing to assume certain lease "pickups"; that is, they agreed to pay lease rentals to Domtar's former landlords, whose premises were being vacated.

Mr. Justice Heald stated[54] that the relevant jurisprudence applicable to the issue was summarized in the judgment of Mr. Justice Thurlow in the case of *Oxford Shopping Centres*. Mr. Justice Heald reviewed *Oxford Shopping Centres* and then stated:

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50 Supra footnote 34, at 5098.

51 79 DTC 5347, at 5340 (SCC).

52 Supra footnote 45, at 5466.

53 Supra footnote 44.

54 Ibid., at 5210.

> In my view, the double rationale of the *Oxford Shopping Centres* case, set out *supra*, applies equally to the case at bar. On its facts the case at bar is, in my view, a stronger case in support of the appellant's position that subject expenditure is on account of income. In *Oxford*, the advantage accruing to the taxpayer as a result of the payment, was of a lasting or more or less permanent nature. That is not true of the $790,000 expended for "lease pick-ups" in this case. The evidence in this case was clear and uncontradicted that, at the most, it would likely take from 30 to 36 months to achieve economic occupancy. . . . It seems clear to me that subject expenditure was a "running expense" and in the same category as for example, an extensive advertising campaign to obtain tenants or an offer to a prospective tenant of a rent-free period as an inducement to enter into a long-term lease or a finder's fee for obtaining tenants and leases. As Mr. Vineberg characterized it, the $790,000 was spent to "prevent a hole in income" said monies being spent "to plug the hole."[55]

In summary, before the *Canderel* and *Toronto College Park* cases, there simply was no case that required a taxpayer to match expenditures with revenues.[56] Again, one wonders why the cases of *Canderel* and *Toronto College Park* proceeded to court, let alone found their way to the Supreme Court of Canada.

## Truer Picture Doctrine

Undoubtedly, one of the reasons was the development of the "truer picture" doctrine. Revenue Canada was of the view that, based on the truer picture cases that had proceeded through the courts, the argument could be made that it was inappropriate to compute income on what was effectively a cash basis and that the deductions by a landlord of TIPs should be matched to income.

Although it is probably accurate to say that the doctrine of the truer picture became generally known to practitioners only as a result of the decisions of the Federal Court of Appeal in *West Kootenay Power and Light Company Limited v. The Queen*[57] and *Maritime Telegraph and Telephone Company, Limited v. The Queen*,[58] this doctrine is not a new one. The first extended discussion in a Canadian case of the truer picture approach appears in *MNR v. Publishers Guild of Canada Ltd.*[59] (although that phrase is not employed).[60] The business of the taxpayer in that case

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[55] Ibid., at 5211-12.

[56] In *Canderel*, in an argument before the Supreme Court, Mr. Dupont for the taxpayer specifically made this point. When Mr. Gill was responding, the court asked him to provide a case in which a taxpayer was required to match current expenditures with revenues. He was unable to do so. In rebuttal, Mr. Dupont observed that "the Emperor has no clothes"—there is no case that requires a taxpayer to match current expenses with revenues.

[57] 92 DTC 6023 (FCA).

[58] 92 DTC 6191 (FCA).

[59] 57 DTC 1017 (Ex. Ct.).

[60] Madam Justice Desjardins in *Canderel*, infra footnote 87, reviewed extensively the jurisprudence relating to the truer picture doctrine.

was the selling of books and magazines through door-to-door canvassers. In computing its income for the relevant taxation years, the taxpayer used the instalment method of income recognition (which excluded from income in the year of sale the gross profit content of the instalments that remained unpaid at the end of the year). The minister reassessed on the basis that the full sale price should be included in revenue in the year of sale. When the minister was unsuccessful before the Tax Appeal Board, the minister appealed to the Exchequer Court of Canada. In rendering the court's decision in favour of the taxpayer, President Thorson stated:

> A system of accounting that would be appropriate to one kind of business is not necessarily appropriate to a different kind. Only an arbitrary minded person would contend that there is only one system of accounting of universal applicability. . . .
>
> *[T]he prime consideration, where there is a dispute about a system of accounting, is, in the first place, whether it is appropriate to the business to which it is applied and tells the truth about the taxpayer's income position and, if that condition is satisfied, whether there is any prohibition in the governing income tax law against its use.* If the law does not prohibit the use of a particular system of accounting then the opinion of accountancy experts that it is an accepted system and is appropriate to the taxpayer's business and most nearly accurately reflects his income position should prevail with the Court if the reasons for the opinion commend themselves to it [emphasis added].[61]

In *West Kootenay*, the taxpayer was a hydroelectric utility that included in its income for financial statement purposes an estimate of the value of electricity that had been consumed by its customers between the time they last had their meters read and the year-end, for which they had not yet been billed. For income tax purposes, the taxpayer excluded from its income the value of the electricity that had been consumed but not yet billed. Mr. Justice MacGuigan stated:

> In my view, it would be undesirable to establish an absolute requirement that there must always be conformity between financial statements and tax returns, and I am satisfied that the cases do not do so. 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.
>
> The result often will not be different from what it would be using a consistency principle, but the "truer picture" or "matching approach" is not absolute in its effect, and requires a close look at the facts of a taxpayer's situation.[62]

Later in his reasons, he referred to the above principle as the "truer picture approach."

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[61] Supra footnote 59, at 1026.

[62] Supra footnote 57, at 6028.

The *West Kootenay* case was followed in the decision of the Federal Court of Appeal in *Maritime Telegraph and Telephone*. The taxpayer in that case had billed its clients for local and long distance charges on a monthly basis. Before 1984, it had included in its income the value of the services that it had performed but for which it had not yet billed, but then commenced to exclude such amounts from income for tax purposes. At the trial level, Mr. Justice Reed, in finding that the taxpayer was precluded from switching to the "billed method" of recognizing income for tax purposes, stated:

> It is clear from the evidence that both methods of accounting are in accordance with Generally Accepted Accounting Principles. At the same time, while there is some evidence that the billed method is used by some utility companies, there was no evidence that any *large* Canadian telephone company uses the billed method for its general financial statements. Also, it is fair to conclude that the earned method accords a "truer" picture of the company's income for the year in question than does the billed method. The plaintiff is engaged in providing a continuing service which by its very nature results in revenue accruing daily.[63]

In the Court of Appeal, Mr. Justice MacGuigan stated that Mr. Justice Reed had found "that the earned method gives a truer picture of the taxpayer's income for the year than the billed method" and stated that "[t]his 'truer picture' approach was adopted by this Court in *West Kootenay*."[64]

While the truer picture cases do deal with timing issues in that they consider in which year certain amounts are to be included in income, they do not deal specifically with the deductibility of current expenses, which was the issue in *Canderel* and *Toronto College Park*, or the timing of the inclusion of receipts as in *Ikea*.

## THE INCLUSION ISSUE

Although *Ikea* will always be considered one of the trio of the timing cases, initially it fell within the genre of lease inducement cases. In those cases, the tenant took the position that the lease inducement payment was on account of capital, did not reduce the cost of the capital assets acquired with the payment, and was not required to be included in income. This issue was considered by the Supreme Court in *Ikea* and settled, although with little discussion.

The theory that lease inducement payments were on account of capital and received free of tax arose as a result of the decision in *Birmingham Corp. v. Barnes*,[65] in which it was held that the cost to a taxpayer of depreciable property is what the taxpayer pays for the property and is not reduced by any reimbursement. *Birmingham Corp.* was referred to by Mr.

[63] 91 DTC 5038, at 5039 (FCTD).

[64] Supra footnote 58, at 6192.

[65] [1935] AC 292 (HL).

Justice Walsh in *The Queen v. Canadian Pacific Limited*,[66] in which the court considered a number of different transactions in which Canadian Pacific was engaged during its 1965 taxation year. In one form of transaction, Canadian Pacific, acting at the request of a third party, made certain capital expenditures for the benefit of the third party. In the computation of its income for the relevant taxation year, Canadian Pacific claimed capital cost allowance in respect of the assets it had acquired as a result of making the capital expenditures on the basis that the amounts received from the third party did not diminish the capital cost of the assets to Canadian Pacific. The minister argued that because Canadian Pacific itself had not paid for the work done, it was not entitled to claim capital cost allowance. However, the Federal Court of Appeal rejected this argument.[67]

In *The Queen v. The Consumers' Gas Company Ltd. (Consumers' Gas No. 1)*,[68] the Federal Court of Appeal followed *Canadian Pacific*. The taxpayer received substantial amounts as reimbursements from third parties to relocate portions of its natural gas pipelines at the request of the third parties. The court held that the reimbursements did not reduce the capital cost of the improvements made.[69]

In *The Queen v. The Consumers' Gas Company Ltd. (Consumers' Gas No. 2)*,[70] the Court of Appeal considered whether receipts from third parties in respect of an average annual number of about 225 relocations in the relevant taxation years should be brought into the income of the taxpayer. Mr. Justice Hugessen, in rendering the decision of the court, came to the conclusion that the reimbursements did not form part of the income, since there existed no provision in the Act requiring such amounts to be brought into income. Although these amounts were reflected in the

[66] 76 DTC 6120 (FCTD), aff'd. 77 DTC 5383 (FCA).

[67] See, in particular, Pratt J's comments, ibid., at 5386 (FCA).

[68] 84 DTC 6058 (FCA).

[69] It was the position of the minister that Consumers' Gas was required to include the reimbursements in its revenue for the purpose of computing its income under the Act, but this issue was not decided by the court because of a defect in the minister's pleadings. The minister's principal submission was that while the reasoning in *Canadian Pacific* may have entitled the respondent to add the gross cost of the relocations to the undepreciated capital cost of the assets and to calculate capital cost allowance on the whole of the relocation costs, *Canadian Pacific* neither considered nor decided the question whether such receipts were revenue that had to be included in the income of Consumers' Gas for tax purposes. The minister's position in *Consumers' Gas* was not considered on its merits because the minister's pleadings were such that the taxpayer could not anticipate that this would be the minister's argument. Mr. Justice Urie, in rendering the decision of the Court of Appeal, stated, ibid., at 6062, "I am of the opinion that no reasonable reader of the aforementioned paragraphs of the Amended Statement of Defence would anticipate that if the Court were to find that the principle of the *Canadian Pacific* case were followed . . . the Respondent's position would be that the receipt of the reimbursements was on income account although the expenditure would be for capital account."

[70] 87 DTC 5008 (FCA).

income account of the taxpayer corporation for accounting purposes, they did not have to be treated as income for taxation purposes.[71]

At the time that *Ikea* proceeded to court, there were a number of cases before the courts[72] involving the taxation of TIPs received by tenants, and the tax bar hoped that a suitable case would be heard by the Court of Appeal,[73] if not by the Supreme Court of Canada.

*Ikea* was factually not a good lease inducement payment case from the perspective of taxpayers because the amount received by Ikea far exceeded the amount spent by it on fixturing; in most situations, the amount received by way of a TIP would not have significantly exceeded the amount of the fixturing expenses incurred by the tenant. It was undoubtedly for this reason that the taxpayer in *Ikea* argued that if it were required to bring the TIP into income, the TIP should be spread over the period of the lease. From the perspective of symmetry, if Revenue Canada argues that a landlord is required to follow accounting principles and deduct the expenditures in accordance with GAAP, there is seductive appeal to the argument that a taxpayer who must include the amount in income as an inducement payment should be able to include the amount in income in accordance with GAAP. The general rules relating to how the accounting rules should apply to the calculation of income for the purposes of the Act are set out above. These are, however, *general* rules, and there is no specific jurisprudence that would support the proposition that the amount should be included in income in accordance with GAAP. The jurisprudence that did exist suggested that the amount should be included in income at the time of receipt of the payment. The case of *Robertson v. Minister of National Revenue*,[74] a decision of Mr. Justice Thorson of the Exchequer Court, has long stood for the proposition that an amount is to be included in the income of the taxpayer if the taxpayer has unrestricted control over the amount and is not subject to any restriction, contractual or otherwise. The jurisprudence has consistently followed this reasoning.[75]

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[71] Mr. Justice Hugessen made the following comment, ibid., at 5011: "It is common ground here that the cost of pipeline relocations is a capital outlay and that the receipts from third parties in respect thereof need not be taken into account in determining undepreciated capital cost for the purposes of calculating capital cost allowance. The mere fact that this results in such receipts not [sic] being reflected in income does not make them income. Absent some provision of the statute specifically bringing them into income, they continue to be treated, as required by generally accepted accounting principles, as capital receipts."

[72] See the jurisprudence referred to in Carr, supra footnote 7.

[73] *The Queen v. Westfair Foods Limited*, 91 DTC 5073 (FCTD), did proceed to the Court of Appeal: 91 DTC 5625 (FCA). However, that case involved a payment to compensate a taxpayer for the termination of a lease, and the taxation of lease inducement payments was not in issue.

[74] (1944), 2 DTC 655 (Ex. Ct.).

[75] *Diamond Taxicab Assn. Ltd. v. MNR*, 53 DTC 1111 (SCC); *The Queen v. Imperial General Properties Limited*, 85 DTC 5045 (FCA); *MNR v. Atlantic Engine Rebuilders Ltd.*, 67 DTC 5155 (SCC); and *Versalite Pacific Shipyards Inc. v. The Queen*, 88 DTC 6352 (FCA).

## DECISIONS IN THE THREE CASES

It was against the jurisprudential background discussed above that the taxpayers and the Crown in *Toronto College Park*, *Canderel*, and *Ikea* proceeded to the courts.[76]

### Trial Level

#### *Toronto College Park*

The parties to the litigation prepared a statement of agreed facts in which they agreed that the payments were made in the ordinary course of TCPL's business and no issue was taken with the amounts or their bona fides. It was also agreed that the payments were made to earn income.

As stated above, TCPL had filed its tax returns on the basis that the TIPs were on account of income, and the minister reassessed on the basis that the TIPs were on account of capital.[77] At trial,[78] the minister accepted that the payments were on income account but argued that the taxpayer was required to amortize such payments over the life of the leases. Neither party led any evidence as to the proper accounting method, and TCPL argued that since the minister had reassessed on the basis that the outlays were on account of capital, the minister had the onus to adduce evidence to show that the taxpayer's position was not appropriate.

On the basis of the jurisprudence discussed above, the taxpayer obviously wanted the TIPs to be categorized as running expenses so that they could be deducted immediately. Just as obviously, the minister wanted the expenses to be matched to the leases, and hence amortized, and argued that the "truer picture" doctrine required the matching of the TIPs to the lease payments.

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[76] The *Toronto College Park* trial took place before the *Canderel* trial, but *Canderel* was heard by the Court of Appeal before *Toronto College Park*. All three were heard by the Supreme Court on the same day, *Canderel* first, *Toronto College Park* second, and *Ikea* third.

[77] At the time that Canderel and TCPL were reassessed, Revenue Canada's position on TIPs paid by a landlord was as follows:

1) Where the lease inducement payment is made by a landlord outside the ordinary course of its business, the payment is a capital payment that is not deductible.

2) Where the payment is made by a landlord in the ordinary course of its business and the purpose of the payment is to obtain the lead or anchor tenant for a project, the payment is an eligible capital expenditure.

3) Where a lease inducement is paid in the ordinary course of a landlord's business to a non-anchor tenant, the payment is considered to be on income account. Where the payment is made initially to lease the premises, the amount of the payment should be deferred and amortized over the term of the related lease. Payments made to re-lease the space may be deducted in the year in which the expense is incurred or may be deferred and amortized over the term of the related lease.

The above position is set out in "Revenue Canada Panel," in *Creative Tax Planning for Real Estate Transactions—Beyond Tax Reform and into the 1990s*, 1989 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1989), 8:1-59, at 8:6-9.

[78] *Toronto College Park Limited v. The Queen*, 94 DTC 6172 (FCTD).

After reviewing the case law consisting of *Cummings*, *Oxford Shopping Centres*, *Associated Investors*, *Naval Colliery*, and *Tower Investment*, Madam Justice Simpson explained her approach as follows:

> I have concluded that the case law suggests the following approach.
>
> • I should determine first whether the expense is a running expense in the sense that it cannot be specifically allocated to a matching revenue item.
>
> • If the expense is a running expense, I must decide whether it is current or whether the benefit extends beyond the year of payment even though it cannot be matched as the revenues it generates are non specific.
>
> • If I conclude that the benefit of a running expense extends beyond the year of the expense, a taxpayer has two options. It may either deduct in the year of the expense, even if the income picture is somewhat distorted, or defer the deduction if deferral accords with GAAP and creates a truer income picture.[79]

Without elaborate reasons, she concluded for the following reasons that the expenses were running expenses, which TCPL was entitled to deduct in the year of expense:

> On these facts, I am satisfied that the Payments were current running expenses because their primary objective, which was to attract tenants to the Building, was achieved in the year of the expense. Any secondary benefits in the form of non specific revenues from the tenancies were too imprecise to affect this conclusion.[80]

In dealing with the "truer picture" argument, Madam Justice Simpson stated simply that there was no evidence before her about whether deferral or immediate deduction produced a truer picture of TCPL's income.[81]

### *Canderel*

At trial,[82] Canderel led considerable evidence to support the proposition that the TIPs were designed to create an immediate benefit and that one should look to the immediate benefit and not attempt to match the TIPs to the lease payments. According to the evidence, Canderel had to find tenants by project completion, or shortly thereafter, or risk the following adverse consequences:

• the operating and financing costs would have to be borne entirely by the joint venturers;

• permanent financing would not be obtained, leaving the joint venturers with a demand full-recourse loan funding a long-term asset with floating interest rates; and

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[79] Ibid., at 6175.

[80] Ibid.

[81] Ibid.

[82] *Canderel Limited v. The Queen*, 94 DTC 1133 (TCC).

• the project would become known as not having gained market acceptance and thus would be less likely to attract stable, creditworthy tenants.

Canderel presented expert evidence to support the proposition that the expense was immediately deductible in accordance with GAAP. The minister also presented significant accounting evidence to establish that the preferred method of accounting was to amortize the TIPs over the duration of the leases to which they related.

His Honour Judge Brulé, in coming to his conclusion, held that there were four main benefits generated from the TIPs by the taxpayer. These were

> (1) to "prevent a hole in income" otherwise caused by maintaining a vacant building;
>
> (2) to satisfy the underlying requirements of its interim financing and to obtain permanent financing;
>
> (3) to meet its competition, maintain its market position and reputation;
>
> (4) to earn revenues through rentals, management and development fees.[83]

After reviewing much of the jurisprudence discussed previously in this article, His Honour Judge Brulé held that the expenses were running expenses, that matching was not the appropriate method for tax purposes, and that Canderel should be allowed to adopt the expensing method. In addition, His Honour Judge Brulé indicated that there was no requirement under the law for consistency in accounting methods between financial statements and income tax calculations. As a result, he allowed the appeal.

### *Ikea*

In dealing with the question whether the inducement payment was on account of capital or on account of income, His Honour Judge Bowman at trial[84] held that the payment could not be connected with any capital purpose and that the amount of $2,650,000 was income to the taxpayer from its business.

His Honour Judge Bowman then went on to consider whether the payment was to be included in income in the year of receipt or could be amortized over the period of the lease. The taxpayer led evidence to support the proposition that if the lease inducement payment were on account of income, the method it had used to compute its income for tax purposes was in accordance with GAAP. Interestingly enough, in *Ikea*, it was the minister who took the position that accounting procedures were irrelevant.

There simply was no jurisprudence that supported the taxpayer in its position that the amount should not be included in income because of GAAP. In his decision, His Honour Judge Bowman referred to *Robertson*[85]

[83] Ibid., at 1142.

[84] *Ikea Limited v. The Queen*, 94 DTC 1112 (TCC).

[85] Supra footnote 74.

and concluded that Ikea had to include the TIP in income in its 1986 taxation year because Ikea's right to the TIP became absolute in 1986.[86]

## Federal Court of Appeal

### *Canderel*

Two concurring opinions were given by the Federal Court of Appeal,[87] one delivered by Mr. Justice Stone with which Mr. Justice Robertson concurred and one delivered by Madam Justice Desjardins.

Mr. Justice Stone began by stating that, at least in the Federal Court of Appeal, the matching principle had been elevated to the status of a legal principle.[88] In support of this startling proposition, he referred to Mr. Justice MacGuigan's judgment in *West Kootenay* where he stated:

> 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.[89]

The essence of the court's decision was that the expenses were not running expenses and the expenses were not incurred in earning income solely in the 1986 taxation year but in all of the years in which the respective leases were to run. Mr. Justice Stone held that since the expenses could be matched, they should be matched; that they could be so matched was evidenced in the fact that they were matched for financial reporting purposes.

It is certainly a startling jump of logic to hold, as did Mr. Justice Stone, that the *West Kootenay* case, which held that the truer picture was based on evidence, stood for the proposition that the matching principle of accounting had been elevated to the status of a legal principle.

In a much longer judgment, Madam Justice Desjardins reviewed the law relating to section 9, to running expenses, and to the truer picture. After discussing *Oxford Shopping Centres*,[90] she referred to the statement of Mr. Justice Thurlow in that case[91] that the matching principle will apply to expenses related to particular items of income but does not apply to the running expenses of the business as a whole:

> What is at stake here is whether T.I.P.s are expenses related to a particular item of income, or whether they are running expenses. If they are related to a particular item of income, the "matching principle" will apply. If they are running expenses, the taxpayer will have the option of deducting the amount in full or amortizing it.

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[86] Supra footnote 84, at 1125-26.

[87] *The Queen v. Canderel Limited*, 95 DTC 5101 (FCA).

[88] Ibid., at 5102.

[89] Supra footnote 57, at 6028.

[90] Supra footnote 45.

[91] Ibid., at 5466-67.

> T.I.P.s are clearly expenses related to particular items of income. . . . The real and immediate effect of the T.I.P.s is to pull a string of revenues. It is the revenues which, once they flow in, on account of the T.I.P.s, have the remaining financial benefits described by the trial judge.
>
> *Matching of T.I.P.s is compulsory* [emphasis added].[92]

This description of the law is not consistent with the previous jurisprudence. In *Tower Investment* and *Canadian Glassine*, it was held that a taxpayer could deduct current expenses in the year or match them, but was not compelled to match them. Matching had never previously been held to be compulsory.[93]

### *Toronto College Park*

At the Federal Court of Appeal,[94] TCPL argued that to require amortization or matching would be to render subsection 18(9) of the Act redundant and meaningless. The court held that there is a difference between amortization and matching; certain expenses can be amortized even though they cannot be matched to a particular revenue stream.

The taxpayer also argued that the minister had failed to establish that amortization of the TIPs provided a truer picture of the taxpayer's net income, and therefore the taxpayer was entitled to deduct the entire expense as was permitted under GAAP prevailing at the time the payments were made. Mr. Justice Robertson dealt with this argument as follows:

> According to the analysis provided in *Canderel*, the issue is not which of the three GAAP options gives the truer picture of the taxpayer's profit or net income. Rather the question is whether an expense in question can be matched with a specific source of revenue. If it can, then it must be amortized. In *Canderel* this Court was unanimous in holding that tenant inducement payments could be so matched and therefore the "amortization method is the only method acceptable for income tax purposes" (per Desjardins, J.A. at 270). *That conclusion stands as a matter of law and is unaffected by whatever expert testimony might have been proffered with respect to the suitability or appropriateness of any one of the options outlined in GAAP*. As is well known, the calculation of "profits" under section

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92 Supra footnote 87, at 5113.

93 In "Running Headlong into the GAAP (Again)," Current Cases feature (1995), vol. 43, no. 3 *Canadian Tax Journal* 738-45, at 744, T.E. McDonnell commented, "*Canderel* appears to be the first case in which the Court of Appeal has decided that the concept of running expenses is limited to outlays that have the character of general overhead expenses. In that respect, it is a significant decision. With the exception of outlays on account of inventory, it has generally been understood that an outlay properly characterized as an expense is deductible in the year in which it is incurred. The *Oxford* case is a clear example. The decision in *Tower Investment* has been rationalized on the basis that where an item of expense benefits future periods, the taxpayer has the option to deduct it in full in the year in which it is incurred or to amortize it on some reasonable basis over those future periods. The addition of subsection 18(9) to the Act effective December 12, 1979 supports the view that an amount characterized as an expense is deductible in the year in which it is made or incurred."

94 *The Queen v. Toronto College Park Limited*, 96 DTC 6407 (FCA).

> 9 of the Act is a question of law: see *Symes* v. *Canada* [1993] 4 S.C.R. 695 at 723 [emphasis added].[95]

The highlighted portion of the foregoing quote constituted a huge extension of the law. There simply was no jurisprudence to support it.

The foregoing statement of Mr. Justice Robertson may well have been a blessing in disguise. One never knows why the Supreme Court of Canada decides to hear a case. *Canderel* had been refused leave on its first application to the Supreme Court. Presumably, at that time, the Supreme Court did not find the issue to be of national importance. It may have been that a statement such as the foregoing, which clearly extended the law, was enough to cause the Supreme Court to hear *Toronto College Park* and *Canderel*.[96]

#### *Ikea*

At the Court of Appeal, the taxpayer did not argue that the receipts should be capital receipts. The only argument raised by counsel for Ikea was that the taxpayer was entitled to match the income to the term of the lease. The court said simply that it had never been suggested that the matching principle should be applied to the exclusion of the line of authorities beginning with *Robertson*.[97]

## Supreme Court of Canada

### *The Deduction Issue*

Mr. Justice Iacobucci speaking for the court gave extensive reasons in *Canderel* on the deduction issue and gave much more concise reasons in *Toronto College Park*.

#### *Canderel*

Mr. Justice Iacobucci began his legal analysis in *Canderel* by recognizing that the determination of profit under subsection 9(1) is a question of law and stated:

> The great difficulty which seems to have plagued the courts in the assessment of profit for income tax purposes bespeaks the need for as much clarity as possible in formulating a legal test therefor. The starting proposition, of course, must be that the determination of profit under s. 9(1) is a question of law, not of fact. Its legal determinants are two in number: first, any express provision of the *Income Tax Act* which dictates some specific treatment to be given to particular types of expenditures or receipts, including the general limitation expressed in s. 18(1)(a), and second, established

95 Ibid., at 6411.

96 It is also possible that what caused the Supreme Court to hear these cases was the argument that there was an inconsistency between the law relating to the timing of the receipt of income and the law governing the timing of the deduction of expenses, and that Canada's highest court should address this inconsistency.

97 Supra footnote 74. See the jurisprudence referred to in footnote 75, supra.

> rules of law resulting from judicial interpretation over the years of these various provisions.
>
> Beyond these parameters, any further tools of analysis which may provide assistance in reaching a determination of profit are just that: interpretive aids, and no more.[98]

In his review of the law, Mr. Justice Iacobucci commented that the compartmentalization of the income calculation by reference to rigid categories of expenses (running and matchable) has led to a process that is far more complicated than necessary.[99] He went on to state that the taxpayer's focus should be on attempting to portray his or her income in the manner that best reflects his or her true financial position for the year and provides an accurate picture of profit.[100] Finally, he commented that the competing concepts of running expenses and matching, which appear to be at play in the appeal, fall into the category of well-accepted business principles, no more, no less, and that they are simply important interpretive aids that may assist, but are not determinative, in the illumination of an accurate picture of the taxpayer's income.[101]

Mr. Justice Iacobucci subsequently summarized the law as follows:

> The outlined framework for analysis is, of course, only as useful as its application to actual cases. Turning to the facts of this case will illustrate how this principled approach to the computation of income is intended to operate. Before I do this, however, it may be both convenient and useful to summarize the principles which I have set out above:
>
> 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., are not rules of law but interpretive aids. To the extent that they may influence the calculation of income,

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98 Supra footnote 1, at 6106. One is reminded of Robert Browning's famous exhortation:

> Ah, but a man's reach should exceed his grasp,
> Or what's a heaven for?
>
> *Andrea del Sarto*, l. 97.

99 Supra footnote 1, at 6108.

100 Ibid.

101 Ibid.

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.[102]

Mr. Justice Iacobucci then indicated that the method of calculation adopted by Canderel was not inconsistent with any provision of the Income Tax Act or the rule of law. He indicated that subsection 18(9) had no application to the TIPs. He further indicated that the case law also supports this method of computation, noting that *Tower Investment* held that in the particular circumstances, amortization was an acceptable way to obtain an accurate picture of income, and that no general rule of law was thereby developed.[103]

It is regrettable that Mr. Justice Iacobucci did not stop at that point. Instead, he continued:

At this stage, then, Canderel was free to deduct the payments entirely in the year incurred. But that does not end the matter. It remains to be seen whether the method chosen by Canderel was in accordance with the case law principles as outlined above and with well-accepted business principles, and whether it provided an accurate picture of its income for the year in question. Even if that were so, the Minister would still be entitled to insist on an alternative treatment of the expenditures if it could be shown that such would provide a *more* accurate picture. To answer these questions will require an examination of the evidence and the findings of the trial judge.[104]

He then went on to review the evidence and the findings of fact at the Tax Court and stated that the findings made by the trial judge outlined above were very indicative. While some of the four primary benefits enjoyed by Canderel would be realized over a period of years, others, such as the satisfaction in interim financing, maintenance of market position, and reputation were benefits that were immediately realized by Canderel in the year the payments were made. Mr. Justice Iacobucci then stated:

In its submissions before this Court, Canderel posited a variety of other questions which would arise out of the treatment of the matching principle as a compulsory rule of law. For example, if an induced tenant were to break its lease before the end of the term, how, and pursuant to what authority, would the balance of the TIP be deducted from income? What if the rate of rent varied over the term of the lease; would this affect the rate of amortization? Additionally, without any clear, principled distinction between this case and *Cummings*, *supra*, what other expenses incurred in the course of securing tenants for a building would be required to be amortized

[102] Ibid., at 6109-10.

[103] Ibid., at 6111.

[104] Ibid.

> rather than currently deducted? Moreover, what would happen if the leased premises were disposed of before the TIPs were fully deducted? These are questions which simply cannot be answered by reference to the law as it presently exists, and for good reason: in a case such as this, there is simply no uniform solution by which the most accurate picture of the taxpayer's profit may be obtained. It is therefore an artificial and arbitrary solution to impose the matching principle, as a matter of law, upon circumstances where its application quite evidently creates serious difficulty. To my mind, the uncertainties created by the type of judicial legislation engaged in by the Federal Court of Appeal stand as clear examples of the difficulties contemplated in *Sparrow Electric*, *supra*.[105]

This seems to be a make-weight argument at best. It is clearly not in my own best interests, as a legal beagle, to concede territory to the accountants. However, if one were prepared to accept that GAAP determined the meaning of profit for purposes of subsection 9(1), the accountants would undoubtedly employ some method for handling these various items in the income tax returns of a taxpayer.

Mr. Justice Iacobucci then said that he would find it difficult to conclude that the amortization of payments over the terms of the leases would provide a more accurate picture of Canderel's income than would their immediate deduction in the year expended.

### *Toronto College Park*

In this decision, Mr. Justice Iacobucci first summarized his decision in *Canderel*. Then, in applying the general principles to the facts in this case, he stated[106] that as to the question of conformity with well-accepted business principles, it was, in his opinion, determinative that the trial judge in the instant case found that the primary purpose of the TIPs was to achieve a benefit that was realized entirely in 1983, the inducement of prospective tenants to lease space in the building. Consequently, he held that the amortization of the payments over the terms of the various leases would seem to make little sense. He also went on to state that the most that can be said in favour of the matching principle is that in cases where expenses can be related directly to specific items of future revenue, it may yield a more accurate picture of income to offset the expenses against the future revenue, notwithstanding that the actual expenditures were made or incurred in another year.[107]

## ***The Inclusion Issue***

### *Ikea*

At the Supreme Court of Canada, Ikea argued, first, that the payments were tax-free capital receipts and, second, that if they were on income account, they should be amortized over the period of the lease.

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[105] Ibid., at 6111-12.

[106] Supra footnote 2, at 6091.

[107] Ibid.

Referring to the argument that the payment was on capital account, Mr. Justice Iacobucci held that the case law cited by His Honour Judge Bowman, beginning with *Birmingham Corp.*[108] and continuing through *IBM*,[109] reaffirmed the proposition that where a payment is made to a taxpayer as a reimbursement for the cost of capital property, it is to be treated as a capital receipt for tax purposes, and where a payment is made as a reimbursement for an expense on revenue account, it is to be treated as income. He held that even the case law cited by Ikea in support of its contention that the TIP was a capital receipt in the end commended the opposite conclusion. He commented that in *Woodward Stores Limited v. The Queen*,[110] the payment in question, while clearly a TIP, was earmarked specifically as a "fixturing allowance." It was advanced for the express purpose of reimbursing a capital expense and therefore constituted a capital receipt. Similarly, in *Westfair Foods*,[111] the payments made to the taxpayer were characterized by the court as capital receipts only because they were compensation for the premature termination of leases and therefore related to the disposition of a capital asset. According to Mr. Justice Iacobucci, both of these cases were entirely consistent with the law as stated by His Honour Judge Bowman and provided no specific assistance to Ikea's argument.[112]

Mr. Justice Iacobucci then canvassed the law relating to capital versus income with respect to TIPs and concluded:

> The payment was clearly received as part of ordinary business operations and was, in fact, inextricably linked to such operations. On the evidence, no question of linkage to a capital purpose can seriously be entertained. *Had Ikea wished, it could have requested that the T.I.P. be advanced expressly for the specific purpose of fixturing, or to defray some other capital cost.* It did not do so, however, and the payment was in fact made free of any conditions for or stipulations as to its use. Therefore, whether the T.I.P. represented a reduction in rent or a payment in consideration of Ikea's assumption of its various obligations under the lease, it clearly cannot be treated as a capital receipt and should have been included in Ikea's income [emphasis added].[113]

Mr. Justice Iacobucci then addressed the issue of timing. This issue was the one most easily dealt with by the court. In essence, the court simply applied what it considered to have always been the law. After referring to the jurisprudence, including the *Robertson* case,[114] Mr. Justice Iacobucci confirmed the realization principle, that an amount may have

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[108] Supra footnote 65.

[109] Supra footnote 9.

[110] 91 DTC 5090 (FCTD).

[111] Supra footnote 73.

[112] Supra footnote 3, at 6097.

[113] Ibid., at 6099.

[114] Supra footnote 74.

the quality of income even though it is not actually received by the taxpayer but only realized in accordance with the accrual method of accounting. He went on to hold that amounts received or realized by a taxpayer, free of conditions or restrictions upon their use, are taxable in the year realized, subject to any contrary provision of the Act or other rule of law, and that the TIP received by Ikea in the present case fitted that description perfectly.[115]

## ANALYSIS

The Supreme Court of Canada has enunciated in the trilogy of timing cases a number of principles that will be extremely relevant in future litigation.

### The Realization Principle

The most appropriate starting place in analyzing the decisions of the court is to consider the court's statement of the realization principle in *Ikea*. Later in the analysis, the simplicity of that statement is contrasted with the complex analytical framework developed by the court for determining the deductibility of current expenses.

The realization principle stated by the court is that once a taxpayer becomes entitled to an amount that is not subject to any conditions, the amount should be included in income under section 9 of the Act. That principle is to apply notwithstanding any generally accepted accounting principle.

Some tax practitioners are concerned that the decision in *Ikea* will encourage Revenue Canada to use the court's statement of the realization principle as the basis for reassessing taxpayers and including amounts in income under section 9 that were previously included under paragraph 12(1)(a).[116] Amounts included under section 9 are not the subject of any reserve, but amounts included under paragraph 12(1)(a) may be subject to a reserve pursuant to paragraph 20(1)(m).

Since *Ikea* stands for the proposition that section 9 includes in income amounts that are not subject to any restriction, and since paragraph 12(1)(a) assumes that the amounts in question have not been earned or are received subject to a condition that there may be a repayment, this concern may not be well founded. However, even if Revenue Canada is able to include some amounts under section 9 that were previously included in paragraph 12(1)(a), the court did not change the law at all in this respect;

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[115] Supra footnote 3, at 6099. Mr. Justice Iacobucci stated that the tenant inducement agreement made it clear that the sole condition precedent to receipt of the payment was the assumption of Ikea's obligations under the lease agreement and further stipulated that the payment was to be made within seven days of Ikea's commencing business in the premises, pursuant to the lease. Thus, Ikea's right to the payment became absolute at that time.

[116] Paragraph 12(1)(a) requires a taxpayer to include in income an amount that is received but not earned, or that may be subject to repayment.

it simply restated the law, which has certainly been in existence since *Robertson*, that where a taxpayer has an absolute right to an amount that is not subject to restrictions, contractual or otherwise, that amount must be included in income.

## Receipt of TIPs

It is unfortunate that the issues applicable to the receipt of TIPs were not discussed more fully in *Ikea*. The court's brevity may well have been due to the unusual facts in *Ikea*. As noted earlier, in most situations, the amount received by way of a TIP would not have significantly exceeded the amount of the fixturing expenses incurred by the tenant.

The court at least has rendered a judgment that does not nullify the provisions of paragraph 12(1)(x) and has outlined the manner in which a taxpayer must frame its documents to ensure that paragraph 12(1)(x) does apply. In general, the taxpayer should make it clear that the amount it receives is to be used for fixturing.

The court has impliedly blessed the line of cases ending in *Consumers' Gas No. 2*[117] and has held that expenses that reimburse capital payments are on account of capital. The test that the court has formulated to determine whether a payment is on account of capital or on account of income is highly mechanical and is one of form over substance.[118] His Honour Judge Mogan had it right in *IBM*.[119] In the real world, the tenant does not care to what the payment is allocated and does pay a higher rent in one form or another in order to get the inducement. To state that any payment is actually allocated to the fixturing of the premises is a fairy tale. Before the introduction of paragraph 12(1)(x), a taxpayer who received an inducement that was not more than the amount of the fixturing presumably received either a tax-free capital receipt or a taxable income receipt, depending upon whether the taxpayer had the foresight or the good luck to document the condition that the payment was for fixturing. The debate about the categorization of most payments has been eliminated as a result of the introduction of paragraph 12(1)(x).

## Well-Established Commercial Principles

The analytical framework established by Mr. Justice Iacobucci in *Canderel* demands an understanding of well-established business principles. However, we are no closer to understanding in any practical sense what well-established business principles are and how they are to be determined. The court has not embraced GAAP[120] and has told us that GAAP

117 Supra footnote 70.

118 The court has shown its preference for form in the recent case of *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

119 Supra footnote 9.

120 Obviously, some accountants in the tax community will not be happy with this aspect of the court's decision. See Webb, supra footnote 18.

are just another tool to help us to determine what profit is in any particular circumstance. The tax adviser in giving advice and the litigator in preparing a case are left to wonder when a court will refuse to stray from the principles of GAAP and when a court will hold that GAAP are not determinative. Perhaps Potvin[121] is correct in saying that although the courts refuse to embrace GAAP, unless there is a judicial principle that has become well established, such as the realization principle, the courts will be reluctant to stray too far from GAAP. In short, although Mr. Justice Iacobucci has taken the time to explain patiently the principles of determining profit for purposes of the Act, he has not provided us with any particular practical tools that will be helpful in advising clients and in preparing cases for court.

## The Deduction Principle

### *A New Test*

The court showed itself quite capable of enunciating a very simple and straightforward principle with respect to the realization of income. It is unfortunate that it did not provide as simple a rule for the deductibility of current expenses. Before the decisions of the Court of Appeal in *Canderel* and *Toronto College Park*, the law was that a taxpayer could deduct a current expense in the year in which it was incurred but had the option to amortize the deduction of that expense if it produced a benefit in subsequent taxation years. Although it is difficult to justify granting to the taxpayer the option of amortizing current expenses,[122] the rule certainly should be that current expenses are deductible in the year in which they are incurred.

Fortunately, the court has rejected the matching principle as a rule of law. However, the court did not put the genie back in the bottle and return to the law existing before the Court of Appeal decisions in *Canderel* and *Toronto College Park*. The law relating to the timing of the deductibility of current expenses has been altered.

In most cases, current expenses will still be deductible in the year in which they are incurred. However, the court unfortunately left open the possibility that in some circumstances, the taxpayer will be required to match a current expense against a stream of revenues.[123] Tax advisers perceive the decisions of the court in *Canderel* and *Toronto College Park* to be great victories for the taxpayer. However, the war perhaps has not been won. It is a virtual certainty that Revenue Canada will in due course find a case where it can be argued that current expenditures should be matched and will reassess the taxpayer accordingly.

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[121] Supra footnote 10.

[122] See the text accompanying footnote 42.

[123] The Department of Finance has preceded the court on this issue in implementing section 18.1. However, there are many circumstances in which section 18.1 will not apply but where the decision of the court might apply.

Moreover, it appears that a taxpayer no longer has a right to match current expenses unless it can demonstrate that matching gives a more accurate picture of its income.

### *Shortcomings of the Test*

The test[124] that the court has propounded for determining whether current expenses should be matched is, at least theoretically, a very unwieldy one. Perhaps it is just a matter of semantics, but if the method used by the taxpayer results in an accurate picture, how can what the minister proposes present a more accurate picture? Presumably, if one method is accurate, another method cannot be more accurate. It may well be that one method gives an answer that is closer to complete than another, or is closer to giving an accurate picture and is less deficient than another; but this is not what the court said.

Mr. Justice Iacobucci has also presented a test that contains a shift in onus. Once the taxpayer has shown that its method produces an accurate picture, the minister has the onus to show that the minister's method produces a more accurate picture.[125] The test should be contrasted with the simpler test propounded by Mr. Justice Iacobucci in *The Queen v. Friedberg*, in which he held that once a taxpayer demonstrates that the taxpayer's method is appropriate, the inquiry stops.[126]

Had Mr. Justice Iacobucci indicated that it is simply a matter of evidence to determine which method gives the better result, a judge in any particular case would have been required to decide whether the method proposed by the taxpayer or that proposed by the minister resulted in a more accurate picture. In practice, this is how the convoluted test enunciated by Mr. Justice Iacobucci will work. While a trial judge in coming to his conclusion will no doubt cite the mantra formulated by the court, in all likelihood, the judge will determine which evidence he or she prefers

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[124] See the text accompanying footnote 102.

[125] In a theoretical sense, if the test were simply which method provided the more accurate picture and if the methods proposed by the taxpayer and by the minister presented equally accurate pictures, the minister would be successful because the taxpayer would not have discharged its onus. (For a recent discussion of the well-known principle that the taxpayer has the initial onus and the circumstances in which the taxpayer may shift that onus, see the comments of Madam Justice L'Heureux-Dubé in *Hickman Motors Limited v. The Queen*, 97 DTC 5363, at 5376-77 (SCC).) Under the test proposed by Mr. Justice Iacobucci, if the taxpayer's method does provide an accurate picture and the minister's method presents an equally accurate picture, the taxpayer will be successful because it will have discharged its onus, but the minister will not have discharged the minister's onus of having established that the minister's method produces a more accurate picture.

[126] 93 DTC 5507, at 5508 (SCC), where Mr. Justice Iacobucci stated, "On the facts, the respondent [the taxpayer] reported his losses when they were actually incurred, and his gains when they were actually realized. In our view, the appellant [the Crown] has not demonstrated that there is any error in adopting this approach."

and decide accordingly. The recitation of the court's test will be for the purpose of form only.[127]

### *More Accurate Picture*

In establishing the test for determining income, the court has imported the doctrine of "truer picture" or "more accurate picture" into the realm of deductibility where it was never applied before. The "truer picture" cases have dealt with the issue of timing where it was not clear in which year a certain amount of income belonged. They have not dealt with the timing issue of amortization or matching. In this respect, the decisions in *Canderel* and *Toronto College Park* will encourage litigation, not settle it.[128]

The test propounded by the court is very much an evidentiary one. In the future, taxpayers and the minister will engage in endless argument as to which facts are relevant and which accounting principles are more accurate.

Because the test is an evidentiary one, the court cannot present any guidance as to what facts should be relevant in future litigation. But one would not have thought that some of the facts in *Canderel* and *Toronto College Park* should be relevant to the determination of the proper method of determining the timing of the deduction of current expenses. For example, in *Canderel* reference was made to the fact that the leases filled a hole in the taxpayer's income and allowed Canderel to obtain financing. Supposing the facts had been that Canderel was a highly successful company that simply paid TIPs because that was the way the market operated. As stated above, that was the method of doing business in the early 1980s. Would the decision then have been different? How relevant is it that Canderel had financial difficulties? Would the court have arrived at a different result if the taxpayer had been in a position of financial strength? If so, the court's decision might be viewed as demonstrating, in an unusual way, the charge that there is one law for the rich and another for the poor.

## CONCLUSION

The trilogy of timing cases offers no pithy conclusion regarding the tax treatment of TIPs. The Supreme Court of Canada flatly rejected the Federal

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[127] See Brian J. Arnold, "Supreme Court of Canada Discusses Financial, Tax Accounting" (March 9, 1998), 16 *Tax Notes International* 730-35, at 732, where the author criticizes the court for providing no clues as to how Revenue Canada could establish that its picture of profit is more accurate than the taxpayer's. In practice, this will not likely be a problem. The trial judge will simply determine whether the evidence presented by the taxpayer or that presented by the minister is the more compelling and will decide, on the basis of that evidence, whether the taxpayer has discharged its onus and whether the minister has discharged the minister's onus. While the language of the judgment may have to be more complicated to satisfy the technical wording of the court's judgments, in practice, in most cases the statement of the law enunciated by the court will not present difficulties to the trier of fact.

[128] See supra footnote 4.

Court of Appeal's attempt to raise the matching principle to a rule of law. At the same time, the court did not state a simpler test for the deductibility of current expenses and did not state in a user-friendly form to trial courts and litigants the principle that is to be applied to determine when current expenses are deductible. It is also regrettable that the court did not deal more fully with the characterization of the reimbursement of expenses.

Members of the tax litigation bar can take some solace in the knowledge that there will be more cases of this nature to contest in the future.