Proving Business Expenses: Checklists and Commentary

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Introduction

At an organising meeting for the 2012 B.C. Canadian Tax Foundation Conference I commented that a discussion of business expenses would be a good addition to add to another proposed paper. Before I could gather my wits I was being volunteered by Mr. Chapman[1] to write a paper on the topic. Over the next several meetings it became apparent that Mr. Chapman was actually only interested in having someone tell him that all of his business travel expenses are still deductible, even when a business trip somehow involved tickets to a concert.[2] Unfortunately, in the interim period, the proposal mutated into a completely unwieldy origami sculpture of subtopics, income tax provisions, case law and conflicting CRA policy statements.

In hindsight, I should have anticipated how this paper would be unworkable if I tried to make it definitive. Anyone who has ever looked at the five page T2125 "Statement of Business or Professional Activities" will know that the "income" portion of the form takes up only a few lines. The rest of the form is almost wholly dedicated to items that might be used to reduce that income. Also, anyone who has represented a client in an audit will know that the auditor will take the position that income means (at a minimum) all bank deposits that cannot be shown to be something other than income.[3] Business expenses are *not* all the withdrawals from that same bank account. Expenses must be proven. The extent and type of proof required is in the

discretion/whimsy of the auditor. Even when an expense claim is well documented the auditor can still put a fly in the ointment by saying that the expense is not related to the business or it is personal in nature.

What follows is a review of the basic principles.

1. What is a business expense?
2. What is a reasonable business expense?
3. What evidence is required to establish an expense?

The paper then examines some unusual expense categories. Where time and space permits, excerpts from the 2012 CRA Audit Manual are included.[4] The Audit Manual provides techniques for conducting an audit.

The excerpts from the Audit Manual are provided without much commentary. I see the value of including excerpts as threefold.

1. Clients sometimes find the inquiries from an auditor baffling and think that an auditor is out to get them. The Audit Manual excerpts should assist in determining if the client's suspicions are correct. Since the Audit Manual is a guide for auditors it provides real value as a check against auditors taking extreme positions.
2. The excerpts should telegraph what an auditor is interested in and take away some of the mystery in the questions that arise in expense audits.
3. The excerpts (and other CRA publications) reflect policy biases of the CRA. Those biases are not always an accurate reflection of the case law. It will not come as a surprise that the

CRA expresses affection/disdain for various judicial decisions. I have tried to support my comments on those biases with appropriate case law references.

Throughout the paper various checklists are provided. Checklists are ubiquitous in law and accounting. For this paper the checklists are written with the idea: "I am involved in a dispute about expenses; here is a shortcut to items I might consider."

Even though the audit result may reek, during the audit it is difficult to justify the time and cost of arguing over each expense that is ultimately rejected in the result. It makes sense to try and salvage an audit before it goes completely awry. A level-headed application of the basic principles can turn potentially appalling result into a result that might not be good, but might be good enough.

PART I -- WHAT IS A BUSINESS EXPENSE?

Paragraph 18(1)(a) of the Income Tax Act ("**ITA**") is the beginning of a long list of limitations on potential expenses. It provides that no deduction shall be made for:

> **18**(**1**)(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property.[5]

The question "*what is a business expense*" begs for the tautological answer: "*an expense incurred for a business*." What really needs to be asked is:

1. What is the purpose of the expenditure?
2. Does the ITA have a specific restriction against this expense?

Sometimes there is a business purpose to an expense; for example, a restaurant business buying an oven, but the ITA restricts the deductibility of the expense (as a capital expenditure).[6] The focus of a dispute may be on trying to get around a specific limitation in the ITA. Then there are the expenses that are denied because an auditor believes they had no business purpose at all. Paragraph 18(1)(a) is usually cited to deny the deduction of personal expenses by a business.

Paragraph 18(1)(h) of the ITA also provides that personal expenses are not deductible as business expenses. The provision is probably unnecessary in light of paragraph 18(1)(a), but at least it serves to clarify that personal expenses are not business expenses. Still, no matter how many times I read paragraphs 18(1)(a) and 18(1)(h) together, I still come to the conclusion, "that's not helpful at all."

In *Symes v. R.*[7] the Supreme Court of Canada ("**SCC**") provided guidance on how to determine the nature of an expense. That guidance is not easily distilled into a test. In fact, Iacobucci J., writing for the majority, provides a concise analysis of the weaknesses of various "business purpose" tests posited in the precedents and by the parties and concludes as follows.

> **[73]** Upon reflection, therefore, no test has been proposed which improves upon or which substantially modifies a test derived directly from the language of paragraph 18(1)(a). The analytical trail leads back to its source, and I simply ask the following: did the appellant incur child care expenses for the purpose of gaining or producing income from a business?[8]

The temptation is to conclude that Iacobucci J. is just playing the tautological mind game mentioned above. However, his reflections about the nature of a business expense are quite instructive.

A determination of the purpose of an expense is an examination of the taxpayer's intentions. Iacobucci J. says that courts will "look for objective manifestations of purpose."[9] As always, intentions are determined by actions.[10] There is no fixed list of questions whose answer will determine the nature of an expense.

Fallout from *Symes*

The SCC does not render decisions that are limited to their particular facts. The principles stated in *Symes* are to apply generally, not just to the narrow circumstances described in that decision. *Symes* was a "personal versus business expense" case. One of its most intriguing applications was in *BJ Services v. R*,[11] a "current versus capital expense" case.

In *BJ Services*, Campbell J. states the following:

> **[29]** …paragraph 18(1)(*a*) … relies on the phrase "for the purpose of", the SCC, in *Symes v. R.* (1993), [1994] 1 C.T.C. 40 (SCC), is clear that if the expenses are business in nature, instead of personal, the test for deductibility may be met by showing the expense satisfied a need of the company. Expenses incurred by a business, which are ancillary to its primary functions and activities, are not immediately excluded from being deductible. As a result this renders the paragraph 18(1)(a) restriction porous and allows the Nowsco expenses to pass through the excluding provisions, as long as they are business in nature and not personal. *There need not be a direct link between expenses and revenue. Expenses may be deductible, provided they are not personal and meet some business need of the taxpayer.*[12] (Emphasis mine)

The "ancillary expenses" in *BJ Services* had the primary effect of maximizing shareholder value. The Tax Court stated that even though the expenses were related to maximizing shareholder value, the expenses were integral to conducting business and could not be divorced from the corporate activities of gaining and producing income.[13]

BJ Services has been distinguished in other cases on the basis that the expense was capital in nature,[14] and where a holding company paid court ordered wage settlements (instead of the insolvent operating company).[15] However, the decision has been followed in the context of internal reorganizations of a private corporation.[16] Despite *Symes* and *BJ Services*, the Canada Revenue Agency ("**CRA**") is not particularly interested in allowing takeover costs or transaction costs as current expenses.[17]

The CRA Audit Manual

Almost all business audits include a review of the expenses of the business. The CRA instructs its auditors to look for specific items in expense claims. The existence of these items may trigger a more detailed audit of business expenses. Part 13.9.22 of the Audit Manual[18] instructs that the following are indicia of personal expenses being passed off as business expenses.

> *Personal Expenses*
>
> When scanning the purchase journal watch for the following:

1. Purchases from suppliers that do not carry goods that would normally be used in the normal business activity
2. Purchase invoices made out to the taxpayer/registrant personally or to another family member
3. The delivery address is the taxpayer/registrant's residence
4. Personal purchases may be paid by credit card. Scan the credit card statements to determine whether the purchases include personal items. Ensure that the taxpayer/registrant has not claimed personal travel as a business expense.
5. Where the business activity includes selling or purchasing products that are general household items the risk of personal use of products increases. Indirect methods of verifying the[19] (*Document ends*)

Personal or Business Expense Checklist

In *Symes* Iacobucci J. commented on the nature of business expenses and the evidence that might be relevant in determining the nature of an expense. His comments about the nature of business expenses and the evidence to consider in determining the nature of an expense are provided in this checklist.[20]

1. It should be clear that the intentions of the taxpayer are being reviewed. The nature of an expense is not determined by results. Therefore, expenses should not be denied simply because a business is unprofitable.[21]
2. If an auditor is inquiring about the revenue stream that resulted from an expense, it may be appropriate to assert that the inquiry is unfair. It is safe to assume that the auditor is concerned about something related to the expense, so redirecting the inquiry is usually a more fruitful approach. For example, an inquiry about the revenue *resulting* from a gift of Canuck tickets to a financial planner is not a fair question, but asking *why* the gift was made is a reasonable inquiry about the purpose of the gift.[22]
3. The expense does not need to be directly traced to the production of income. There is no requirement of a cause and effect relationship or that the receipt of income must occur in the same year as the expense is incurred.[23]
4. The expense, if incurred for a business purpose, can result in losses for the business.[24]
5. There is no exact dividing line between personal life and business life. To suggest that they are easily separated is a simplistic view of the modern business world.[25] In this respect an expense can be for business consumption and personal consumption.[26]
6. It is often enough to ask does the expense satisfy a need of the business or a need of the taxpayer? However, the answer to that question may be insufficient since it presupposes that an expense will only meet one type of need.[27]
7. Is the expense ordinarily allowed as a business expense by accountants?[28] Putting the question another way, is the expense one normally incurred by others involved in the taxpayer's business?[29]
8. Would a particular expense have been incurred if the taxpayer was not engaged in the

pursuit of business income?[30]

9. The "extent that a taxpayer can make a lifestyle choice while maintaining the same capacity to gain or produce income" tends to be seen as personal consumption decisions, and the resultant expenses as personal expenses.[31]

10. Traditionally, expenses that simply make the taxpayer available to the business are not considered business expenses since the taxpayer is expected to be available to the business as a *quid pro quo* for business income received.[32] This traditional assumption is questionable in light of *Symes*.

PART II -- WHEN IS AN EXPENSE REASONABLE

Now that the nature of a business completely expense is clear, the next consideration is whether the expense is reasonable. In many tax audits, paragraphs 18(1)(a) & (h) of the ITA are coupled with an examination of whether an expense was reasonable under section 67 of the ITA. Section 67 is straightforward.

> **67** In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.[33]

In *Stewart v. R.*[34] the SCC sets out steps to be taken before section 67 applies. The proper analysis is to determine if there is a source of income pursuant to section 9 of the ITA. The characterisation of expenses occurs in other provisions of the ITA, particularly under section 18.[35] In respect of section 67 the SCC stated as follows.

> As well, if, in the circumstances, the expense is unreasonable in relation to the source of income, then s. 67 of the Act provides a mechanism to reduce or eliminate the amount of the expense. Again, however, excessive or unreasonable expenses have no bearing on the characterization of a particular activity as a source of income.[36]

To date the SCC has only provided that section 67 of the ITA is a tool for characterizing business expenses as reasonable or unreasonable. Currently, there are no particularly helpful SCC directions on how to make that determination.

The limited guidance provided by the SCC may change when the Court delivers its decision in *GlaxoSmithKline Inc. v. R.*[37] Leave to appeal was granted in March of 2011 and the SCC heard the appeal in January 2012.

As of the writing of this paper the SCC has not rendered a decision in *Glaxo*.

Glaxo concerns the value of goods transferred between non-arm's length corporations under the former subsection 69(2) of the ITA. The Minister of National Revenue reassessed GlaxoSmithKline by reducing certain expenses to an amount that would have been reasonable in the circumstances as provided for in subsection 69(2) of the ITA.

In *Glaxo*,[38] the Federal Court of Appeal ("**FCA**") imported the reasonableness test from *Gabco Ltd. v. MNR*[39] to the analysis to be performed under subsection 69(2) of the ITA. *Gabco* informs almost all of the other decisions under section 67. If the SCC modifies or nullifies the *Gabco* test then the value of those decisions will need to be re-examined.

The *Gabco* decision was delivered in 1968.[40] The dispute was over the quantum of wages paid to a non-arm's length family member. In allowing the appeal, Cattanach J. stated the following test for the whether an expense is reasonable in the circumstances.

> It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.[41]

This is a clear statement that a taxpayer's business judgement is not in issue under section 67. However, this does not mean that the CRA is not allowed to make inquiries about quantum. Cattanach J. also stated that the Minister of National Revenue is entitled to enquire if remuneration is out of proportion to the services provided and to disallow the disproportionate amount on the basis that it is a distribution of taxable profits.[42]

Section 67 was considered by the FCA in *Mohammad v. R.*[43] The issue was the deductibility of interest paid on the debt incurred for the purchase of a rental property. The key for the CRA was that 100% of the purchase price was financed with debt. At the trial level the overarching issue was whether the rental property had a reasonable expectation of profit ("**REOP**").[44]

Robertson J. specifically stated that the test of reasonableness under section 67 is separate from a REOP test.

> Section 67 of the Act, and its predecessors, speak to the reasonableness of a particular expense. The provision does not speak to the reasonableness of a particular expense, nor expenses collectively, when measured against revenues.[45]
>
> ...
>
> Section 67 of the Act cannot be invoked to limit an otherwise deductible expense on the ground that it is excessive or disproportionate in relation to revenues.[46]

The FCA also stated that when evaluating reasonableness there should be a search for objective evidence on whether an expense is reasonable,[47] and expressed discomfort with equating "unreasonable" with "extravagance" since deciding something is extravagant is a conclusion that is informed by personal considerations.[48]

In *Hammill v. R.*[49] the FCA stated that the case law had applied section 67 in a manner consistent with the following statement by Krishna, from *The Fundamentals of Canadian Income Tax*, 3rd edition regarding the purpose of section 67.

> The word "reasonable" [in section 67] would appear to relate primarily to the size or the amount of the deductions claimed or quantified and not to the type of the expense. "The purpose of the rule is to prevent taxpayers from artificially reducing income by deducting inordinately high expenses",...[50]

In noting the historical application of section 67, the FCA proposed that the *Stewart* decision could signal the possibility that the section may have a broader application.[51]

Audits and Section 67

In an audit it is not unusual to argue about whether an expense is "*reasonable.*" The real argument may be over the nature of the expense. Of course, it is unreasonable for a business to

deduct personal expenses as business expenses. However, the wording of section 67 of the ITA would not allow a personal expense to be denied as unreasonable.

Section 67 provides that the determination of whether an expense is reasonable only occurs if the expense is found to be "*otherwise deductible*." Personal expenses are not deductible as business expenses so section 67 does not apply.

If a proposal letter states that an expense is denied because it is personal and/or unreasonable in the circumstances it makes sense to ask how the expense is unreasonable. The point is only to determine the nature of the dispute. There is nothing gained by telling an auditor that the cost of a client's ballroom dancing lessons were quite reasonable and therefore should not be denied pursuant to section 67 of the ITA. It makes more sense to go back to the client and inquire about the business purpose of the expense.

Reasonable Expense Checklist/Items to Remember

The checklist for the application of section 67 of the ITA is sometimes difficult to separate from a personal or business expense analysis under section 18. The checklist and comments are meant to assist in determining what evidence should be gathered (if any) to prove an expense is reasonable.

1. If an audit result proposes that an expense is *personal* and *unreasonable*, seek clarification.
2. Is the auditor really saying the expense is personal? If yes, then evidence about the business nature of the expense is required.
3. Is this an issue of quantum? If yes, then evidence of how the quantum is reasonable should be presented.
4. Neither the CRA nor the courts should use section 67 as a method of second guessing the business judgement of the taxpayer. Poor decision making is not a basis for denying an expense under section 67.
5. Despite (3) and (4), issues of quantum typically arise where a payment is being made to someone who is perceived as not arm's length with the payor. In *Gabco* the court acknowledged the Crown's concerns about the amounts paid to a family member. However, the court concluded that the evidence showed the payments were reasonable.
6. The client should be able to provide a business reason for the expense. In *Hammill* the FCA stated that circumstances might arise where a client would pay more than market value for an expense if there are sound business reasons for doing so.
7. Section 67 applies to reduce the quantum of an unreasonable expense to a reasonable amount.
8. An expense is not deemed to be unreasonable based on the revenue generated by the business.
9. An expense should not be denied simply because the auditor thinks it is extravagant. The personal biases of an auditor should not come into play.
10. Payments to family members and extravagant expenses are dealt with under paragraphs 18(1)(a)&(h).

11. Generally, a dispute over reasonableness is preferable to a dispute about the nature of an expense. A personal expense is denied in whole. There is an opportunity to negotiate an expense to a reasonable amount. However, a settlement reducing an expense to a "reasonable amount" may be difficult for a client to accept if there is no apparent personal benefit to the expense.
12. Case law that pre-dates the 2002 SCC decision in *Stewart* should be reviewed closely. In pre-2002 cases section 67 was sometimes invoked as part of a larger REOP analysis. That same expense might be reasonable absent REOP.
13. If the dispute is really a dispute about the reasonable nature of an expense, the CRA may have a published policy statement on the issue. For example, the amount of remuneration paid to owner/managers of businesses is not usually challenged by the CRA unless the remuneration causes some unusual tax advantage.[52]

PART III -- EVIDENCE OF EXPENSES

Disputes about the nature of an expense or whether it is reasonable in the circumstances might require evidence gathering to show that nature, or how the quantum of the expense compares with other amounts spent by other taxpayers. This section is not concerned with that kind of evidence.

Most tax advisors have been caught up in audits where the client's business records resemble a Jackson Pollock painting - or worse, a blank canvas. The audit result sometimes reflects the frustration of the CRA auditor and the reassessment will insinuate that the client magically generated revenue without incurring any expenses at all.

If the audit result is wholly unsatisfactory the next step is to file an objection. That is probably a good time to get a tax lawyer involved in the resolution of a dispute. The tax lawyer will probably approach this kind of a file from an evidentiary basis. What do we need to prove? How do we prove it?

The CRA Audit Manual

The value of providing evidence to prove expenses can be clearly seen in the instructions given to CRA auditors. Part 13.9.22 of the Audit Manual[53] makes it clear that unvouchered expenses are not acceptable.

> *Auditing Expenses Claimed without Supporting Vouchers*[54]
>
> 1. Where expenditures are not supported with the appropriate documentation, the expense should be disallowed unless there is other satisfactory evidence to support the amount claimed. Indirect audit techniques may be used to determine the reasonableness of expenses without supporting documentation
> 2. Documents or vouchers required to support ITCs claimed are very specific. There are limited situations where ITCs can be claimed without supporting documentation.
> 3. Any missing voucher may be significant regardless of the fact that most other vouchers are available for verification. The nature of the transaction, the amount involved and the explanation provided by the taxpayer/registrant should be considered in determining whether to request the supporting documents or

information from a third party.

4. Judgment should be used where minor items are concerned. Where there are numerous small items that are not supported by voucher or where the taxpayer/registrant has been advised in the past to retain supporting information, an adjustment may be warranted.
5. In cases where the taxpayer/registrant does not have a formalized system of filing purchase invoices, a list of invoices should be given to the taxpayer/registrant and time allowed to locate them for review.
6. A cancelled cheque is not sufficient evidence to support the expense claimed nor does the cancelled cheque provide the required information to support ITCs. Significant expenditures should include an examination of the source document. GST/HST audit procedures should include testing a sample of purchase source documents unless the audit scope is limited and excludes the expenses/ITCs.
7. The form of payment may indicate concern. Where expenses are normally paid by cheque, cash payments for significant expenses should be included in the sample selected for testing.

The Law

Subsection 230(1) of the ITA requires taxpayers to keep records and books of account. Section 248(1) of the ITA defines "record" as including "an account, an agreement, a book, a chart or table, a diagram, a form, an image, an invoice, a letter, a map, a memorandum, a plan, a return, a statement, a telegram, a voucher, and another other thing containing information, whether in writing or any other form." Subsection 230(1) is sometimes cited as the justification for disallowing expenses where the auditor is dissatisfied with the taxpayer's records. A lack of adequate books and records does not, by itself, allow an auditor to disallow an expense.

The rule is set out clearly by the SCC in *Hickman Motors Ltd. v. R.*[55]

> where the ITA does not require supporting documentation, credible oral evidence from a taxpayer is sufficient notwithstanding the absence of records.[56]

The CRA acknowledges that the ITA provides no specific requirement to keep records. Chapter 10 of the CRA Audit Manual, "Conducting the Audit"[57] states as follows.

> There are no specific statutory requirements as to the precise nature of the books and records that a taxpayer/registrant must keep. The auditor, together with the advice and assistance of the team leader, has to make this determination using professional judgement and after taking into account the facts and circumstances of the particular situation. Factors to be taken into account when determining the adequacy of the records include the size of the business, the accounting abilities of the employees, the type of industry and the industry's accounting practices. The record-keeping requirements of other organizations with which the taxpayer/registrant deals such as banks, landlords, other creditors and statutory or regulatory bodies can also be considered when determining the adequacy of the books and records.[58]

This commentary is not as hard-line as the instructions in Part 13 of the Audit Manual. A direction to use judgement and to take the particular circumstances of the taxpayer into account

is surely the preferred approach. Regardless, the Audit Manual provides the following commentary on the case law.

> *Jurisprudence*
>
> The jurisprudence on the issue of defining the adequacy and content of books and records is limited. Judges have frequently commented on the adequacy or inadequacy of records in specific circumstances, but a model of an adequate accounting system has not been suggested.
>
> Inadequate books and records frequently have an impact on court cases in the sense that, if in the judge's opinion the records are inadequate and do not support the taxpayer/registrant's position, the Minister's assessment is generally upheld. The courts have generally found that taxpayers/registrants must prove the Minister's assessment wrong on the balance of probabilities.[59]

As noted in the introduction to this paper one of the reasons for including excerpts from the Audit Manual is to get a feel for the policy biases of the CRA. The slant in the Audit Manual is towards disallowing unvouchered expenses and viewing the lack of vouchers as suspicious. I am concerned that the comment on jurisprudence may cause auditors to treat the lack of vouchers as fatal to any claims for expenses. I am not aware of a section in the Audit Manual directing auditors to instruct taxpayers on how to gather adequate documents.

On occasion I have encountered audits where the auditor makes suggestions to the taxpayer about how an expense might be proved. Clients appreciate an auditor who can explain the rules the auditor has to follow, while at the same time suggesting ways to prove an expense.

My own view is that Tax Court judges often become exasperated with both parties in expense cases. Where the documents are confusing and incomplete a judge may disallow an appeal[60] or allow an appeal completely.[61] Often a judge will recognize that a business must have had expenses. Despite the poor documentary support for those expenses the judge will allow some expenses based on the evidence presented in court that day.[62]

Former Chief Justice Bowman summarized the state of the law in *Benjamin v. The Queen*[63]

> **[6]** Whatever may be the policy of the CRA to require documentation to support an expense, a payment or a deduction, it is not the policy of this court, unless the taxing statute specifically requires it (as for example, in the case of charitable donations). If a taxpayer in court can demonstrate through credible oral testimony that a payment was made or an expense incurred, the court must make a finding based on that evidence and give effect to it. *The court cannot avoid its responsibility to base its conclusions on the evidence adduced by saying in effect "It doesn't matter how credible your testimony is, if you don't have a piece of paper you must necessarily lose."*
>
> **[7]** The cases referred to by the respondent do not support the proposition advanced by the respondent. They say merely that if an appellant lacks documentary evidence he or she has a more difficult task in meeting the onus of proof. If the appellant has made out a prima facie case by credible oral testimony and it is unrefuted, the appellant should win. *The cases in which an appellant has lost were ones in which both paper and credibility were lacking*.[64] (My Emphasis)

Bowman C.J.'s comments express a different view of judicial reasoning regarding the adequacy of expense records than the one posited in the CRA Audit Manual.

The problem of sufficiency of documentary proof bogs down many audits. In *Jorgensen v. R.,*[65] Sheridan J. stated as follows.

> **[12]** Certainly the Appellants would have been well advised to maintain a daily record of the Truck's use. *However, the standard for records keeping is one of adequacy, not perfection.* While the Appellants did not keep a formal log, they did maintain sufficient source records of their business activities to allow them, when requested to do so by the auditor, to reconstruct a reasonable diary of the business use of the Truck. In respect of their farm machinery and equipment sales business, the records track their attendance at various auctions throughout rural Saskatchewan and in larger centers such as Regina, Calgary and Edmonton.[66] (Emphasis mine)

The (lack of) Documentary Evidence Checklist

Where any audit has gone awry, the objection should be approached with two questions in mind: (1) what do we need to prove? and (2) how do we prove it? In expense disputes the case law indicates that a lack of documentation can be overcome with credible oral evidence. The default position is almost always to try and provide some documentary evidence.

This checklist assumes that the audit result is a foregone conclusion. These are steps that might be taken after the audit.

1. Consider bringing a different advisor into the fold for the objection process. Often there are cost considerations that militate against using an additional or new advisor. My experience is that the initial advisor is often relieved to have a messy expense file moved to a different desk.
2. If the matter has a real chance of proceeding to Tax Court bring a tax lawyer onto the file at the objection stage.
3. Make an Access to Information request for the audit file.
4. Review the audit report and working papers. The specific inadequacies in the business records are usually stated very clearly in the working papers.
5. Start compiling evidence based on the comments in the audit report. The client should be given this task if possible. For example:
    a. Can the client obtain copies of invoices from suppliers?
    b. Can bank or credit card statements be used to trigger a client's memory about various expenses?
6. How did the client pay for the expenses? Cancelled cheques and credit card statements should be compiled.
7. Did the client pay cash for expenses and not obtain a receipt? Why?
8. For items like the failure to keep a vehicle log, can the client provide reasonable estimates based on secondary source information (i.e. a meeting calendar)? Is the client doing the same work today? Start keeping a vehicle log during the objection period.

9. Have a frank discussion with the client about credibility. Claiming a little $200 tap dancing lesson as a business expense can have the same effect as putting a little metal fork into a garburator.
10. Where documents supporting expenses cannot be provided, get the client to explain why not. This explanation should be provided to the appeals officer, unless the explanation is something like "I made it up."
11. Try to obtain the best evidence possible, but do not get bogged down in a search for perfection. Often partial written records can be bolstered by credible statements from the client.
12. Organise the compiled evidence in a meaningful way. Submit the material in a way that the Appeals Officer will understand.
13. Don't bad mouth the auditor. Expect the Appeals Officer to consult with the auditor on the file.

As a final note, try and get a feel for the Appeals Officer assigned to the file. Some Appeals Officers see their role as being limited to ensuring accuracy. In our office these Officers are called "confirmers." Thankfully, they are a rare breed. The Auditor General has commented on the role of the Appeals Officer in 2004.[67] Chapter 6 of the 2004 Auditor General's Report stated as follows.

> Appeals officers are expected to do more than check the accuracy of an audit. They are expected to try to resolve disputes administratively. If that is not possible, the taxpayer or registrant can appeal the decision to the Tax Court of Canada, which is a more expensive solution. There are many ways to resolve disputes administratively, from simply explaining the basis for an assessment, to reaching a common understanding of the facts involved and the applicable laws, to agreeing on a settlement. [68]

Often, a frank discussion with the Appeals Officer about their concerns will provide enough information to determine if there is a chance of fixing the audit result at the objection stage. If the Appeals Officer does not want to discuss the file in any meaningful way, try to get it reassigned or prepare for court.

PART IV -- POT LUCK OF ODDBALL EXPENSES

This portion of the paper is fraught with even more opinions. Some of the expense issues described below have never been properly litigated. Others show that the CRA's position is something less than an unbiased expression of the case law.[69] The following commentary is not provided with the cynical hope that it will create more litigation. It is more a collection of issues left dangling on files that were settled for other reasons and a review of quirky ITA provisions. I had hoped to cover many more provisions this review. In other words, these are not the only oddball expenses in the ITA

A. Section 67.1

I am pleased to be able to advise Mr. Chapman that I have an answer to his question about the deductibility of travelling expenses incurred for activities that mix business and pleasure. In *T. Evans Electric Ltd. v. R.,*[70] the court allowed a corporation that used its own plane to take clients

on fly-in fishing trips a full deduction for the plane operating costs. "Flying in a noisy little Cessna to get to the fishing may be enjoyable to some, but likely not to most... The fishing starts when you get to the lake."[71] The Tax Court of Canada interprets "enjoyment of entertainment" as "specifically [excluding] the means of getting to and from the event or service";[72] and states that there is a "distinction between true entertainment costs and transportation costs."[73]

Based on that decision, Mr. Chapman could reasonably take the position that travelling to a concert is an activity separate and apart from the entertainment. However, because *T. Evans Electric* is an informal procedure case, it is not a binding precedent. Unfortunately for Mr. Chapman, the CRA does not accept the results of this case and takes the position that subsection 67.1(1) applies to the costs of travelling to entertainment. The CRA prefers the reasoning in *Sie-Mac Pipeline Contractors Ltd. v. MNR*.[74] In that case the court held that paragraph 18(1)(l) applied to the costs of travelling to a lodge. The CRA position is that the reasoning in *Sie-Mac Pipeline Contractors* should apply to subsection 67.(1).

Even if the CRA is correct, Mr. Chapman should still be able to claim the travel expense since he is traveling to tax conferences. The primary purpose of the expense is for that business purpose. Madonna just happens to be in Vancouver during the same week as the B.C. Conference. According to *Symes* an expense can have more than one purpose and still be allowable as a business expense. I note that he would have to admit that attending a tax conference is not a form of entertainment.

I did not say that I had an answer that was satisfying.

Section 67.1: Marketing or Entertainment?

The *Stapley v. R.*[75] decision clears the problem up. Clients have some difficulty with the notion that an expense that they see as advertising or marketing should be subject to a 50% limitation. Sometimes the complaint is voiced as an acknowledgement that the 50% limitation should apply to the meal the client consumes, but not the one that was purchased for a client's customer.

Mr. Stapley gave vouchers for food, beverages, and entertainment to clients in hope of securing referral clientele. The taxpayer did not even attend with the clients when vouchers were used. The taxpayer claimed 100 per cent of voucher cost as meals and entertainment expense deduction from business income. The FCA held that the vouchers were, on their face, intended for use as meals and entertainment. Subsection 67.1 clearly restricted deduction of meals and entertainment expenses to 50 per cent.[76]

It might have made more sense for Mr. Stapley to give potential clients vouchers for tangible goods. Paragraph 67.1(4)(ii) of the ITA provides that "entertainment" includes amusement and recreation. Entertainment refers to activities, not purchases of electronic games and musical instruments.[77]

Exceptions to the Limitations

The 50% limitation on meals and expenses is often assumed without question. Subsections 67.1(2), (3) and (4) provide multiple exceptions to the general 50% limitation, including, in some circumstances,[78] the following:

1. Where food, beverages and entertainment are part of the business, the limitation does not apply. Restaurants, thankfully, are not subject to the limitation.

2. The cost of entertaining the client at a charity's annual fund-raising dinner would be exempt from the 50% limitation. However, some charitable events do not qualify for this exception.
3. Amounts ultimately billed to a client and identified in the account submitted to the client as an expense relating to meals are fully deductible. The 50% limitation applies to the client.
4. An employer is not subject to the 50% limitation on allowances or reimbursements for meal or entertainment expenses that are included in an employee's income (pursuant to subsection 8(1)).
5. The 50% limitation does not apply if the employer incurs the amount for food, beverages or entertainment that is generally available to all its employees at a particular place of business and is consumed or enjoyed by them. This is the Christmas party exception.
6. The limitation does not apply for meals and beverages served and entertainment provided as part of the cost of travelling on an airplane, train or bus. This exception to the limitation does not apply to food, beverages and entertainment provided while travelling by ship, boat or ferry.

The CRA Audit Manual

Part 13.9.22 of the Audit Manual[79] advises auditors to look for personal expenditures disguised as travel and entertainment expenses. Clients should be prepared not just to have their receipts in order, but to be able to show the business purpose of the expense.

> *Travel and Entertainment Expenses*
>
> During the review of travel and entertainment expenses the following are points that should be considered:
>
> 1. Were the travel expenses incurred for business or personal purposes?
> 2. Where the purpose of the travel was primarily related to the acquisition of capital assets, disposal or reorganization of a business, the expense must be added to the cost base and claimed as capital cost allowance.
> 3. If another person accompanied the taxpayer/registrant, is that person an officer or employee of the company?
> 4. To account for meals and other incidental expenses without vouchers, request the diary or itinerary of the traveler. Vouchers are required to substantiate ITCs claimed.
> 5. Are vouchers for gasoline signed by family members who are not employees? These may be used to help establish the personal use of an automobile.
> 6. Where expenses are claimed for substantial gifts to clients or prospective clients, ensure that the gifts are a legitimate business/advertising expense and not a personal gift from the taxpayer/registrant.
> 7. Food, beverage and entertainment expenses are allowable subject to the 50% limitation, provided the expense was incurred for business purposes, the amount is reasonable, the expense is supported by vouchers and the expense is not otherwise restricted (club dues or memberships).

B. Repairing or Improving

The test for determining whether an expense is a current or capital expenditure is whether an "enduring benefit" is obtained through the expense.[80] The test has been in place for at least 75 years and was expressed in the 1926 House of Lords ruling in *British Insulated and Helsby Cables, Limited, v. IRC Helsby*.[81]

The House of Lords stated that "when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade... such an expenditure [is] properly attributable not to revenue but to capital."[82]

Superficially, the test is appealing. However, there remains no "hard and fast" rule for distinguishing between income expenses and capital outlays. In *Johns-Manville Canada*,[83] the SCC grappled with the issue. In that case the Appellant was forced to buy the land surrounding an open pit mine in order to keep the mine operating. The land purchase did not lead directly to a revenue stream and it gradually disappeared as the mine expanded.

Estey J. of the SCC started a review of the relevant "capital versus current" case law with the following comment.

> **[13]** When one turns to the appropriate principles of law to apply to the determination of the classification of an expenditure as being either expense or capital, an unnerving starting place is the comment of the Master of the Rolls, Sir Wilfred Greene, in British Salmson Aero Engines, Ltd. v. Commissioner of Inland Revenue (1937), 22 T.C. 29, at p. 43:
>
> > ... there have been... many cases where this matter of capital or income has been debated. There have been many cases which fall upon the borderline: indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons...[84]

After reviewing several cases from multiple jurisdictions Estey J. drew the following conclusion:

> **[26]** After this review of the authorities it can be seen that the principles enunciated by the courts and the elucidation on the application of those principles is of very little guidance when it becomes necessary, as it is here, to apply those principles to a precise set of somewhat unusual facts.[85]

Often the assumption is that land, where it is not purchased for resale, is a capital asset. However, in this case, the land did not endure. It was consumed as the mine expanded.

Capital versus Current Checklist

In *Johns-Manville Canada* the SCC offered a list of 10 factors that led to the conclusion that the land expenditure should be allowed as a current expense.[86]

I have taken the liberty of modifying the list into more generic questions. Again, my assumption is that the SCC provides guidance on the law that can be used in other situations. I have added comments from other cases to the list.

1. What was the purpose of the expenditures, when viewed from the practical and business outlook? Was it the removal of a current obstacle in the operation of the taxpayer's business or the acquisition of a capital asset?

2. Are the expenditures incurred year in and year out as an integral part of the day-to-day operations of the undertaking of the taxpayer?
3. Do the expenditures form an easily discernible, more or less constant, element and part of the daily and annual cost of production?
4. Was the asset acquired for any intrinsic value or merely by reason of need, and after being used in the business, did the asset acquire intrinsic value or was it "consumed" in the business?
5. Did the expenditures produce a transitional benefit and one which had no enduring value because similar expenditures were required in the future if the business was to continue?
6. Did the property acquired in any given year produce anything permanent? Was there a transitional asset created, but the asset disappears as it was consumed by the business?
7. The nature of an expenditure is made clear when it is shown that it has been incurred annually for several years and there is no evidence whatever to indicate that business operations can continue without this annual expenditure.
8. Will the capitalization of these expenditures produce an asset which may be made subject to either capital cost or depletion allowance?[87]
9. Do the expenditures add to the productive capital assets of the business? Do they increase the productive capacity of the business? Are they expenditures which if not incurred would bring the business to a halt?[88]
10. Are the expenditures relative to the cost of running the business small and are they directly related to the cost of operation averaging over a long period?

Notes from Other Cases

1. Repairs done with resale in mind are disqualified from deductibility.[89] Whether or not an agreement for sale has been entered into is a significant factor.
2. Repairs are generally current expenses. It is not necessary for repairs to be because of "wear and tear."[90] However, if the work results in an improvement to the building, "the related cost may be classified as a capital outlay even if there is no increase in value."[91]
3. However, an upgrade can constitute a capital outlay. In *Shabro*,[92] the FCA found that replacing the ground floor of a building with a new floor where the old floor had been laid on garbage was a capital outlay.

The CRA Audit Manual

The CRA Audit Manual instructs auditors to examine certain categories of expenses with a view to capitalizing them.[93]

> *Auditing of Expenditures that should be Capitalized*
>
> Review of expenditures should include ensuring that expenditures that should be capitalized have not been expensed. Audit procedures include the following:
>
> 1. Ensure that mortgage payments are properly allocated to interest expense and principal.

2. Query legal bills. Determine whether the expense is allowable or whether it should be capitalized. For more information see IT99R5 - (Consolidated) Legal and Accounting Fees [*].
3. Property taxes paid in the period prior to acquisition and in the period subsequent to disposal are capital expenses.
4. Installation costs, freight, customs duties and foreign exchange must be added to the acquisition cost of the capital asset.
5. Major repairs or alterations and improvements must be capitalized. Examine the repair expense account to determine whether any amounts should be capitalized. In some cases the voucher may not be sufficient to determine whether an amount is a capital or current expense. Other correspondence may be available to establish the nature of the costs incurred. For more information see IT128R Capital cost allowance - Depreciable property [*].
6. Repairs done as part of a general reconditioning or improvement project may need to be capitalized.
7. Where the purpose of repairs is to put the property in a saleable condition, the costs should be capitalized.
8. Where buildings or equipment are acquired that are in need of major repairs or alterations, ensure that the costs of repair or alteration are capitalized.
9. In some cases equipment may be purchased in components and expensed where the amount should be capitalized.
10. Expenses incurred as the result of the disposal of an asset (commissions, legal expenses, transportation costs etc.) should be deducted from the proceeds of the disposal and not claimed as a current expense.
11. Where ITCs are claimed on acquisitions of capital property or for repairs and maintenance of capital property, ensure that the property is used in commercial activity of the taxpayer/registrant. The ITC may have to be prorated depending on the use of the property.

C. Mileage Logs

I cannot recall a client who has ever had an acceptable mileage log book. There is no requirement in the ITA for a taxpayer to keep a mileage log book.[94]

The Audit Manual states as follows:

> Where the taxpayer/registrant purchases supplies or uses capital property to earn income as well as for personal use, only the portion of the expense or capital cost used for business purposes is deductible for income tax purposes. The allocation must be reasonable under the circumstances. *Where the expense/ITC claimed is for the business use of an automobile, a mileage log is required*.[95] (Emphasis mine)

The case law consistently notes that there is no statutory requirement for a mileage log book. However, the lack of such a requirement has not caused the courts to ignore a lack of evidence

proving the business use of a vehicle.

Either the energy required to keep a proper log book is out of proportion to the benefit gained or taxpayers are just willing to accept rough estimates of the business use their vehicles. Since 2010, a self-employed individual can use a motor vehicle mileage logbook that was maintained for a sample period representative of the motor vehicle's use.[96] Perhaps this sampling system will not be as onerous and lead to the production of more mileage logs.

Advisors get caught in the middle in these disputes. A client who has been warned by his or her own advisor to keep mileage records is aghast when the audit proposal letter reduces the business claim from 90% to 20%.

If the lack of a mileage log book has arisen as an issue in an audit the client has to undertake the task of reconstructing the log or finding some sort of alternative proof. The following might be helpful in salvaging some of the claimed business use of the vehicle.

1. What is the nature of the business? Some businesses almost require the use of a vehicle. An outright denial of the claim is probably inappropriate in those cases.
2. What can the client provide after the fact? For example:
    a. Can a log be derived from an appointment schedule?
    b. Is the client doing the same work today as in the audit period? If yes, prepare a log on a current basis. This log is not perfect, but it is better than no documentary evidence at all.

Typically, the advisor is caught between a client who has claimed almost all of the vehicle use as business related and an auditor who is of the opinion that the percentage is crazy, so the client gets nothing. Making the client go back and reconstruct the log, or compile other evidence is a reasonable approach and allows for resolution of the dispute without the client incurring a lot of advisor fees, but only if the auditor accepts that the failure to keep a log is not fatal to a mileage claim.

D. Expenses for Yachts, Camps, Lodges or Golf Courses

Paragraph 18(1)(l) of the ITA has always struck me as an example of legislative micromanaging. The paragraph applies for years after 1971. Perhaps the use of yachts was becoming a concern for Parliament in the 1960's. The provision is so nitpicky that it can lead to absurd results as the case law below shows.

For example, in *Sie-Mac Pipeline Contractors*,[97] the appellant was denied the deduction of the expense for entertaining clients at a rural fishing lodge. At trial, Jerome A.C.J. stated the following about the provision.

> **[9]** There would be no justice, no legal basis in principle for permitting this taxpayer to entertain his guests in downtown Edmonton or in Jasper, and not permit it at this facility, unless there is some very clear reason for doing so. If Parliament intends to make that distinction, I again say that it should do so.[98]

The FCA and the SCC disagreed with the Trial Division of the Federal Court. The FCA stated as follows:

> **[8]** The anomaly of allowing deductions for entertainment of customers in restaurants or hotels, but not on yachts or in lodges is obvious, but it is within the authority of Parliament to make these distinctions if it so chooses. The fact that some may view these distinctions as unfair does not permit the Court to rectify that injustice.[99]

Ways Around the Provision

There are a few ways to limit the impact of paragraph 18(1)(l).

1. If the expense is related to the use of a facility, make sure it is not a lodge. In *Hewlett-Packard (Canada) Co. v. R.*, Woods T.C.J. found that a "lodge" was a rustic facility, not a full-service luxury resort.[100]
2. Holding a meeting in an expensive hotel will therefore not be offside paragraph 18(1)(l). It the meeting was held in a lodge, the expenses incurred for the use of the lodge would not be deductible.
3. If the expense is for the business use of a boat, argue it is not a yacht. In *CIP Inc. v. MNR*,[101] the Tax Court allowed business expenses for a converted tugboat. The vessel was deemed not to be a yacht.
4. For meal expenses, cite IT Bulletin 148R3.[102] That Bulletin provides that meal expenses incurred at a golf club may be deductible so long as the expense is not incurred in conjunction with a golfing activity.[103]

E. The Home Office Expense

Many business owners claim a portion of their residential expenses as business expenses, only to have the claim denied at audit pursuant to subsection 18(12) of the ITA. The expense may be denied even though it is pretty obvious that the home is being used for business purposes.

Putting the issue of the quantum claimed aside, the denied expense can sometimes be reinstated for future years by making a small change in the use of the residence. Sometimes the client does not need to change anything; the nature of the business just needs to be explained better.

Subsection 18(12) of the ITA has two independent tests, but in my opinion, the CRA's interpretation of the subsection results in only one of the tests being applicable.

1. Under paragraph 18(12)(a)(i) residential expenses are deductible if the "in home" work space is the taxpayer's principal place of business.
2. Under paragraph 18(12)(a)(ii) residential expenses are deductible if the "in home" work space is used exclusively to earn income and is used regularly and continuously to meet clients.

Denials usually happen under paragraph 18(12)(a)(ii). On more than one occasion I have seen the denial of home office expenses on the basis that the "in home" work space was cobbled together in a spare bedroom, laundry room or playroom. The space is, therefore, not used exclusively to earn income and meet clients. The requirement of an exclusive works space makes compliance difficult for many people.

The test under paragraph 18(12)(a)(ii) is further denuded by the phrase "*regularly and continuously*." IT 514 provides this example to explain the phrase:

> A home office used by a doctor to meet one or two patients a week is an example of a work space which would not be considered used on a regular and continuous basis for meeting patients. On the other hand, a work space used to meet an average of 5 patients a day for 5 days each week would clearly be used for that purpose on a regular and continuous basis.[104]

IT 514 also notes that the word "principal" is not defined in the ITA but it is considered that the words "chief" and "main" are synonymous to it.[105] I doubt that there are many professionals that meet 5 clients a day for 5 days each week in anything other than their principal place of business.[106] It is this CRA requirement that makes paragraph 18(12)(a)(ii) largely irrelevant.

As noted above, my experience is that clients are usually denied the expense under paragraph 18(12)(a)(ii). These same clients have probably not even considered whether they might fit under the test in paragraph 18(12)(a)(i). A common assumption is that "*principal place of business*" is the place where revenue is generated.

For the 18(12)(a)(i) test the CRA acknowledges the workspace does not need to be used *exclusively* for business purposes.[107] IT 514 also provides examples of businesses that qualify under the test.

1. A principal place of business would include a room in a contractor's residence used to accomplish the functions relating to a contracting business, such as, receiving work orders, bookkeeping, purchasing and preparing payrolls while the remaining activities of the business, the performance of the contracts, are carried out at the customer's location.
2. The work space in a farmer's home utilized to operate the farming business would normally be the farmer's principal place of business.[108]

In both examples, the "income generating activity" is somewhere other than the taxpayer's residence. In *Jenkins v. R.*[109] the Crown argued that "business" meant a calling, trade, manufacture or undertaking and that a principal place of business means the core aspect of the business. In *Jenkins*, the Appellant was a fisher. This meant that the principal place of business would be out on the ocean where fish were harvested.[110]

Miller J. rejected the Crown's approach, pointing out the following:

> **[15]** This approach leaves to some odd conclusions. For example, the principal place of Imperial Oil would be the oilfield and not its downtown Calgary head office; the principal place of business of a farmer might be the combine and not the farmhouse. I could go on.
>
> **[16]** The other flaw in this approach is that it leads to the possibility of numerous places of business, with a dilemma of how to determine which is the principal place of business. So, if Mr. and Mrs. Jenkins had half a dozen boats, all out at sea throughout the season, are they all "places of business"? Is one of them the "principal place of business"? Is that dependent on the number of fish caught? This quickly deteriorates into an awkward analysis.[111]

Miller J. finds that the "principal place of business" is better understood to mean the following.

> "where all that business stuff takes place"; not where the oil is drilled or crop is cut, or fish are fished, but where those necessary elements of telephoning customers and

suppliers, filling in invoices, doing payroll, maintaining books and records, contacting authorities for licences, preparing tax returns, chasing down receivables, handling complaints, creating business plans, preparing financial statements, talking to accountants and lawyers, etc.[112]

While only the rare client will qualify under the 18(12)(a)(ii) test, most clients operating businesses from their homes should qualify under paragraph 18(12)(a)(i).

Home Office Expense Checklist

The following items might useful in an audit of home office expenses.

1. Is the expense going to be denied under paragraph 18(12)(a)(ii)? Does the client do their business planning and bookkeeping at home? Perhaps the client fits under paragraph 18(12)(a)(i).
2. Is the client claiming all of the relevant expenses related to the home office?[113]
3. Section 18(12) cannot be used to create a loss.[114]
4. Subsection 18(12) applies to limit expenses on business income incurred by individuals. Income from property or income earned by a corporation should not be limited by the subsection.[115]
5. Claiming CCA on the residence is a risky strategy. The residence may be deemed to undergo a change in use and lose its status as a principal residence.[116]
6. The expenses should be apportioned between business and non-business use on a reasonable basis, such as square meters of floor space used.[117]

Summary

This paper has been an examination of concepts that are learned early in a tax advisor's training. Somewhere along the line the law regarding business expenses starts to be known intuitively rather than as an application of legal principles. In a dispute it is sometimes difficult to justify the fees that would be charged to go back and refresh that early training. My expectation is that this case law and legislative review has been a good reminder to practitioners of rules they already know.

The checklists and summaries of oddball expense provisions was written with advisors currently involved in disputes in mind. A dissertation might be written on each of the categories covered in the paper. I hope that the previous discussion proves functional to advisors who have an uneasy feeling about the way an audit is progressing and want to check to see if their anxiety is well founded.

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[1] Mr. Larry Chapman, Executive Director and CEO, of the Canadian Tax Foundation.

[2] The Madonna World Tour, September 29, 2012 at Rogers Arena.

[3] The underlying assumption is that there is a possibility of gross profit. The initial question posed by the Supreme Court in *Stewart v R*, 2002 SCC 46, 2002 CarswellNat 1070 at para 50, "*Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?*" is often answered through a determination of the nature of the expenditures of the business.

[4] CRA, *Canada Revenue Agency Audit Manual* (2012 Release) ("Audit Manual"). The Audit Manual is the redacted version available to the public.

[5] *Income Tax Act*, RSC 1985, c 1, s 18(1)(a) ("ITA").

[6] See ITA, s 18(1)(b) *ibid*.

[7] 1993 CarswellNat 1178, [1994] 1 CTC 40 (SCC).

[8] *Ibid* at para 73.

[9] *Ibid* at para 74.

[10] My first year Criminal Law professor explained how intent is determined by actions: the "fact" of a dozen stab wounds would be objective proof against a defense of "I did not intend to stab my boss."

[11] (2003), 58 DTC 2032, [2004] 2 CTC 2169 (TCC [General Procedure]). The expenses were the costs in fending off a hostile takeover bid of a public company. The Crown's primary position was that the expenses were not deductible from the business income, as they were incurred in response to a takeover bid, aimed at maximizing shareholder value and were not incurred for the purpose of gaining or producing income.

[12] *Ibid* at para 29.

[13] *Ibid* at para 38.

[14] *Potash Corporation of Saskatchewan Inc v R*, 2011 TCC 213, 2011 DTC 1163 (Eng.).

[15] *Hanmar Motor Corp v R*, 2007 TCC 618, 2007 DTC 1773 (Eng). The expense was not an expense of the holding company.

[16] *Truckbase Corporation v R*, 2006 TCC 215, 3 CTC 2409.

[17] See: IT 99R5 para 16, and CRA Views 2006-0195981C6. In response to a query about the deductibility of fees related to a share redemption the CRA stated: "Since these fees would be incurred in connection with transactions of a capital nature, the said fees would generally constitute expenditures or outlays of a capital nature and their deduction as current expenses would be precluded by paragraph 18(1)(b) of the Act. The redemption of shares is a transaction of a capital nature, for more details see Nik Diksic & Christian Desjardins, "Tax Treatment of Transaction Costs" (Canadian Tax Foundation Conference Report, 2006) 38:1.

[18] *Supra*, footnote 4.

[19] *Ibid.* Please note that the Audit Manual cuts off in mid sentence. I assume it is redacted from this point. I have edited the list by enumerating the Audit Manual guidelines.

[20] A checklist is only a list of points to be considered. There is no definitive expense test or expense checklist. Remember that the checklists in this paper are shortcuts of items to consider when deciding when to claim an expense or if a taxpayer is engaged in a dispute about the nature of an expense.

[21] The SCC confirmed this position in *Stewart, supra* footnote 3.

[22] Regardless, results may be provable. They may, therefore, be evidence of intent. For example, if the gift of Canucks tickets led to a client referral.

[23] *Symes, supra* footnote 7 at para 57.

[24] *Ibid.*

[25] *Ibid* at para 70.

[26] *Ibid* at para 87.

[27] *Ibid* at para 72. In *Symes* the answer was twofold. Childcare expenses had a personal element and allowed the Appellant to work as a lawyer. Business and personal needs were being met. See Vern Krishna, *The Fundamentals of Income Tax Law* 2009, (Toronto: Carswell, 2009) c 9, where Krishna states that *Symes* separates a "needs" test from a "purpose" test. According to Krishna, the taxpayer's child care expenses met the needs test in that the taxpayer could not operate her business without incurring the expense. Despite this, the SCC stated that the expense merely made her available to practice her profession, rather than for any purpose intrinsic to the operation of the business itself.

[28] *Symes*, s*upra* footnote 7 at para 75. This is not to give over the determination of intent to the accounting profession. See Peter Hogg, Joanne Magee & Jinyan Li, *Principles of Canadian Income Tax Law*, 7th ed (Toronto: Carswell, 2010) c 6.3, which comments that *Symes* asserts that determining 'profit' is a question of law, and GAAP is only an interpretative aid in determining profits for the purpose of reporting income from business.

[29] *Ibid*. Common expenses are not likely to raise concerns in an audit. Unusual expenses may not be show up on a conservative financial statement. In these circumstances "business intent" is not easy to presume if the only inquiry is whether the expense is common. This test should be a warning to accountants. If the expense is uncommon, expect further proof to be required.

[30] *Ibid* at para 76. This is like the "needs" inquiry. Would the taxpayer incur this expense if she or he was not in business? Again, the answer can be yes and no. For example, a meal expense might be denied on the grounds that the taxpayer would still need to eat regardless of the business. However, the same taxpayer would not pick up the group's lunch tab at a non-business lunch.

[31] *Ibid* at para 78. This kind of analysis is also a test of reasonableness, which is discussed below.

[32] *Ibid* at para 79. In my opinion the SCC has difficulty with this distinction. The majority and minority decisions argue against it. The reasoning of the majority relies on the conclusion that childcare expenses are completely covered by section 63 of the ITA to resolve the matter. This rationale for disallowing the expense has not been applied consistently. The minority decision makes this point (see paragraphs 232 – 236). Other commentators have drawn the same conclusion. See for example, David Sherman's Notes, "Income Tax Act, 18(1)(h)," which cites *Scott v R*, 1998 CarswellNat 1208, 229 NR 273 (FCA) as an example of the inconsistency. In *Scott*, a courier was permitted to deduct his extra food expenses, despite food-allowance limits in various sections of the ITA.

[33] ITA, *supra* footnote 5, s. 67.

[34] *Stewart, supra* footnote 3.

[35] *Ibid* at paras 56 - 57.

[36] *Ibid* at para 57.

[37] 2010 FCA 201, 2010 CarswellNat 2409, rev'g 2008 TCC 324.

[38] *Ibid* at paras 71 - 74.

[39] 1968 CarswellNat 285, [1968] 2 Ex CR 511 (Can Ex Ct).

[40] The test is for the application of former subsection 12(2) of the ITA (the precursor provision to section 67 of the ITA).

[41] *Supra*, footnote 39, at para 52.

[42] *Ibid* at para 44.

[43] 1997 CarswellNat 1025, (*sub nom Mohammad v MNR*) [1998] 1 FC 165.

[44] Arguably, the *Mohammad* decision may be of limited value as a result. As noted the FCA separates the section 67 analysis from the REOP analysis.

[45] *Supra* footnote 43 at para 22.

[46] *Ibid* at para 25.

[47] *Ibid* at para 28. In the case the interest rate charged to the Appellant was readily comparable to market interest rates. The fact that the Appellant had 100% financing was not relevant.

[48] *Ibid* at para 29.

[49] 2005 FCA 252, 2005 CarswellNat 1926.

[50] Vern Krishna, *Fundamentals of Canadian Income Tax Law*, 3rd ed (Toronto: Carswell, 1989) at 312, cited in *Hammill*, *supra* footnote 45 at para 50.

[51] *Ibid* at para 51.

[52] CRA, "Income Tax Technical News No. 30" (May 21, 2004); CRA, "Income Tax Technical News No. 22" (January 11, 2002).

[53] *Supra*, footnote 4, at Part 13.9.22.

[54] I have edited the list by enumerating the Audit Manual guidelines.

[55] 1997 CarswellNat 3046, [1997] 2 SCR 336.

[56] *Ibid* at para 87.

[57] *Supra* footnote 4, c 10.0.

[58] *Ibid*, see Part 10.2.3 "Requirement to Keep Adequate Books and Records."

[59] *Ibid*, see Part 10.2.1 "Requirement to Keep Books and Records."

[60] *Pedersen v MNR*, 1999 CarswellNat 2633, [2000] 1 CTC 2799 (TCC[Informal Procedure]).

[61] *House v R*, 2011 FCA 234, 2011 CarswellNat 3184.

[62] *Rotondi v. MNR*, 2010 TCC 378, 2010 CarswellNat 2298 [Informal Procedure].

[63] 2006 TCC 69 (CanLII), 2006 DTC 2265 at 2266.

[64] *Ibid* at paras 6-7.

[65] 2009 TCC 37, 2009 CarswellNat 82 [Informal Procedure].

[66] *Ibid* at para 12.

[67] Office of the Auditor General of Canada, *2004 November Report of the Auditor General of Canada* (2004).

[68] *Ibid*, "Canada Revenue Agency Resolving Disputes and Encouraging Voluntary Disclosures" at para 6.26.

[69] Not always in a negative manner. Some policies appear to recognize that the legislation inadvertently penalizes some taxpayers.

[70] 2002 CarswellNat 2675, [2002] GSTC 115 (TCC[Informal Procedure]).

[71] *Ibid* at para 11.

[72] *Ibid*.

[73] *Ibid* at para 12.

[74] CRA, VIEWS 2005-0152091I7 "Frais de déplacement - activité divertissement"; *Sie-Mac Pipeline Contractors Ltd. v. MNR*, 1991 CarswellNat 677, [1992] 1 C.T.C. 341 (FCA).

[75] 2006 FCA 36, (*sub nom R v Stapley*) 2006 CarswellNat 1409.

[76] ITA, *supra* footnote 5, s. 67.1.

[77] CRA VIEWS 2009-0337381I7 "Sens du mot divertissement."

[78] See CRA, Income Tax Interpretation Bulletin IT-518R, "Food, Beverages and Entertainment Expenses" (April 16, 1996) for the exceptions to the 50% limitation and the exceptions to the exceptions.

[79] *Supra* footnote 4, Part 13.9.22.

[80] Arthur Cockfield & Carl MacArthur, "Computation of Profit and Timing: Principles for the Recognition of Revenue and Expense" c 6 in Tim Edgar, Daniel Sandler & Arthur Cockfield, eds, *Materials on Canadian Income Tax*, 14th ed (Toronto: Carswell, 2012) at 477.

[81] *British Insulated and Helsby Cables, Limited, v IRC*, [1926] AC 205 (HL), cited in *Materials on Canadian Income Tax*, *ibid* at 497.

[82] *Ibid*.

[83] *Johns-Manville Canada Inc v R*, 1985 CarswellNat 313, [1985] 2 SCR 46 (SCC).

[84] *Ibid* at para 13.

[85] *Ibid* at para 26.

[86] *Ibid* at para 28.

[87] There is no capital cost allowance ("CCA") class for Land. Depletion refers to extraction of the minerals in the land. In most other cases there is some CCA class that will apply to the property. This factor will almost always work against current deductibility.

[88] This expenditure on land is much like the ancillary expense of child care described in *Symes*, *supra* footnote 7 and the transaction costs described in *BJ Services*, *supra* footnote 11.

[89] *Montship Lines Ltd v MNR*, [1954] CTC 295 (Ex Ct), appeal to SCC dismissed without reasons.

[90] John W Dunford, "The Deductibility of Building Repair and Renovation Costs" (1997) 45 *Canadian Tax Journal* 395.

[91] *Ibid*, referring to *Earl v The Queen*, 1992 CarswellNat 465, [1993] 1 CTC 2081 (TCC) at para 2087.

[92] *Shabro Investments Ltd v R*, 1979 Carswell Nat 217, (*sub nom The Queen v Shabro Investments Ltd*) [1979] CTC 125 (FCA).

[93] *Supra* footnote 4.

[94] *1277302 Ontario Ltd. v. R.*, 2006 TCC 118, 2006 CarswellNat 421 (TCC[Informal Procedure]).

[95] *Supra* footnote 4 at Part 13.9.22.

[96] See Ruby Lim & Sheryl Mapa, "Sample Mileage Logbooks" (2011) 19 *Canadian Tax Highlights* 2.

[97] *Supra* footnote 74.

[98] *Sie-Mac Pipeline Contractors Ltd v MNR*, 1990 CarswellNat 322, [1990] 2 C.T.C. 8 (FC[Trial Division]).

[99] *Supra* footnote 97.

[100] 2005 CarswellNat 1765, 2005 TCC 398, 2005 D.T.C. 976, [2005] 4 C.T.C. 2274 (TCC[General Procedure]).

[101] 1985 CarswellNat 503, [1986] 1 C.T.C. 2525 (TCC).

[102] CRA, Income Tax Interpretation Bulletin IT-148R3, "Recreational Properties and Club Dues" (July 21, 1997) .

[103] *Ibid* at para 4.

[104] Canada Customs and Revenue Agency, Interpretation Bulletin Number IT-514 (February 3, 1989), at para 3.

[105] *Ibid* at para 2.

[106] Canada Tax Service**,** *McCarthy Tétrault Analysis, 18(12)*, "Work Space in Home" provides the following

summaries on the issue of "regular and continuous"

> In *Vanka v. R.*, [2001] 4 C.T.C. 2832 (TCC), the taxpayer was a doctor who used his home office to see an average of one patient per week and to receive an average of seven patient calls per evening. The Tax Court of Canada held that such activity was sufficient to constitute "regular and continuous use" (within the meaning of subparagraph 18(12)(a)(ii)) of the home office for the purpose of meeting patients. The Court also noted that the words "meeting patients" in subparagraph 18(12)(a)(ii) did not require the physical presence of the patients in the office but could be accomplished by answering patients' phone queries. A contrary conclusion to that in *Vanka* was reached in the case of *Molckovsky v. R.*, 2004 CarswellNat 18. In *Molckovsky*, the Tax Court of Canada held that seeing one patient per day and receiving an average of one phone call per day did not meet the criteria of "regular and continuous" in subparagraph18(12)(a)(ii).

Vanka was an informal decision. The CRA does not see it as binding. See David Sherman's Notes "Income Tax Act, 18(12)" for references to CRA documents.

[107] *Supra* footnote 104 at para 2.

[108] *Ibid.*

[109] 2005 CarswellNat 601, 2005 TCC 167, [2005] 2 C.T.C. 2156, 2005 D.T.C. 384 (Eng.) (Tax Court of Canada [Informal Procedure]).

[110] *Ibid* at para 15.

[111] *Ibid* at para 15 and 16.

[112] *Ibid* at para 18.

[113] Typically a percentage of rent, mortgage interest, utilities, property taxes and insurance.

[114] See ITA, s 18(12)(b).

[115] See CRA VIEWS 2002-0120025.

[116] See CRA, Interpretation Bulletin IT 120R6 (July 17, 2003).

[117] See CRA VIEWS, 2010-0379101E5.

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