TaxWatch Canada LLP

AN EXAMPLE OF 'TAX THINK' – CONSIDERING EXPENSES

THEORY – HOW TO THINK LIKE A TAX PROFESSIONAL
(Now that's a scary thought)

ITA: Income Tax Act (Canada)

First Hurdle
The Expenditure Must be Deductible
The good old ITA 18(1) (a) [see Judges Quotes] states an outlay or expense incurred by a taxpayer is not deductible from income to the extent it is not incurred for the purpose of producing income from property or business of the taxpayer. The expenditure has to be for a business purpose – not as easy a determination or agreeable by CRA as you may suppose. Refer to the article "How to Design a Deductible Expense", which has extensive comments on this subject.

Second Hurdle
Capital, Current Expense or Inventory
Once an expenditure is treated as deductible it falls into four categories.

1. Capital Expense. Tangible and intangible assets are depreciated under the capital cost allowance (CCA) provisions. You must place the amount in a class (definitions provided by the ITA). That class then has a maximum annual rate (%) that the assets may be deducted against income for the period. Part years (less than 12 months on inception) and first year acquisitions reduce the amount of this CCA deduction in the year of acquisition. Reference ITA 20(1) (a), 20(1) (b).

2. Current Expenses (of the taxation period). This is where you want to be.

3. Inventory. Costs accumulated and deducted as calculated on consistent basis when inventory sold or loses value.

4. The Combination (of the first 3 categories). Don't be afraid to allocate expenditures to the most suitable category. Asset acquisitions have side effects (costs such as professional fees, installation, delivery) and some of these components can be treated as current expenses. See 'What to Embrace when Claiming Immediate Deductions' (below).

Next Hurdle

Onus of Proof

You must be able to prove an expense was laid out to produce income of the taxpayer. The blending of personal elements, intentions and reasons for payment, documentation, non-arm's length considerations, timing restrictions (losses, elections, adjustments), ownership and legal obligations to pay all have relevance to CRA if they want to attack your deductions.

Special Categories

Numerous current expenses are allowed (that would not otherwise be) due to specific sections of the ITA. Some expenses have special treatments (timing, eligibility) and others are treated separately by the ITA. Interest costs are theoretically not a current expense (considered a capital item) but are reflected under ITA 20(1) (c) and (e).

No Unmovable Rules

Normally, an expense has to be a legal obligation to pay. Watch those year-end accruals. You have to start somewhere, which is usually an accounting type statement of income and expenses. Then you add/deduct expenses and capital items to reconcile the accounting income to taxable income, based on your judgment of the effects of the ITA. That's why it is common and ideal to have two sets of financial statements, one the official records of the business, the other for tax filing and compliance. Two sets of statements – are we suggesting non-compliance? Actually – two sets of statements are the sophisticated way to report only what is required or desired to different stakeholders, only one of which is CRA. You move from one or the other as you correctly label what is presented; assurance report from account or a simpler Notice to Reader (that's right, you mention it may not be appropriate for their purposes) or the most critical version – For Tax Purposes Only.

Let's follow along to enjoy what expenditures may be deductible from immediate income.

WHAT TO EMBRACE WHEN CLAIMING IMMEDIATE DEDUCTIONS, IDEAS AND STRATEGIES

These comments are not in any context of a specific case, but they all have to do with expenditures.

Subjective, circumstantial and factual. This is the state of affairs that influence the outcome of tax filing outcomes:

Subjective because you have to convince CRA your position is more sustainable and comparable to successful taxpayer outcomes then CRA's position – if you can get CRA to relax and not be so arbitrary and self-serving.

Circumstantial because you have to know how the many variable situations have evolved to create an informal outlook of where your expenditure fits within the great scheme of CRA and tax court historical decision making. The ITA rarely covers the specific circumstances businesses get themselves into. It is left for you to interpret your best tax treatment and the best manner (risk / benefit) of support for that treatment.

Factual because by careful foresight you can influence the facts of what happened, when it occurred, where, how much and why.

Here is how you can influence the circumstances and facts to validate your obviously biased objective to claim current expenses.

You will feel more confident in claiming the immediate write-off of expenditures (of any kind) if you have specific reasons and support for your position. No circumstances are identical and you cannot depend on CRA's agreement to your tax filing position. You are expected to self-assess your tax filing position. But with the support and reasoning provided herein, it is doubtful you will lose the entire argument, and rare that you would be penalized for providing a reasonable position you feel is compliant.

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