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• DEDUCTION OF EXPENSES FOR TAX PURPOSES •

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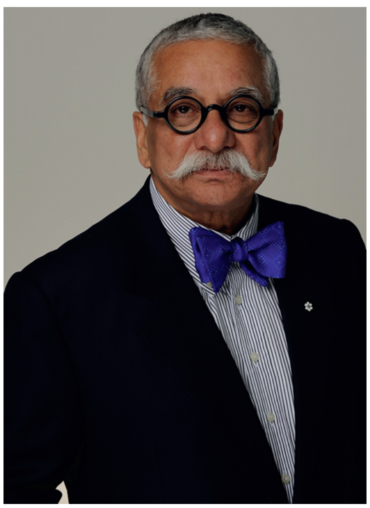

Vern Krishna CM

• In This Issue •

The deductibility of expenses for tax purposes is a complex mix of various legal and policy doctrines. The starting point of the analysis is to determine whether the taxpayer has a taxable source of income. If the taxpayer has a source of income from business or property, subsection 9(1) of the *Income Tax Act* provides that the income is the profit from that business or property for the year". "Profit" means *net* income from the two sources — that is, after deducting allowable expenses.

SOURCE OF INCOME

The source of income analysis involves three steps:

(1) Is the activity of the taxpayer undertaken in a commercial venture for the pursuit of profit?[1]

(2) If the activity is commercial in nature, we must determine whether the source of the income is from business or property?

(3) If the activity has a personal or hobby element to it, we look to see whether it was conducted with a view to profit.

Where the activity is clearly commercial, we do not need to second guess the taxpayer's business decisions. For example, a lawyer carrying on a professional practice does so as a commercial business that involves the pursuit of profit. Hence, by definition, the practice is a source of business income.

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For an activity to be classified as commercial, the taxpayer must have the subjective intention to profit, and there must be evidence of businesslike behaviour to support his or her intention.[2] Thus, the taxpayer must establish that his or her predominant intention is to make a profit from the activity, and that he or she carries on the activity in accordance with objective standards of businesslike behaviour.[3] However, a commercial activity that falls short of being a business may, nevertheless, be a source of property income.

GENERAL LIMITATIONS ON DEDUCTION OF EXPENSES

Having determined that the taxpayer has a source of income, the next step is to determine if the expenses of the source are deductible from its income. Once again, the starting point is to determine if the expenses are deductible under ordinary commercial and accounting principles in determining the profit of the business or property.

There are, however, additional rules that apply to determine deductibility. Subsection 18(1) and section 67 prescribe the general rules for the deduction of expenses. To be deductible from income, the expense must:

1. Be of an income, and not a capital, nature (para. 18(1)(b));
2. Be incurred for the purpose of earning income (para. 18(1)(a));
3. Not be on account of personal expenses (para. 18(1)(h));
4. Not be expressly prohibited by the Act (for example, para. 18(1)(c)); and
5. Be reasonable in amount (section 67).

PUBLIC POLICY LIMITATIONS

In addition to the general limitations on deduction, there are several specific policy prohibitions that further restrict the deduction of expenses. The prohibitions serve different purposes from those of generally accepted accounting and commercial principles, or the rules in sections 18 and 67. Some are intended to protect the revenue base, whilst others reflect socio-economic and political considerations.

MEALS AND ENTERTAINMENT

The Act arbitrarily limits deductions for meals and entertainment to 50 per cent of the lesser of the amount paid, and the amount that would be reasonable in the circumstances.[4] The limitation applies even if the taxpayer incurs the amount exclusively for business purposes. The theory of the limitation is that such expenses have a personal element. Thus, for example, where a taxpayer pays $400 for a business dinner for four persons, he may deduct only $200. The percentage arbitrarily assumes that the personal element was one-half of the expenditure.

BRIBES AND ILLEGAL PAYMENTS

Section 67.5 prohibits the deduction of illegal payments, such as, bribery of foreign public officials. The prohibition reflects moral, rather than economic, values. Indeed, if anything, the provision disadvantages Canadian companies from competing for international contracts in countries (and there are many) where bribery is a normal way of doing business. For example, Transparency International publishes a Corruption Perceptions Index, which measures the perceived levels of public sector corruption in 176 countries. The Index measures on a scale of 0 (highly corrupt) to 100 (very clean). 70 per cent of all countries routinely score less than 50 per cent — that is, are sufficiently corrupt to receive a failing grade.

Denmark appears to be the cleanest country, followed by Finland and New Zealand. Canada comes in at 9th position, and leads the Americas. Somalia is at the bottom of the list, beaten only by North Korea and Afghanistan. Thus, Canadian companies involved in Algeria, Libya and Nigeria have paid millions of dollars to obtain lucrative contracts in those countries. For example, Montreal-based SNC is alleged to have landed at least $4 billion in contracts in Algeria during a decade of doing business in North Africa. The Panama Papers revealed that a number of those deals were obtained through the services of a firm registered in the British Virgin Islands.

For tax purposes, however, a taxpayer may not deduct an amount incurred in respect of an expense for the purpose of doing anything that is an offence under section 3 of the *Corruption of Foreign Public Officials Act*, or under any of sections 119 to 121, 123 to 125, 393 and 426 of the *Criminal Code*, or an offence under section 465 of the *Criminal Code*.[5] These provisions deal with various criminal offences.

Criminal Code	
Section 119	Bribing judges, members of Parliament and members of a provincial, or territorial legislature.
Section 120	Bribing officers involved in criminal law administration, such as police officers, justices and officers of a juvenile court.
Section 121	Paying government employees or officials to obtain contracts or other benefits.
Section 123	Attempts to influence municipal officials through bribery, threats, or deceit.
Section 124	Selling or paying for an appointment to an office.
Section 125	Influencing or negotiating appointments and dealing in offices.
Section 393	Paying off a collector who fails to collect a fare or admission fee.
Section 426	Secretly paying an agent a commission and deceiving the agent's principal.
Section 465	Conspiracy to commit an act that is an offence under the *Criminal Code*.
Corruption of Foreign Public Officials Act (CFPOA)[6]	
Section 3	Bribing a foreign public official.

There is no clear demarcation between illegal bribes and legal facilitation payments, and one must exercise judgement or risk prosecution. Under *CFPOA,* a bribe is a payment of value to a foreign official to obtain, directly or indirectly, a business advantage by inducing the official to use his or her position to render a favourable decision. Items of value may include cash, computer equipment, medical supplies, and vehicles.

Section 4 *CFPOA* exempts facilitation payments made for the purpose of expediting or securing performance by a foreign public official of any act of a routine nature that is part of the foreign public official's duties or functions. Thus, payments for the issuance of permits, licenses to qualify a person to do business, and services normally provided, such as police protection, loading and unloading of cargo, the protection of perishable products or commodities from deterioration, or the scheduling of inspections related to contract performance or transit of goods are excluded from bribes.

A "foreign public official" is a person who holds a legislative, administrative or judicial position of a foreign state, or who performs public duties or functions for the state. Thus, for example, foreign officials include foreign military officers in charge of procurement and defense contracts.

The American equivalent (*Foreign Corrupt Practices Act*) requires publically traded companies to maintain proper books and records and have a system of internal controls to provide reasonable assurance that transactions are properly executed and recorded in accordance with generally accepted accounting principles.

There is no bright-line test as to what is a "bribe". The three most common areas of concern are gifts, travel and entertainment. There is an important distinction, however, between small gifts, which may be a token of esteem, and extravagant gifts that are intended to corrupt decisions. For example, a dinner gift of a bottle of single malt Scotch whiskey costing $300 may be appropriate for a senior official; a collector bottle with a value of $128,000 (as one released in China) may raise eyebrows and prosecutorial interest. The CRA does not provide guidelines for what constitutes a "reasonable payment". Businesses must exercise judgment, preferably with the benefit of legal counsel.

In the finest American regulatory tradition, the Securities & Exchange Commission and the Department of Justice has issued 120 pages of guidelines intended to assist businesses distinguish between proper and improper gifts, travel and entertainment expenses, and facilitation payments. For example, the guidelines say that entertaining a foreign official at dinner might be entirely acceptable, whereas, spending $10,000 on dinners, drinks and entertainment would probably not pass the test. Similarly, a trip to Paris for a foreign government official and his spouse might cross the line if the trip consisted primarily of touring and social activities in a chauffeur driven vehicle.

Corporations going abroad to do business need to consider the implications of the anti-bribery laws. To be sure, there are many countries in the world where it is impossible to do business without paying a bribe. Hence, no bribe, no contract. Indeed, many offshore financial havens exist to launder corruption money. However, necessity does not whitewash the offence, and is not a defence to criminal prosecution and tax sanctions. There is no limitation period applicable to illegal payments, and the Minister may reassess the taxpayer, and impose taxes, penalties, and interest for any taxation year.[7]

FINES AND PENALTIES

Fines and penalties incurred in the ordinary course of earning income were generally deductible in computing income from a business or property, unless the underlying action or omission was so egregious or repulsive that the fine or penalty could not reasonably be considered to have had an income-earning purpose.[8]

Section 67.6 was enacted to prohibit the deduction of fines and penalties, even where the taxpayer incurs them to earn business income. The policy of the prohibition is that permitting a deduction for such expenses would alleviate the financial sting of the penalty by making it less expensive. Hence, the moral value of the prohibition outweighs any business linkage between the fine and the taxpayer's business activities.

A fine is a monetary punishment for breaking a statutory or regulatory rule. The prohibition against deduction applies to all penalties imposed by law, whether by government, government agencies, regulators, courts, tribunals, or any other person with statutory authority to levy fines or penalties. The prohibition, which also applies to fines and penalties imposed under the laws of a foreign country, does not apply to settlements for breaches of a law or rule.

The theoretical rationale for the prohibition is that a deductible fine or penalty blunts the cut of financial sanctions by making it cheaper for the taxpayer on an after-tax basis. The statutory prohibition against the deduction of fines and penalties does not extend to proceeds of crime forfeited to the state. Forfeitures may still be deductible as business expenses, provided that they are not proceeds received from an egregious crime. In a gesture of tax neutrality, for example, a Dutch court allowed a bank robber to offset the cost of his pistol — $3,200 — used in a hold-up as a legitimate expense of doing business.

The prohibition against deduction increases the pressure on businesses to settle in litigation with governmental agencies. For example, where the Ontario Securities Commission brings an action against a company for alleged violations of the *Securities Act*, the defendant needs to consider whether it should settle the action without prejudice and admission of liability, or pursue its rights in litigation. If it settles the action it will probably be able to deduct the amount of the settlement as an ordinary business expense in computing income for tax purposes. If it does not settle the action and loses, it will pay any fine or penalty with *after-tax* dollars. Thus, regulators can use the financial threat of non-deductibility of any ultimate sanction as an extra-judicial weapon to pressure unwarranted settlements.

The prohibition in section 67.6 does not apply to legal fees to defend against prosecutions that can lead to fines, provided that the legal fees are otherwise deductible.[9]

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1 *Stewart v. Canada*, [2002] S.C.J. No. 46, 3 C.T.C. 439, 2002 SCC 46.

2 *Ibid*.

3 *Ibid*. at para. 54.

4 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp), s. 67.1.

5 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp), ss. 67.5(1).

6 S.C. 1998, c. 34.

7 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp), ss. 67.5(2).

8 *65302 British Columbia Ltd v. Canada,* [1999] S.C.J. No. 69, [2000] 1 C.T.C. 57 (SCC).

9 CRA Views Docs 2008-0271801I7, 2008-0294701E5.

• CANADA REVENUE AGENCY FROWNS UPON THE USE OF US LLPS AND LLLPS •

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The Canada Revenue Agency (the "**CRA**") recently delivered an unwelcome message to Canadian residents that invest in the United States through partnerships constituted as "limited liability partnerships" ("**LLPs**") or "limited liability limited partnerships" ("**LLLPs**"). Canadian investors will need to promptly consider the best means of mitigating the impact of the CRA's new position on the characterization of US LLPs and LLLPs.

BACKGROUND

The laws of many US states permit the registration of several different types of partnerships, each with unique attributes and varying degrees of liability protection afforded to individual members.

1. LLPs

The US LLP, a special form of general partnership, first gained prominence among lawyers and accountants 25 years ago. In the late 1980s, volatility in the real estate and energy markets in Texas led to the collapse of a significant number of banks and "savings and loans". With the insolvency of such financial institutions, creditors increasingly made claims against the accounting and law firms that previously advised the institutions. Under the prevailing partnership law at the time, each member of those firms that were constituted as partnerships was liable for such claims, irrespective of whether the particular partner had rendered any services to the relevant institution.

The fallout from the banking and "savings and loan" crisis led to the introduction of LLP legislation, beginning in Texas in 1991, which recognized a special form of partnership, an LLP, members of which would not generally be liable for damages and obligations arising from the negligence or malfeasance of another member of the partnership.

Over time, LLP legislation in certain US states began to permit partnerships conducting businesses other than the provision of professional services to be registered as LLPs. Certain LLP legislation also extended limited liability protection to cover most debts and obligations of the partnership, not just those attributable to the negligence or wrongful acts of a fellow partner. Virtually all US states now permit the registration of LLPs.

2. LLLPs

In the late 1990s, certain US states went a step further and began to permit limited partnerships to be registered as LLLPs.

An LLLP is a limited partnership that has made an appropriate registration with the relevant state authority to be characterized as an LLLP. As a limited partnership, an LLLP has one or more general partners that are responsible for managing the affairs of the partnership and one or more passive, limited partners that do not play an active role in the management of the partnership. Absent registration as an LLLP, the general partner of a limited partnership is liable for the debts and obligations of the partnership, while the limited partners that do not participate in the management of the partnership generally enjoy limited liability in respect of such debts and obligations.

LLLP legislation provides that no partner of the LLLP, whether they be a general or limited partner, is liable for the debts and obligations of the partnership. The ability to register a limited partnership as an LLLP has been added to the partnership legislation in approximately one-half of all US states.

Two of the principal advantages cited in favour of registering a limited partnership as an LLLP are (i) the avoidance of the need to incorporate a special purpose company to serve as the general partner of the partnership (which would be subject to the debts and obligations of the partnership), and (ii) the ability to relieve all partners of exposure to the liabilities and obligations of the partnership (*i.e.*, both general partners and limited partners that participate in the management of the business of the partnership).[1]

In recent years, the registration of US partnerships as LLPs or LLLPs has become increasingly commonplace.

CANADIAN TAX CHARACTERIZATION OF LLPS AND LLLPS

The CRA typically applies a two-step approach to determining whether a particular foreign legal relationship should be characterized as a partnership or a corporation for Canadian tax purposes. First, the CRA generally examines the characteristics of the foreign relationship, as provided under both the applicable foreign law and the agreement(s) governing the relationship, to ascertain its operative characteristics. Thereafter, the CRA compares the characteristics of the foreign relationship with the characteristics of relationships known under Canadian law to determine whether the foreign relationship more closely resembles a Canadian corporation or a Canadian partnership.

Historically, the CRA had not overtly contested the characterization of US LLPs and LLLPs as partnerships for Canadian income tax purposes. However, at a meeting of the International Fiscal Association ("**IFA**") in May of 2015, the CRA announced that it was reviewing the proper characterization of LLPs and LLLPs formed under the laws of the State of Florida. The CRA further indicated that it was the agency's preliminary impression that such partnerships should possibly be characterized as corporations for Canadian income tax purposes.

New CRA Position

At a meeting of IFA in Montréal on May 26, 2016, the CRA announced that the agency had concluded that LLPs and LLLPs formed under the laws of the States of Delaware and Florida more closely resembled corporations than partnerships and should be characterized as such for Canadian tax purposes. The CRA placed considerable weight on the fact that LLPs and LLLPs formed under the laws of the two states appear to have a separate legal personality and that members of such partnerships are entitled to extensive limited liability protection.

The CRA's new announcement will effectively result in LLPs and LLLPs formed under the laws of the States of Delaware and Florida being treated by the CRA no differently than limited liability companies formed under US law.

While the CRA has yet to indicate whether its new position will apply to LLPs and LLLPs formed under the laws of other US states, it is widely expected that the principles underlying the CRA's recent announcement will be applied to characterize LLPs and LLLPs constituted under other comparable state laws as corporations.

Implications

Subject to the transitional relief described in greater detail below, Canadian resident members of most US LLPs and LLLPs will be required to report their equity investments in such partnerships as share investments in a corporation, rather than as interests in a US partnership.

In the past, Canadian investors will have typically included the business income allocated from such partnerships in their own taxable income for Canadian tax purposes, and will have sought to claim a Canadian foreign tax credit in respect of US taxes paid on the allocated income. However, such reporting will no longer be permitted under the CRA's new interpretive approach.

Although Canadian investors will continue to be subject to US taxation in respect of income allocated from LLPs and LLLPs, the CRA will now consider the earnings of the partnership to instead be taxable at the US corporate level. As a consequence, a Canadian investor's ability to claim a foreign tax credit or deduction in respect of such US tax will be restricted.

The timing of Canadian taxation in respect of the earnings of a US LLP or LLLP will be dependent on when distributions are made by the partnership, which will frequently lead to cross-border tax inefficiencies and instances of double taxation.

The spectre of heightened or double taxation will demand that Canadian investors in US LLPs and LLLPs reassess the prudence of their investments.

The CRA's new interpretive position may also have adverse historical implications for existing members of US LLPs and LLLPs. To the extent that the CRA seeks to apply its new position to existing partnerships, past failures by Canadian members to properly account for distributions made by the partnership, or the US taxes paid in respect of the income of the partnership, may invite significant additional tax, penalties and interest.

To mitigate the impact of the CRA's announcement, Canadian investors in a US LLP or LLLP may wish to advocate for the conversion of the partnership into a conventional US limited partnership that is recognized as a partnership by the CRA for Canadian tax purposes. The operative statutes in most US states permit such a conversion on a relatively efficient (and potentially tax-free) basis through a simple filing. Unfortunately, in many instances, minority Canadian investors in an LLP or LLLP will lack the legal ability or economic influence to compel the conversion of the LLP or LLLP into a conventional limited partnership. In addition, where conversions are practically feasible, care will need to be taken to ensure that the transitional relief described below applies in respect of the LLP or LLLP, so as to ensure that the CRA does not take the position that the relevant Canadian investor has disposed of its interest in a corporation, and reacquired an interest in a partnership, for Canadian tax purposes.

Transitional Relief

The CRA has announced that it will offer transitional relief in respect of certain US LLPs and LLLPs, which will allow for such entities to be treated as partnerships retroactively from the time of their formation, so long as the following conditions are satisfied:

1. Neither the LLP/LLLP, nor any of its members, has ever taken the position that the LLP/LLLP was anything other than a partnership for Canadian income tax purposes;
2. The partnership was formed and carried on business prior to July, 2016, and was not previously constituted as an LLC that was subsequently converted into an LLP or LLLP;
3. The members of the partnership intended that the entity was to be treated as a partnership from the time of its formation for Canadian tax purposes; and
4. Prior to 2018, the LLP/LLLP is converted into some other relationship that the CRA recognizes as a partnership.

REQUIRED FUTURE ACTIONS

Any Canadian taxpayer that is a member of a US LLP or LLLP should carefully assess the income tax consequences of the CRA's new administrative position and chart out ameliorative steps as soon as possible. Such Canadian taxpayers should also determine whether they are entitled to claim the benefits of the CRA's transitional relief, as well as identify any past reporting or compliance deficiencies, the consequences of which could potentially be mitigated by a voluntary disclosure.

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[1] However, several commentators have noted that the liability limitation offered under LLLP legislation has yet to be tested in the courts. Moreover, when operating in those states that do not formally recognize "foreign" LLLP legislation, there is some question as to the degree to which one should rely on the added liability protections ostensibly offered by an LLLP relative to a conventional limited partnership. As a consequence, the advantages afforded by LLLP legislation may, from a practical perspective, often be more incremental than fundamental.