Analysis/Commentary --- Canada Tax Service -- McCarthy Tétrault Analysis, 12(1)(a), (b)

"P-53"

12(1)(a), (b) -- Amounts to be Included

Date: 2005-11-30

Purpose

Sections 9 to 11 which deal with the "Basic Rules" for determining a taxpayer's income or loss from a business or property, are followed by sections 12 to 17, headed "Inclusions". The latter provisions list a number of specific items to be included as income when making that computation and describe a number of situations deemed to give rise to such income.

Paragraphs 12(1)(a) and (b) represent an important and substantive departure from the case law in legislating with respect to the date on which an amount received or receivable shall be deemed to acquire the character of "income". This classic question had been considered by the Exchequer Court in *Robertson Ltd. v. Minister of National Revenue*, [1944] C.T.C. 75 in which Thorson, J (as he then was) made the following statement:

> ... the question remains whether all of the amounts received by the appellant during any year were received as income or became such during the year. Did such amounts have, at the time of their receipt, or acquire during the year of their receipt, the quality of income, to use the phrase of Mr Justice Brandeis in *Brown v Helvering* [291 US 193]. In my judgment, the language used by him, to which I have already referred, lays down an important test as to whether an amount received by a taxpayer has the quality of income. Is his right to it absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment? To put it in another way, can an amount in a taxpayer's hands be regarded as an item of profit or gain from his business, as long as he holds it subject to specific and unfulfilled conditions and his right to retain it and apply it to his own use has not yet accrued, and may never accrue?

Paragraphs 12(1)(a) and (b) answer this question in the affirmative. By specific legislation amounts which might be excluded from income on the above principle are now included in income (subject always to the possibility that the taxpayer might be entitled to deduct a reserve under subsection 20(1) in respect of the unearned portion of such income). In practice, however, it is understood that receipts which are within the general contemplation of *Robertson Ltd. v. Minister of National Revenue* and which can be said to have been more or less formally received in trust, will not be brought into charge by this provision. (See also *Canadian Fruit Distributors Ltd. v. Minister of National Revenue*, [1954] C.T.C. 284 and *Minister of National Revenue v. Atlantic Engine Rebuilders Ltd.*, (*infra*).)

Application

Amounts Received in the Year

General Rule in Paragraph 12(1)(a)

All amounts received in the year in the course of a business are now included in computing income for tax purposes even though conservative business and accounting practice might dictate deferment until a subsequent year. Specifically paragraph 12(1)(a) includes:

> 1. all amounts actually received on account of services not rendered or goods not delivered. Examples of this would be payments received on account of prepaid insurance, prepaid rent, prepayments for work to be done under contract not yet begun or goods not yet delivered, and amounts received from the sales of transportation tickets or bread and milk tickets. In *Anderson v. Minister of National Revenue*, [1972] C.T.C. 2318 (TRB), a payment of $1,890 received by a farmer under the *Prairie*

Grain Advance Payments Act, against grain to be delivered in the following year, was held to be income when received.

2. all amounts actually received which for any other reason are considered not to have been earned in the year of receipt. This would include payments which will belong to the recipient absolutely only upon the happening of some uncertain future event or upon the performance by the recipient of some stipulated thing, such as payments for the warranty of merchandise sold. This provision appears to overrule the finding of the Exchequer Court in the case of *Robertson Ltd. v. Minister of National Revenue*, [1944] C.T.C. 75, which dealt with the question of including in income premium advances for employer's liability insurance in respect of contracts in respect of which the exact premium was not yet ascertainable. However, this point was recently placed in some doubt by a unanimous judgment of the Federal Court of Appeal in *Imperial General Properties Ltd. v. R.*, [1985] 1 C.T.C. 40, discussed below.

3. all amounts actually received in the year in the course of carrying on a business under an arrangement that they must be returned when the taxpayer receives back from a customer articles used to deliver goods to the customer. This would include deposits made to a taxpayer by his customers which he is liable to return to them upon their bringing back some kind of a container such as oil drums, wire and cable reels and the like. See Interpretation Bulletins IT-165 (cancelled) and IT-165R, "Returnable Containers" (now archived), reproduced below under the heading "Returnable Containers".

In *Minister of National Revenue v. Atlantic Engine Rebuilders Ltd.*, [1964] C.T.C. 268 (Exch), the appellant's business included the rebuilding of automobile engines in respect of which the customer was required to furnish the appellant with his old "core", or another like it, to be rebuilt in turn. If no such core was provided, the customer was charged a "core deposit", which the appellant recorded as a liability against the day when the customer would furnish such a core, when his deposit would be refunded. The Exchequer Court agreed with the Minister that such deposits were received as "income" by virtue of this section, but it allowed the appeal on the ground that an equivalent amount was deductible, not as a reserve under this section, but as a liability that persisted until such time as the cores should be furnished and the deposit refunded. The Minister's appeal from this judgment was dismissed by the Supreme Court of Canada in a divided judgment, reported at [1967] C.T.C. 230, on the ground that there was "no basis, having regard to the realities of the situation, on which these deposits [could] properly be treated as ordinary trading receipts".

Deposits received by real estate developers from building contractors, to be applied on the purchase of lots, were held not to be received as "income" under paragraph 12(1)(a) in *Dartmouth Developments Ltd. v. Minister of National Revenue*, [1967] Tax A.B.C. 780; *Calgary Suburban Developments Ltd. v. Minister of National Revenue*, [1968] Tax A.B.C. 188.

Initial lump-sum franchise fees were held not to be amounts contemplated by paragraph 12(1)(a) so as to allow the taxpayer to claim reserves under paragraph 20(1)(m) in *Dixie Lee (Maritimes) Ltd. v. Minister of National Revenue*, [1981] C.T.C. 2840 (TRB). The decision of the Federal Court-Trial Division is discussed in the commentary to paragraph 20(1)(m).

In *Imperial General Properties Ltd. v. R.*, [1985] 1 C.T.C. 40 (FCA), a real estate developer on October 29, 1968 made an agreement to sell a parcel of real estate for $844,000, $20,000 payable on that day, $50,000 on the closing date, October 31, 1968, $145,000 upon registration of the subdivision, and the balance upon the fulfilment of certain conditions within two years. One of the conditions was that the municipality would rezone the subdivision to permit the construction of apartment buildings. Another condition was that there would be compliance with the Ontario *Planning Act*. If these conditions were not met, the purchaser could either waive the conditions or terminate the contract and receive a refund of the amounts paid. The conditions were fulfilled in 1969 and 1970 and the transaction was completed in 1970. The taxpayer contended that the proceeds of sale were taxable in 1968 so that it could utilize its prior losses against the profits that would be realized on the sale. The Minister took the position that the sale occurred in 1970 as there was no enforceable contract until the description of the land was finalized and the transaction could not be completed until the condition regarding the *Planning Act* was met. The Federal Court-Trial Division held that the intention of the purchase was to allow for the possibility of completing the contract before the fulfilment of the conditions stipulated, which were not true conditions precedent, and that the property was sold in 1968. On appeal by the Crown, the Court of Appeal held that the sale was not completed in 1968, the $70,000 received in 1968 did not become income until 1970, and the balance of the purchase price was not receivable until the 1970

taxation year when the condition relating to compliance with the *Planning Act* was fulfilled. With respect to the $70,000 deposit that the taxpayer received by October 31, 1968, the Court of Appeal held that since subparagraph 85B(1)(a)(ii) of the pre-1972 Act (predecessor to subparagraph 12(1)(a)(ii)) dealt with deposits, these were not covered by subparagraph 85B(1)(a)(i). The Court therefore concluded that section 85B did not apply to the moneys paid by the purchaser to the taxpayer in 1968. Leave to appeal to the Supreme Court of Canada was denied in June 1988.

Amounts Receivable

General Rule in Paragraph 12(1)(b)

All amounts receivable for property sold or services rendered will normally be included in income in the year in which the sale took place or the services were performed (para 12(1)(b)). It does not matter that payment of the amount or some part of it may not be due until some future date. However, it is essential that the taxpayer have completed the performance of the service contracted for and thus have perfected a right to such an amount, so that it is legally characterized as a "receivable", before it is included as income under paragraph 12 (1)(b) (see under "Holdbacks", below).

The only escape from the application of this rule is the acceptance by the Minister of the taxpayer's method of doing business on a pure cash basis. Where the method adopted by the taxpayer for computing income has been accepted, and where that method does not require the taxpayer to include an amount in computing income from business until it has been received, this paragraph does not apply. In other words, a taxpayer who reports income according to the cash method described by subsection 28(1) is not required to include receivables.

In *Weinstein v. Minister of National Revenue*, [1968] C.T.C. 357, the appellant contended that he had not "adopted" the accrual method in respect of the sales of certain real estate but that the Minister had simply applied that method. It was held by the Exchequer Court, however, that his failure to challenge the Minister's treatment constituted an adoption of that method by him.

Rent receivable in an amount dependent upon the lessee's sales volume was held to be "receivable" by the landlord at the end of the lease year even though the quantum could not be determined until later (*Willow Manufacturing Co. v. Minister of National Revenue*, [1967] Tax A.B.C. 406).

In *West Hill Redevelopment Co. v. Minister of National Revenue*, [1986] 2 C.T.C. 2235 (TCC), a taxpayer corporation which took back mortgages from purchasers of its condominium units at interest rates below the prevailing market levels was required to include in income the full amounts secured by the mortgages as "receivables" pursuant to paragraph 12(1)(b). The Federal Court-Trial Division (at [1991] 2 C.T.C. 83) affirmed the decision of the Tax Court. In so ruling, the Court rejected the taxpayer's contention that the mortgages were held as inventory and the argument that the subsection 16(1) rules concerning "blended payments" should be applied.

For taxation years ending after 1982, paragraph 12(1)(b) was amended to expressly deem an amount to have become receivable in respect of services rendered on the earlier of (a) the day when the account for the services was rendered, and (b) the day when the account would have been rendered had there been no undue delay in doing so. This amendment was made concurrently with the changes in the law applicable for the 1983 and subsequent taxation years to certain professional businesses not qualifying for the special treatment under section 34. See also the commentary to section 10.

Paragraph 12(1)(b) was discussed by the Federal Court of Appeal in *Maritime Telegraph & Telephone Co. v. R.*, [1992] 1 C.T.C. 264, but was held not to be applicable on the basis of the trial judge's factual finding that the "earned method" (estimating the amount of revenue earned by year-end even though some customers had not yet been billed) gave a truer picture of the taxpayer's income for the year than the billed method and was thus the appropriate method of accounting for this taxpayer.

In *Chartwell Management Inc. v. R.*, [2005] 1 C.T.C. 2435 (TCC), the Court held that paragraph 12(1)(b) of the Act requires the inclusion of receivables for services rendered for tax purposes even when the CICA handbook does not require them to be recorded for accounting purposes because they are likely uncollectable.

Expropriation, Arbitration and Court Awards

When land that represents stock-in-trade of the taxpayer is expropriated by a public authority, the question of when the profit should be accounted for arises. In *Lechter v. Minister of National Revenue*, [1966] C.T.C. 434, such land was expropriated by the federal government by notice given in 1954, when transfer of the land was deemed to be effected by deposit of notice with the relevant registry office. In 1955 a formal offer was made by the government and accepted by the taxpayer. However, the Treasury Board did not formally authorize payment until 1956, which was the taxation year to which the profit was imputed by the Minister. It was held by the Supreme Court of Canada that under the "ordinary rules of mandate" the ratification by the Treasury Board in 1956 had retroactive effect to 1955, when the offer was made and accepted. That is, the compensation became clothed with "receivability" within the meaning of paragraph 12(1)(b) at the time of offer and acceptance.

The time at which compensation for expropriated property becomes "receivable" was again in issue in *Minister of National Revenue v. Benaby Realties Ltd.*, [1967] C.T.C. 418, decided by the Supreme Court of Canada. Here again, the critical time was held to be the moment when the amount was fixed by arbitration or agreement, notwithstanding that the right to receive compensation was acquired earlier, at the moment of expropriation. The *Benaby Realties* case was followed by the Supreme Court in *Vaughan Construction Co. v. Minister of National Revenue*, [1970] C.T.C. 350, in which the Court fixed the time at which the compensation for expropriated property became "receivable" as the moment the amount was fixed by the Court to which the matter had been referred.

Again, in *Cementation Co. (Canada) v. Minister of National Revenue*, [1977] C.T.C. 2360, the foregoing cases were cited by the Tax Review Board in holding that a claim under a contract dispute became receivable by the appellant as soon as it was awarded under *The Arbitration Act* of Ontario, notwithstanding that the time for appealing from the amount of the award did not expire until the following year.

Similarly, in *Commonwealth Construction Co. v. R.*, [1982] C.T.C. 167 (FCTD), aff'd [1984] C.T.C. 338 (FCA), amounts received by the taxpayer pursuant to a judgment from which an appeal was launched were held to be taxable in the years received and not in a subsequent year when the appeal was abandoned pursuant to a settlement agreement between the parties. The taxpayer contended, to no avail, that the amounts received were subject to repayment in whole or in part if the appeal was successful and that therefore they did not acquire the "quality of income" until the taxpayer had an unqualified right to retain the funds. In reaching its decision, the Court held that the possibility of a successful appeal did not derogate from the "quality of income" of the payments in issue at the time they were received. When paid to the taxpayer, the amounts were not subject to any specific or unfulfilled conditions, and the necessity of returning the moneys, in whole or in part, if the appeal was successful was viewed as a condition subsequent which did not affect the unrestricted right of the taxpayer to use the funds when received. See also *Foothills Pipe Lines (Yukon) Ltd. v. R.*, [1990] 2 C.T.C. 448 (FCA) (application for leave to appeal to SCC dismissed in April 1991).

"Holdbacks"

In the construction industry it is the usual practice, when work to be performed under a contract extends over a significant period of time, for the owner, or principal, to make interim payments to the contractor from time to time. These payments are based on formal progress reports and serve not only to reimburse the contractor for expenditures on behalf of the principal, but also to yield the contractor a proportionate amount of the profit expected to be finally realized when the contract is completed. However, these payments based on progress reports are normally subject to a percentage "holdback" (often 10 per cent) in order to ensure the satisfactory completion of the job. These holdbacks are normally not paid over until the owner receives professional assurance that the work is acceptable. Whether unpaid holdbacks in these circumstances constitute "receivables" of the contractor within the meaning of paragraph 12(1)(b) was a matter of some uncertainty, following apparently conflicting judgments of the Exchequer Court in *Wilson v. Minister of National Revenue*, [1960] C.T.C. 1, and *Minister of National Revenue v. J. Colford Contracting Co.*, [1960] C.T.C. 178. However, the judgment in the latter case was appealed to the Supreme Court (at [1962] C.T.C. 546) which affirmed the conclusion of the lower court to the effect that, in these circumstances, contractor's holdbacks are not to be brought into income as "receivables", within the meaning of this section, until the year in which the architect's or engineer's final certificate accepting and approving the work done is issued.

This does not mean that the taxpayer cannot include a holdback in income, since this subsection only provides

that where an amount *is* receivable it is required to be included in income. In *Wilchar Construction Ltd. v. R.*, [1979] C.T.C. 117 (FCTD), aff'd [1981] C.T.C. 415 (FCA), the taxpayer had not followed the practice of deferring income representing holdbacks but, upon a reassessment (with respect to other matters not disputed), claimed that such holdbacks should not have been included in income. The Court held that the effect of the *Colford* decision was not to oblige the Minister to exclude holdbacks if the taxpayer failed to do so. The taxpayer was estopped from changing the basis of calculating income when it was too late to apply the same method to a subsequent taxation year which was statute-barred.

A scheme to obtain possession of holdbacks prematurely, by providing collateral to the owner, proved successful in *Françon Ltée v. Minister of National Revenue*, [1973] C.T.C. 708 (FCA). While agreeing with the Minister that the holdback was income when so received, the Court held that the appellant's outlay for the collateral was deductible at the same time, with the result that taxable income was not affected and would not be affected until the appellant reacquired its collateral at the time the holdback would normally have been released.

Prepaid Funeral Costs

For the 1993 and subsequent taxation years, the rules concerning "eligible funeral arrangements" (as defined in subsection 248(1)) are set out in section 148.1. Prepaid funeral costs received by a funeral director must in some circumstances be accounted for as income in the year of receipt but in other circumstances should not be reported as income until the year in which the services are rendered. The administrative position in this matter was formerly set out in Interpretation Bulletin IT-246, "Funeral Directors -- Prepaid Funeral Costs", dated August 25, 1975. That bulletin was cancelled and replaced by paragraph 20 of IT-531, "Eligible Funeral Arrangements", dated January 29, 1999. See the commentary to section 148.1.

Lawyers' Trust Accounts

Interpretation Bulletin IT-129R, respecting the tax treatment of lawyers' trust accounts, is reproduced in the commentary to section 34.

Rule of Construction

Nothing in the foregoing reduces the scope of other sections of the Act or can be taken to mean that items not mentioned are not to be included in computing income from a business (subsec 12(2)).

Deductions respecting Amounts Received or Receivable

The apparent severity of paragraphs 12(1)(a) and (b) is mitigated considerably by complementary provisions, found in paragraphs 20(1)(m), (m.1), (m.2) and (n) and subsections 20(24) and (25). Paragraph 20(1)(m) permits the deduction of a reasonable reserve in respect of goods not yet delivered and services not yet rendered, rents paid in advance, and returnable deposits on containers (other than bottles). Paragraph 20(1)(m.1) permits the deduction of a reasonable reserve in respect of goods and services that will have to be delivered or rendered after the end of the year under certain extended warranties. A deduction may be claimed under paragraph 20(1)(m.2) if an amount previously included in income under paragraph 12(1)(a) has been repaid. Provided that a joint election is made as set out in subsection 20(25), subsection 20(24) permits a taxpayer to deduct a reasonable amount paid to another taxpayer for undertaking to provide services or goods in respect of which amounts were included in the taxpayer's income under paragraph 12(1)(a). Finally, a reasonable reserve may be claimed under paragraph 20(1)(n) in respect of the unrealized portion of the profit from a sale having an extended period for payment. For detailed discussion, see the commentary to the relevant provisions.

Returnable Containers

The treatment of returnable containers, whether as inventory or as depreciable property, as well as the treatment of customer deposits and the deduction of a reserve in respect thereof, are dealt with in Interpretation Bulletins IT-165 (cancelled) and IT-165R (now archived), reproduced below. Revenue Canada indicated in IT-165R that IT-165 was applicable to taxation years commencing before February 16, 1984, the issue date of IT-165R. However, it should be noted that IT-165 was issued before the enactment of

subsections 10(4) and (5) of the Act, applicable with respect to property acquired after December 11, 1979, and was cancelled by IT Directive 1, dated March 16, 1990.

Interpretation Bulletin

Interpretation Bulletin IT-170R reviews the administrative position concerning the timing of the recognition of income with specific reference to the sale of real property and shares.