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THE TAXATION OF PREPAID INCOME

Joseph Frankovic

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Précis

Dans le présent article, l'auteur traite des aspects juridiques et administratifs de l'imposition du revenu payé d'avance. Dans la première partie de l'article, il effectue une analyse théorique à partir de principes et de politiques fiscales de base pour déterminer la méthode la plus appropriée de déclaration du revenu payé d'avance aux fins de l'impôt sur le revenu. Il aborde trois méthodes couramment suggérées de constatation du revenu payé d'avance, incluant la méthode généralement utilisée en vertu de la Loi de l'impôt sur le revenu, et conclut qu'aucune méthode n'est théoriquement juste. Il conclut toutefois que l'idéal théorique serait généralement irréalisable et impossible à mettre en pratique puisqu'il exigerait la prise en compte des coûts futurs prévus de celui qui reçoit le revenu. La question revient donc à déterminer quelle autre méthode pourrait être considérée comme le « second choix » pour l'imposition du revenu payé d'avance. Selon l'auteur, la méthode à privilégier devrait permettre de mesurer adéquatement le gain économique net de celui qui reçoit le revenu, être simple à administrer et assurer la neutralité entre le paiement d'avance du revenu et le paiement au moment de l'exécution. Compte tenu de ces critères, il conclut que le second choix est la méthode généralement utilisée en vertu de la Loi de l'impôt sur le revenu, qui permet le report intégral de la constatation de nombreux types de revenu payé d'avance à l'année où le revenu est gagné.

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Dans la deuxième partie de l'article, l'auteur analyse l'imposition du revenu payé d'avance en vertu du droit canadien. Il commence par discuter des principes de *common law* en vertu desquels le montant reçu au titre de marchandises ou services futurs n'est inclus dans le revenu que s'il est qualifié à titre de revenu. Cette exigence est respectée lorsque le droit du bénéficiaire de conserver le montant payé d'avance est inconditionnel ou soumis à une condition résolutoire. L'auteur fait valoir que la qualification à titre de revenu est souvent difficile à justifier parce qu'elle peut facilement entraîner des conséquences fiscales différentes pour des contribuables dans des situations économiques semblables, compte tenu de la forme juridique de l'opération en cause. L'auteur avance un argument semblable lorsqu'il évalue les distinctions juridiques entre les dépôts pour des marchandises et des services (apparemment non imposables au moment de la réception) et le revenu payé d'avance au titre de marchandises ou de services (apparemment imposable). |

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L'auteur discute ensuite des règles de la loi applicables au revenu payé d'avance qui, à première

vue, semblent simples. En vertu de l'alinéa 12(1)(a) ¨ ¨, les sommes reçues au titre de marchandises non livrées ou de services non rendus avant la fin de l'année, ou qui, pour toute autre raison, peuvent être considérées comme n'ayant pas été gagnées dans l'année, sont incluses dans le revenu. Une provision facultative prévue à l'alinéa 20(1)(m) ¨ ¨ au titre des marchandises non livrées ou des services non rendus permet en réalité de reporter la constatation des sommes s'y rapportant à l'année où elles sont véritablement gagnées. Malgré l'apparente clarté de ces dispositions, certaines questions demeurent sans réponse. Par exemple, on ne sait pas très bien si l'alinéa 12(1)(a) s'applique aux dépôts au titre de marchandises ou de services. De manière plus significative, il n'est pas évident que cette disposition s'applique aux sommes soi-disant qualifiées à titre de revenu (ou non). Selon certains arrêts, une somme pouvait être qualifiée de revenu avant d'être gagnée, mais dans des arrêts plus récents, on a conclu qu'une fois la somme qualifiée à titre de revenu, elle est considérée comme gagnée en droit. Dans cette dernière optique, si une somme reçue est qualifiée de revenu, elle est incluse dans le revenu dans l'année où elle est reçue en vertu de l'article 9 plutôt que de l'alinéa 12(1)(a), qui peut empêcher l'application de la provision prévue à l'alinéa 20(1)(m). De plus, la provision de l'alinéa 20(1)(m) ne s'applique pas à toutes les sommes non gagnées. Il est donc manifeste que toutes les formes de revenu payé d'avance n'ont pas droit au même traitement. L'auteur estime que ces écarts ne sont généralement pas justifiés.

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Abstract

In this article, the author discusses the legal and policy issues relating to the taxation of recipients of prepaid income. In the first part of the article, he undertakes a theoretical analysis, using fundamental taxation principles and policies, in order to determine the most appropriate method of reporting prepaid income for income tax purposes. He discusses three commonly proposed methods of recognizing prepaid income, including the method generally employed under the Canadian *Income Tax Act*, and concludes that none is theoretically correct. However, he also concludes that the theoretical ideal would be largely unworkable and impractical, since it would require taking into account the recipient's anticipated future costs. The question to be addressed, then, is which alternative method might be considered the "second-best" approach to taxing prepaid income. The preferred method, the author suggests, should provide the proper measure of the recipient's net economic gain, simplicity and administrative convenience, and neutrality as between prepayment of income and payment upon performance. On the basis of these criteria, he concludes that the second-best alternative is the method generally employed under the *Income Tax Act*, which permits full deferral of the recognition of many types of prepaid income to the year in which the income is earned.

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In the second part of the article, the author analyzes the taxation of prepaid income under Canadian law. He begins with a discussion of the common law principles. Under the common law, an amount received on account of future goods or services is included in income only if it attains "the quality of income." This requirement is met where the recipient's right to retain the

prepaid amount is unconditional or subject only to a condition subsequent. The author argues that the quality-of-income-concept is often difficult to justify because it can easily lead to different tax consequences for taxpayers in similar economic positions, depending on the legal form of the transactions in question. He makes a similar argument when considering the judicial distinctions | between deposits for goods or services (which apparently are not included in income upon receipt) and prepaid income on account of goods or services (which apparently are).

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The author next discusses the statutory rules relating to prepaid income. The statutory system appears simple on its face. Under paragraph 12(1)(a) ¨ ¨, an amount received on account of goods that are not delivered, or services that are not rendered, by the end of a year, or that for any other reason may be considered unearned in the year, is included in income. An optional reserve is allowed under paragraph 20(1)(m) ¨ ¨ in respect of goods not delivered or services not rendered, which effectively allows the recognition of the amount to be deferred until the year in which the amount is in fact earned. Despite the apparent clarity of the provisions, there are certain issues that remain unresolved. For example, it is not clear whether paragraph 12(1)(a) applies to deposits on account of goods or services. More significantly, it is not clear whether the provision applies to amounts that have the so-called quality of income (or not). Although early cases indicated that an amount could have the quality of income before it was earned, subsequent cases have held that once an amount is found to have the quality of income, it is earned as a matter of law. Under this latter view, if an amount received has the quality of income, it is included in income in the year of receipt under section 9 ¨ ¨ rather than paragraph 12(1)(a), which may preclude the application of the paragraph 20(1)(m) reserve. Furthermore, the paragraph 20(1)(m) reserve does not apply to all unearned receipts. It is thus apparent that not all forms of prepaid income are treated equally. The author argues that these discrepancies are generally not warranted.

Keywords: Timing • prepaid • prepayment • receipts • accounting • accrual basis accounting

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Introduction

This article discusses the legal and policy issues relating to the taxation of payments that are received before performance, otherwise known as "prepayments" or "prepaid income." Such amounts are generally payments that are received by taxpayers in consideration for property to be delivered or services to be rendered after the year in which they are received. However, in broader terms, prepaid income refers to any amounts that are received before the year in which they are in fact earned.

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The first part of the article considers the appropriate method of accounting for prepaid income from a theoretical and policy perspective. There are essentially three schools of thought on the issue. Under the most popular approach, the inclusion of a prepayment should be deferred entirely to the year in which the recipient renders the services, delivers the property, or otherwise earns the payment. This approach parallels the treatment followed under generally accepted

accounting principles (GAAP), whereby the earning event is considered the recognition event. The GAAP/deferral approach is employed under the *Income Tax Act*,[1] at the recipient's option, in respect of most prepayments for property or services (although it does not apply to all unearned amounts). In recent years, some commentators have argued that this deferral approach should go one step further by allowing the recipient not only to defer the recognition of the prepayment, but also to deduct imputed interest | expense each year reflecting the increase, over that year, in the value of the recipient's obligation to perform under the contract. Under this "notional loan" approach, the prepayment would effectively be treated as if it were a loan from the payer to the recipient that was "repaid" by the recipient's delivery of the property or rendering of the services. Proponents of the deferral and notional loan approaches argue that both are relatively neutral compared with the third potential method of taxing prepaid income, the "upfront inclusion" approach described below, since the latter approach would significantly overtax prepayments relative to payments made upon performance. By contrast, the deferral and notional loan methods would place recipients of prepayments in a similar (deferral) or virtually identical (notional loan) after-tax position to that of recipients of payments made upon performance.

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Under the upfront inclusion approach, a prepayment is fully included in income in the year in which it is received. According to the proponents of this view, the recipient of a prepayment enjoys an immediate accession to wealth in the year of receipt that cannot reasonably be offset by the recipient's liability to deliver the property or perform the services. In this way, a prepayment is fundamentally different from a loan from the recipient's perspective (in that the present value of the liability to repay a loan exactly equals the amount of the loan). The upfront increase in wealth enjoyed upon the receipt of a prepayment can be offset, if at all, only to the extent of the present value of the recipient's future costs of performance, which will normally differ from the present value of the property or services. Furthermore, since those costs are often contingent and their quantum is typically unknown, it is difficult to justify their implicit or explicit recognition to offset the upfront inclusion of the receipt of the prepayment.

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Interestingly, none of the above methods is the theoretically correct approach to accounting for prepayments. Under the theoretical ideal, a recipient would include in income in the year of receipt the amount by which the prepayment exceeded the present value of the recipient's future costs of performance. Furthermore, the recipient would be allowed to deduct imputed interest between the time of receipt and the time of performance, reflecting the increase in the present value of the recipient's future costs owing to the passage of time and the time value of money. Unfortunately, such an approach would be largely unworkable and impractical, since it would require knowledge of the recipient's future costs as of the time of receipt. These costs often cannot be determined with certainty until they are actually incurred. In order to apply the theoretically correct approach in such cases, it would be necessary to estimate the costs and perhaps their probability of occurrence, and then later make adjustments if the actual outcomes differed from the estimated outcomes. Clearly, this would be a rather cumbersome procedure. It would be significantly simpler and more practical to employ one of the other described methods.

Accordingly, in the first section of the article, I attempt to determine which of the methods outlined above would be acceptable as a practical "second-best" alternative to the theoretically correct yet impractical method of accounting for prepayments.

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The second part of the article discusses the treatment accorded to recipients of prepaid amounts under Canadian law, including the statutory scheme and the | development of the common law concept of "the quality of income." The income tax treatment of recipients under the Canadian system is somewhat inconsistent and not altogether satisfactory. At common law, a prepaid amount is included in the recipient's income if it has the quality of income, which, according to the courts, means that the recipient's right to it is absolute and under no restriction, contractual or otherwise, as to its disposition, use, or enjoyment. The test appears to be based on whether the recipient's right to retain the amount is subject to a condition precedent. For example, if a recipient's right to retain an amount received is conditional upon some element of performance under the contract, the amount does not attain the quality of income unless and until that performance occurs. On the other hand, the fact that an amount may have to be repaid if the recipient does not perform as promised does not necessarily mean that it lacks the quality of income in the year of receipt. That is, the condition of repayment could be a condition subsequent, in which case the amount would be included in income in the year of receipt. It thus becomes apparent that taxpayers in similar economic positions may be taxed differently, depending on the legal form of their respective transactions. Additionally, in recent years, there has been increased uncertainty surrounding the quality-of-income concept as it relates to prepaid income. Although early cases indicated that an amount could have the quality of income before it was earned, recent cases have held that once an amount is found to have the quality of income, it is earned as a matter of law. Under this latter view, which is apparently accepted by the Canada Customs and Revenue Agency (CCRA), if an amount received has the quality of income it is fully included in income in the year of receipt under section 9 ¨ ¨ of the Act. Other prepaid and unearned amounts, presumably those without the quality of income, are included in income in the year of receipt under paragraph 12(1)(a) ¨ ¨; an optional reserve is allowed under paragraph 20(1)(m) ¨ ¨ if the prepayment is on account of goods to be delivered or services to be rendered, or on account of periods for which rent was prepaid, after the end of the year. The reserve, where it applies, effectively allows the recognition of some or all of the amounts received to be deferred until the year of performance. However, the reserve apparently does not apply to amounts included in income under section 9; furthermore, it does not apply to all types of unearned receipts included under paragraph 12(1)(a). Owing in large part to the application (or misapplication) of the quality-of-income concept, prepayments may be treated differently for income tax purposes even if they are economically similar or even identical.

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The Theoretical Framework and Policy Arguments

In this section of the article, I discuss the theoretical framework and policy issues relating to the taxation of prepaid income. In particular, the three commonly proposed methods of taxing

prepaid income—the GAAP/deferral method, the upfront inclusion method, and the notional loan approach—are analyzed and compared with the theoretically "correct" method of taxing prepaid income. Since, for reasons | to be discussed, the theoretical approach would be impractical to implement in most cases, the three other methods are analyzed in order to determine which would provide a viable, "second-best" approach to recognizing prepaid income. (Essentially, the three other approaches are simpler and more practical because, unlike the theoretical approach, they can be applied without taking into account the recipient's costs until they are in fact incurred.)

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Although the discussion focuses largely on the recipients of prepaid income, it is recognized that the decision to tax recipients in a particular manner can affect the decision to tax the payers of such amounts in a particular manner, and vice versa. Accordingly, this section includes some discussion of the taxation of payers in conjunction with the taxation of recipients, particularly for the purpose of determining which method of taxing prepaid income would be most neutral (that is, which method would work best to neither discourage nor encourage the making of prepayments).

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Three Potential Methods of Taxing Prepaid Income

There are two simple ways to account for prepaid income for income tax purposes: full inclusion in the year of receipt ("the upfront inclusion method") or full deferral of the inclusion to the year in which the income is earned ("the deferral method"). The deferral method is employed under GAAP. As noted in the introduction, both methods are ostensibly allowed under the Act for many types of prepaid income. Although there are various arguments in favour of both approaches (which are explored in some detail below), perhaps the most contentious point is whether the recipient's obligation to perform (to provide the goods or services) can reasonably serve to "offset" the amount of the prepayment. Proponents of the deferral method generally argue that the recipient's increase in wealth represented by the prepayment is offset by the recipient's obligation to perform, so that a deferral is warranted,[2] whereas advocates of the upfront inclusion method argue that the recipient's obligation to perform does not, as a general rule, fully offset the amount of the prepayment.[3]

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Under a third method endorsed by some American commentators as the theoretical ideal, the recognition of a prepayment would be deferred to the year of performance (as under the deferral method), but the recipient would also be allowed to deduct imputed interest expense in respect of the prepayment until the year of performance.[4] Proponents of this "notional loan method" argue that a prepayment is economically equivalent to a loan made by the payer to the recipient that is effectively repayable at the time of performance. The notional "repayment" of the loan by the recipient is in turn offset by a notional "payment" by the payer for the goods or services at that time, so that no further cash is required to change hands.

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The mechanics of each method are illustrated using the following example, which will be referred to throughout this article.

Example

A taxpayer receives a prepayment at the end of year 0 in consideration for a $121 service to be rendered at the end of year 2. The appropriate discount rate is 10 percent per annum, so that the amount of the prepayment is discounted to $100, the present value | of the future cost of the service. The taxpayer is an individual who is in a 50 percent tax bracket in all years. The taxpayer's cost of rendering the service in year 2 is nil.

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For the sake of simplicity, I will assume throughout this article that the taxpayer can earn a 10 percent annual return on his investments; in other words, it is assumed that the discount rate used to compute the prepayment equals the taxpayer's expected rate of return on investments. Also, at least for the time being, it is assumed that the service will most likely be performed satisfactorily, so that there is only a nominal chance that the taxpayer will be required to refund the prepayment.

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If the upfront inclusion method were applied to this example, the taxpayer would include the $100 prepayment in income in year 0. Under the deferral method, the taxpayer would include the $100 prepayment in income in year 2. Under the notional loan method, the $100 prepayment would be treated as a loan made to the recipient, with the "repayment" of the principal ($100) and accumulated interest ($21) in year 2 being exactly offset by the payer's obligation to pay the recipient $121 at that time for the service. Accordingly, under the notional loan approach, the recipient would deduct $10 in year 1 and $11 in year 2 as imputed interest expense and include $121 on account of the prepayment in year 2.

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The rationale and policy arguments underlying each of these methods (as well as the arguments that discredit them) are discussed in the text below. Interestingly, as will be shown, none of these alternatives is the theoretically correct method of accounting for prepaid income. Unfortunately, the theoretically correct approach—which is also discussed below—would be difficult to apply in most cases because it would require knowledge, at the time a prepayment was received, of the recipient's future costs associated with the performance. Accordingly, the theoretical ideal is dismissed as being rather unworkable and impractical. The above methods of recognizing prepaid income require no prior knowledge of the recipient's future costs; in all cases, those costs are simply recognized in the year in which they are incurred, which is normally the year of performance.

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The Deferral of Prepaid Income Under GAAP

Until recently, there was little substantive analysis in the income tax literature relating to the taxation of prepaid income. The traditional and widely held view has been, and in certain circles

continues to be, simple and somewhat beguiling. For several years, commentators have argued that the appropriate income tax treatment should be based on the financial accounting treatment, which follows the deferral method and thus defers the recognition of prepaid income until the year in which it is earned. Under GAAP, a prepayment is recorded as an asset that is offset by a corresponding liability in respect of the property to be delivered or the services to be rendered. The amount is considered to be earned at the time the obligation is performed; it is then removed from the liability account and recorded as income in that year. The "earning event" is therefore a prerequisite to realization and the recognition of prepaid income for the purposes of GAAP. The GAAP treatment is said to be appropriate because it results in a matching of the prepaid income to the | recipient's costs incurred in earning that income, thereby providing a better measure of the recipient's net income (at least for accounting purposes) as compared with the upfront inclusion method of reporting prepaid income.

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Somewhat surprisingly, many commentators who support this view provide little or no rationale as to why the accounting treatment is appropriate for income tax purposes. It is often simply conceded that the GAAP treatment is authoritative in this regard and that there is no compelling reason why the income tax treatment should diverge from GAAP. As Alan Gunn noted in 1984, there were at least a dozen articles written at that time that argued in favour of the deferral method with no reference to any principles other than those of financial accounting.[5] To the contrary, Gunn succinctly describes the differences in tax and financial accounting objectives as they relate to prepaid income, and he scathingly (though correctly) criticizes those commentators who automatically assume that the income tax treatment should defer to the accounting treatment:

> Financial accountants devise their rules to achieve matching because the failure to do so would generate financial statements misleading to prospective investors and creditors. Consider, for example, the case of prepaid services income. If payments for services were included in income upon receipt, a business that regularly collected less than its costs could appear profitable by inducing some customers to pay early. The rule requiring deferral of prepaid income makes excellent sense as a matter of financial accounting not because it expresses an ultimate truth about the "nature of income," or defines "income" in some "logical" way, but because it serves the purposes of financial accounting. Those purposes, which derive from the supposition that investors and creditors will use this year's "income" as an estimate of future performance, have virtually nothing to do with the purposes of tax accounting. The tax system need not concern itself with whether this year's income is an accurate measure of the taxpayer's normal profit-generating ability. The willingness of many people to assume, without reflection, that "income" determined by financial accounting principles is or should be "income" for tax purposes demonstrates the continuing relevance of an observation by Lon L. Fuller:
>
> > The proposition that legal rules can be understood only with reference to the purposes they serve would today scarcely be regarded as an exciting truth. The notion that law

> exists as a means to an end has been commonplace for at least a half a century. There is, however, no justification for assuming, because this attitude has now achieved respectability, and even triteness, that it enjoys a pervasive application in practice. . . . We are still all too willing to embrace the conceit that is possible to manipulate legal concepts without the orientation which comes from the simple inquiry: toward what end is this activity directed? Nietzsche's observation, that the most common stupidity consists in forgetting what one is trying to do, retains a discomforting relevance to legal science [footnote omitted].[6]

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Similar to the GAAP treatment, the Act generally follows the deferral method and allows the recognition of most forms of prepaid income to be deferred until the year in which the income is earned. Under paragraph 12(1)(a), prepaid income is included in the year in which it is received, but an optional reserve under paragraph 20(1)(m) is allowed, which effectively allows the deferral of the inclusion of the amount if it is in respect of property to be delivered or services to be rendered in a future year or in respect of rent in a future year. Furthermore, if the amount is refunded—say, if the property is not delivered or the services are not rendered—a final deduction is available so that the amount may never be subject to tax in the hands of the recipient.[7] Accordingly, the net result of the statutory treatment for income tax purposes is the same as that seen under GAAP; the earning event is typically the recognition event.

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Although the government did not provide explicit reasons for the introduction of the statutory reserve (in 1953), it was introduced after extensive lobbying from the accounting profession.[8] It is therefore likely that the reserve was enacted to bring the income tax treatment in line with the accounting treatment. Obviously, this reason does not justify its continued existence or explain why the accounting treatment is desirable for income tax purposes. Although there once appeared to be some consensus that the computation of profit for tax purposes should be more or less governed by financial accounting principles, this notion has been discredited in recent years largely because of fundamental differences between the objectives of financial accounting and those of income tax reporting,[9] and the more "normative" view that income for tax purposes should ideally correlate to economic gain rather than to accounting profit. The description of income and the justification for recognizing amounts in a particular manner for income tax purposes are now commonly and correctly articulated independently from the financial accounting rationale. The existing income tax rules that parallel the accounting rules should therefore be justified (or discredited, as the case may be) by reference to fundamental income tax principles and policies rather than by reference to the financial accounting rationale. From a strictly legal perspective, the Supreme Court of Canada has similarly held that GAAP and other so-called well-accepted business principles are interpretive aids only; that they should apply to the computation of profit for income tax purposes only if they are consistent with the established legal principles; and that if there is any conflict, the legal rules must govern.[10]

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As noted, it is often argued that the GAAP/deferral treatment is appropriate because it results in "matching" of the prepayment with the recipient's costs incurred in earning the prepayment. It is often assumed by commentators, as a self-evident proposition, that the matching of costs to revenues is required in order to arrive at the most accurate measurement of income. However, this general proposition has also been refuted in recent years.[11] The application of the matching principle often results in an inaccurate portrayal of a taxpayer's net change in wealth and true income position for income tax purposes, because revenues and costs are not necessarily recognized in the years in which the corresponding increases and decreases in wealth occur. Moreover, the matching principle typically ignores the time value of money. It typically "shifts" costs and revenues back or forward along a timeline, without regard to the fact that this shifting affects the after-tax values of those costs and revenues. In the context of prepaid income, the shifting of the inclusion of the prepayment to | the earning year, without time value adjustments on account of the prepayment or the recipient's costs, almost always results in an inaccurate measure of the recipient's change in wealth.

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It can be argued that the recipient's obligation to provide the property or render the services will reduce the recipient's net worth in the year in which the prepayment is received, at least to the extent of the present value of the recipient's costs of providing the property or rendering the services. However, this reduction in net worth does not, in itself, justify the adoption of the GAAP treatment for income tax purposes. Except in those cases where the present value of the recipient's costs equals or exceeds the amount of the prepayment, the recipient will enjoy a net increase in wealth in the year of receipt. In contrast, under GAAP, the receipt of prepaid income is always offset by the corresponding liability of the recipient to deliver the property or to perform the services; the amount of this liability is assumed to equal the amount of the prepayment and it is so recorded. Such a hypothesis cannot be considered normative for income tax purposes because, as noted, the recipient will typically enjoy a net increase in wealth in the year of receipt. Perhaps most significantly, the deferral of the inclusion of a prepayment can have the effect of permanently exempting from tax some or all of the investment return earned on the prepayment by the recipient between the time of receipt and the time of performance. Although this particular issue may not be worrisome for the purposes of GAAP, it most certainly is a potential concern for income tax purposes. (The foregoing points are discussed in more detail in the ensuing sections of this article.)

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Last, the GAAP treatment ignores the fact that the recipient of a prepayment has the financial wherewithal to pay tax on the amount received. The recipient has the cash in hand and the current ability to pay the tax on the prepaid income, a matter that is of relevance for income tax purposes even though it is presumably irrelevant for the purposes of GAAP. There is no liquidity concern for income tax purposes in these cases similar to that which arguably justifies the exclusion of other unearned or unrealized amounts from the income tax base until they are in fact earned or realized.

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It is therefore perhaps trite to say that the recognition of prepaid income for income tax purposes should not be determined solely by reference to the financial accounting rationale. A decision to adopt the GAAP treatment/deferral method for income tax purposes must be rationalized independently under fundamental principles and policies of taxation. As will be discussed, in my view, the deferral method may be justified in this manner as a "second-best" alternative to the theoretically correct but largely impractical method of taxing prepaid income.

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The Main Difficulty with Taxing Prepaid Income: Accounting for the Recipient's Obligation To Perform

The Argument That the Obligation To Perform "Offsets" the Prepayment

In the United States, owing to a trilogy of US Supreme Court decisions,[12] prepaid income is often included in the recipient's income in the year of receipt. (There are | some statutory exceptions.) Furthermore, in contrast to the Canadian system, a reserve is not available to defer the inclusion until the year of performance. This difference in income tax treatment probably explains why the taxation of prepaid income has been the subject of much commentary in the United States and why it has been largely ignored in the Canadian income tax literature. Most American commentators who have written on the issue favour either the deferral method or the notional loan method.[13] Many of these commentators reject the upfront inclusion rule on the ground that prepaid income is received in exchange for an equal and reciprocal benefit to be provided by the recipient to the payer. In their view, a prepayment is effectively offset by the recipient's obligation to provide the property or render the services in the future. On the basis of this rationale, these commentators have argued that a recipient does not necessarily enjoy an increase in wealth at the time the prepayment is received, so that deferral of the recognition of the prepayment is warranted. Robert Scarborough states the argument as follows:

> The seller [recipient] does not have any accession to wealth at the time the contract is entered into merely by reason of having received the advance payment. The asset that the seller has received—the advance payment of cash—is offset by a liability to incur expenses in the future in order to perform.[14]

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In contrast, Calvin Johnson leads a smaller contingent of American commentators who argue that the upfront inclusion rule is justified.[15] Johnson's basic position is that a prepayment represents an immediate accession to wealth that cannot reasonably be offset by the recipient's liability to deliver the property or perform the services. Johnson formulates his argument using a simple example of an individual who receives a prepayment for services to be rendered in future years and who will not incur any future costs in performing the services. (For the sake of simplicity, Johnson assumes that the recipient's costs will be either paid or reimbursed by the payer of the prepayment.) In Johnson's view, the recipient's obligation to perform the services (to utilize his own human capital) has no cost for income tax purposes. As a result, the recipient's obligation cannot serve to "block" the inclusion of the prepayment upon receipt. If the liability to perform

services could serve to offset the inclusion of the consideration paid for those services, service providers would never be taxed, because their liability to perform would always offset the fair market value of the consideration received, whether it was received in advance or upon performance.

Johnson thus refers to the proposition that prepaid income should be offset or "blocked" by the liability to perform future services as "the untenable liability rationale." Although Johnson limits his conclusions to zero-cost services, he goes on to argue that where the recipient of a prepayment expects to incur "actual" future costs (as opposed to economic or opportunity costs that are not taken into account for income tax purposes), the discounted present value of the costs should be subtracted from the amount of the prepayment to calculate the not-yet-earned profit in the year of receipt.[16] The problematic issue, as noted above, is that such | costs will often not be known at the time the prepayment is received. This issue is explored further in the text below.

The Distinction Between the Recipient's Tax Costs and Economic Opportunity Costs

As discussed earlier, some critics of the upfront inclusion rule often take the position that the present value of a prepayment equals the present value of the recipient's liability to deliver the property or render the services. They argue that since the two amounts offset each other, the recipient should not be required to include the prepayment in income upon receipt. Unfortunately, it appears that some of these commentators are confusing economic opportunity costs with tax costs. Their position is often predicated on one of two assumptions: either that the recipient's cost of the property or service will equal its value when it is delivered or rendered; or, particularly in the case of services, that the prepayment will be offset by the value of the opportunities forgone by the recipient as a result of receiving the payment.[17]

In my view, and as argued convincingly by Johnson, the "offsetting liability" rationale must be modified to take into account the recipient's actual costs and not his opportunity costs. That is, for income tax purposes, the amount of a taxpayer's deduction must be based on the taxpayer's cost of the underlying expenditure and not necessarily its value,[18] and certainly not on the opportunity cost that the taxpayer may have incurred by making the expenditure. Therefore, in the context of a prepayment, any explicit or implicit deduction of the recipient's future expenditure against the inclusion of the prepayment in the year of receipt should be limited to the present value of the recipient's cost of the expenditure. When this proposition is applied to prepaid services in the case where an individual recipient incurs no future costs in performing—other than the "costs" of his human capital—there are no costs for income tax purposes to offset the increase in wealth represented by the prepayment in the year of receipt. Accordingly, in the no-tax-cost scenario, it is clear that the entire amount of the prepayment should be included in income upon receipt. In this situation, the recipient's opportunity costs are irrelevant in computing income for tax purposes. These opportunity costs, essentially the individual's "cost" of his potential earning capacity, may be considered economic costs, but they

are not costs for income tax purposes.

If, on the other hand, we were to measure "real" economic income, the present value of a person's future earning capacity would be included in "income" as it accrued and thus would be "capitalized" as that capacity increased in value. As a result, the economic "cost" of the capacity to render future services would always be equal to its value. Accordingly, it would be justifiable to allow a full deduction on account of that cost to offset the upfront inclusion of the prepayment received on account of those services. The more general point is that in terms of economic income, the cost of an asset would always equal its value,[19] whereas for income tax purposes, cost and value typically differ owing to the realization principle and the fact that many accretions to wealth, such as enhancements to earning potential, are not included in the income tax base. |

If our income tax system were a full accrual system that included all forms of economic wealth in income, a service provider would include in income, at some point in time, the present value of his capacity to render future services. Turning to our example of a $100 prepayment for a service worth $121 to be rendered in two years' time, the $100 present value of the recipient's income-earning capacity relating to the performance of the service would have been included in the recipient's "income" as it accrued. Furthermore, the amount of this inclusion would have been capitalized so as to form the "cost" of the recipient's earning capacity as it related to the future services. As a result, in this circumstance, the recipient's $100 cost could presumably serve to offset the amount of the $100 cash prepayment. However, this would still leave a net $100 inclusion on account of the recipient's increased income-earning capacity. In other words, under an "ideal" income tax that included all forms of economic income, the recipient would most likely be taxed on the $100 amount in the year of receipt or even a prior year (depending on when the recipient's income-earning capacity relating to the service accrued) rather than in the year of performance. All of the foregoing analysis is a rather roundabout way of demonstrating that, under a less than ideal income tax system, such as the Canadian system, and in the absence of "actual" tax costs to be incurred by the recipient of a prepayment, it is more defensible to include the prepayment in income in the year of receipt than to defer its inclusion to the year of performance. In the absence of future costs, there is no compelling reason why the recognition of the recipient's wealth should be deferred beyond the time that it is converted into the cash receipt.

The "Theoretically Correct" Method of Taxing Prepaid Income: Accounting for the Recipient's Future Costs

The Proper Measure of the Recipient's Change in Wealth

As noted in the preceding section, the inclusion of a prepayment in the year of receipt may reasonably be "offset," if at all, by the present value of the recipient's cost of delivering the property or rendering the service. (It is still assumed that there is only a nominal probability that the recipient will be required to refund the prepayment.) A full offset is warranted only if these

amounts are equal. In a typical situation where the prepayment exceeds the present value of the recipient's future costs, the excess will represent a net accretion to the recipient's wealth in the year in which the prepayment is received. (Herein, this excess amount is referred to as the "profit portion" of the prepayment.) Therefore, for the recipient of a prepayment to be taxed correctly (in the Haig-Simons sense), the profit portion of the prepayment should be included in income in the year of receipt. However, the recipient should be allowed a deduction on account of imputed interest expense each year as the present value of its future costs increases owing to the time value of money, since this amount will represent a decrease in the recipient's wealth.[20] Effectively, such an approach would allow the recipient to earn a tax-free return on the investment of the "non-profit" portion of the prepayment—the portion equalling the | present value of the future costs—owing to the imputed interest deduction allowed in respect of that portion of the prepayment.[21] Accordingly, under the theoretically correct approach, the recipient would be subject to taxation on the investment income earned by investing the profit portion of the prepayment but not on the investment income earned by investing the non-profit portion of the prepayment.

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To illustrate this approach, let us change, for the moment, the no-cost assumption in our example and instead assume that the recipient will incur costs of $48.40 in year 2 when the service is rendered. Under this assumption, the present value of those costs (discounted at 10 percent per annum) is $40.00 at the time the prepayment is received in year 0. Accordingly, for the most accurate measurement of the recipient's change in wealth, the $40.00 present value of his future costs would be deducted from the $100.00 cash prepayment, so that the recipient would include $60.00 (the profit portion) in income in year 0. With a 50 percent tax rate, the recipient would pay $30.00 of tax, leaving him with an after-tax profit of $30.00 ($60.00 before-tax profit minus $30.00 tax) and after-tax cash proceeds of $70.00 in year 0. Over the course of years 1 and 2, the present value of the recipient's future costs would increase by $4.00 and $4.40, respectively (from $40.00 to $44.00 and then to $48.40), and the recipient would be allowed to deduct imputed interest expense equal in amount to that increased liability. Accordingly, under the theoretically correct approach, the recipient would be taxed immediately on the profit portion of the prepayment ($60.00) and taxed on the investment income earned on the after-tax profit portion ($30.00) until the service was rendered. In turn, the recipient would effectively be allowed to invest the non-profit portion of the prepayment ($40.00) and earn a tax-free return on that investment owing to the imputed interest deduction reflecting his future costs. The validity of this result can be demonstrated by comparing the transaction on a before-tax and after-tax basis. Before tax, the present value of the recipient's cash flow would equal $60.00 (using the before-tax discount rate of 10 percent),[22] whereas after tax, the present value of the recipient's cash flow would equal $30.00 (using the after-tax discount rate of 5 percent)[23]—the result that we would expect to see with a recipient in a 50 percent tax bracket.

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Applying the theoretical approach and going back to the assumption that the recipient of the

prepayment had no future costs, the entire amount of the prepayment would represent the profit portion and thus would be included in income in the year of receipt. Johnson is therefore correct when he contends that the taxpayer in his no-cost example should include the entire prepayment in income in the year of receipt. The recipient would not be allowed any imputed interest deduction up to the year of performance (since he had no future costs), so that all of the income earned by investing the prepayment would be subject to tax. At the other extreme, if the present value of the recipient's future costs exactly equalled the amount of the prepayment, the entire prepayment would represent the non-profit portion. Thus, the recipient would report no net income in the year of receipt and, owing to the imputed interest expense deduction computed in respect of the future costs, he could invest the entire prepayment and earn a tax-free return thereon until the service was rendered. It is thus apparent that the upfront inclusion | method and the notional loan method will provide the theoretically correct results in very limited circumstances—in the 100 percent profit and 0 percent profit scenarios, respectively. The deferral method will provide the theoretically correct results only by happenstance.

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As discussed earlier, many commentators have argued that upfront inclusion is inappropriate for prepaid income because the prepayment can be viewed as being offset by the present value of the recipient's liability to perform. Furthermore, the notional loan proponents have argued that the recipient should be allowed a deduction of imputed interest each year reflecting the increase in the expected value of the recipient's liability to perform (rather than the recipient's expected cost) owing to the time value of money. As discussed, applying this approach to our example, the recipient would be allowed a $100 "deduction" to offset the upfront inclusion of the prepayment in year 0 (representing the present value of the $121 service) and an additional deduction of $10 in year 1 and $11 in year 2 as imputed interest, owing to the fact that the present value of the service increased from year 0 to year 2 (from $100 to $121). These commentators would effectively treat the prepayment as a loan and would apparently allow this imputed interest deduction regardless of the amount of the recipient's anticipated costs of performing. Some have argued that the taxation of the profit element of the transaction (the amount of the prepayment in excess of the recipient's actual costs) is a separate issue that should not affect the full deferral of the recognition of the prepayment.[24] For reasons discussed above, it is difficult to rationalize this view. There appears to be no reason why the recipient of a prepayment should be allowed to deduct, against the upfront inclusion of the prepayment, the present value of the expected value (instead of the expected cost) of the recipient's future performance. In a similar vein, it does not make sense to allow the recipient a deduction of imputed interest reflecting the increase in the present value over time of the liability to perform; the theoretically correct approach would limit the imputed interest deduction to the increase in the present value of the cost of performing.

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The theoretically correct approach of recognizing the recipient's costs would be difficult and often impossible to implement in practice because it would require knowledge of the recipient's future costs at the time the prepayment was received. These costs are typically not known with certainty until they are incurred. Applying the theoretical approach in such cases, by estimating

the costs, the probability of their occurrence, and the time value of money, and then later making adjustments if the actual outcomes differed from the estimated outcomes, would prove rather cumbersome. It is therefore more practical to employ one of the other methods of accounting for prepaid income. In terms of simplicity and administrative convenience, either the upfront inclusion method or the deferral method presents a viable and easily workable solution. The potential taxable events are easy to identify (receipt of prepayment, earning event, and/or incurrence of costs), and more significantly, there is no need to estimate the recipient's future costs.

There are undoubtedly some cases where recipients of prepayments are able to reasonably estimate their future costs, and others where recipients effectively "lock | in" or hedge their future costs by way of forward contracts and similar arrangements. Presumably, the theoretical method could be employed in these circumstances and either the deferral or the upfront inclusion method could be employed at the default position in all other circumstances. However, such an approach would inevitably result in recipients in similar economic positions being taxed differently. Furthermore, depending on the default position, recipients subject to the theoretical method could be taxed more heavily than other recipients that had lower costs (if deferral were the default position) or less heavily than other recipients that had higher costs (if upfront inclusion were the default position). Thus, it would be more equitable, and presumably more neutral, to employ one approach to all prepayments.

Choice of a "Second-Best" Measure of Wealth

As discussed, in theory, the recipient of a prepayment should be taxed on the income earned by investing the profit portion of the prepayment but not on the income earned by investing the non-profit portion. In contrast, under the upfront inclusion method, the recipient is taxed on all of the income earned by investing the prepayment. Accordingly, the upfront inclusion of a prepayment results in overtaxation of the recipient because the investment income earned on the non-profit portion of the prepayment is incorrectly subject to tax. At the other extreme, under the notional loan method, the recipient is not taxed on any of the investment income earned by investing the prepayment. Accordingly, this method results in undertaxation of the recipient because the investment income earned on the profit portion of the prepayment is incorrectly exempt from tax.

Under the deferral method, the recipient is not allowed a deduction on account of imputed interest expense on the profit portion of the prepayment, so that the income earned by investing the profit portion is prima facie included in the recipient's income. However, because the inclusion of the profit portion of the prepayment is incorrectly deferred to the year of performance, the "simple" investment income earned on the profit portion effectively ends up being exempt from tax. (This result reflects the principle holding that the deferral of the recognition of an amount received or accrued—such as the profit portion of a prepayment—is the

equivalent of taxing that amount properly upon receipt or accrual but permanently exempting from tax the simple investment return earned on that amount over the period of deferral.)[25] Thus, in regard to the investment income earned on the profit portion of the prepayment, the recipient is effectively taxed only on the "compound" income element.[26] Conversely, it can be shown that, since the deduction of the imputed interest expense on the non-profit portion of the prepayment is effectively and incorrectly deferred to the year of performance,[27] the recipient is effectively denied a deduction for, and is therefore subject to tax on, the compound imputed interest expense on the non-profit portion. (This result stems from the corollary to the principle noted above, namely, that the deferral of the deduction of an accrued expense—such as the imputed simple interest expense on the non-profit portion of a prepayment—is the equivalent of properly deducting that amount as it accrues but then denying a deduction for the interest computed on that amount—such as | the compound imputed interest expense—over the period of deferral.)[28] Accordingly, under the deferral method of reporting prepaid income, the recipient is simultaneously undertaxed (because the simple investment return on the profit portion is incorrectly exempt from tax) and overtaxed (because the compound investment return on the non-profit portion is incorrectly subject to tax).

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The foregoing results are summarized in table 1.

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Assuming that the theoretical approach cannot reasonably be employed, the choice between the other methods of reporting prepaid income might be based on the determination of which method provides the "second-best" measure of the recipient's true income position (change in wealth) from the time of receipt to the time of performance. It is apparent, looking at the results summarized in table 1, that the most accurate method will depend on the specific circumstances—in particular, the relative profit and non-profit portions of the prepayment, which in turn will depend on the amount of the recipient's future costs. For example, if the recipient were expected to incur nil or nominal costs, so that all or most of the prepayment would constitute profit, the upfront inclusion method would present the best measure of the recipient's income position. If, instead, the present value of the recipient's expected costs were equal or approximately equal to the amount of the prepayment, so that all or most of the prepayment would not be profit, the notional loan method would provide the best result. In the in-between cases, the deferral method would often provide the best approximation of the recipient's income position, since the undertaxation in regard to the profit portion would be offset somewhat by the overtaxation in regard to the non-profit portion. Moreover, in those cases where the non-profit portion of a prepayment exceeded the profit portion—in other words, where the present value of the recipient's costs exceeded 50 percent of the amount of the prepayment—the deferral method would always provide a more appropriate result relative to the upfront inclusion method. Even ignoring the above analysis regarding the taxation of investment income earned on the prepayment, on a fundamental level, it would be difficult to justify the upfront inclusion of a prepayment if less than half of it represented the recipient's net economic gain. As discussed,

however, it would be difficult in many cases to compute the recipient's future costs with any certainty, so that one method should apply to all prepayments on the basis of some judgment as to recipients' average future costs. In this regard, there is no reason to believe that the average profit margin on prepayment transactions is significantly different from the average profit margin on other transactions. Assuming that profit margins on prepayment transactions average less than 50 percent (that is, the present value of future costs, on average, exceeds 50 percent of the prepayment), the admittedly arbitrary choice should come down to the deferral method. The case for deferral becomes even stronger if it can reasonably be assumed that most prepayments carry at least a nominal probability of refund.

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Additionally, for prepaid income to be taxed in the same manner as, or a similar manner to, payments made upon performance (payments coinciding with the provision of the goods or services), both the deferral and the notional loan methods | would be superior to the upfront inclusion method. That is, in a payment-upon-performance case, the recipient obviously would not be taxed on any investment income before performance, whereas in the prepayment case where the upfront inclusion method applied, the recipient would be taxed on all of the investment income earned on the prepayment until performance. Thus, under the upfront inclusion method, the recipient would be significantly overtaxed relative to the payment-upon-performance case. Accordingly, the application of the upfront inclusion method would discourage taxpayers from entering into prepayment transactions. These points are discussed in detail later in the article.

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TABLE 1
Taxation of Investment Income Earned by Recipient of Prepayment

Method of reporting prepaid income	Taxation of investment income earned by investing prepayment between time of receipt and earning event	Status of taxation
Theoretical	Recipient taxed on investment income earned on profit portion of prepayment; not taxed on investment income earned on non-profit portion	Recipient taxed correctly
Upfront inclusion	Recipient taxed on investment income earned on profit and non-profit portions	Recipient overtaxed (investment income earned on non-profit portion incorrectly taxed)
Notional loan	Recipient not taxed on any of the investment income	Recipient undertaxed (investment income earned on profit portion incorrectly exempt from tax)

Deferral	Recipient taxed on compound investment income earned on profit portion and compound investment income earned on non-profit portion	Recipient undertaxed (simple investment income earned on profit portion incorrectly exempt from tax) but also overtaxed (compound investment income earned on non-profit portion incorrectly taxed)

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Prepayments Versus Loans

Proponents of the notional loan method (and certain proponents of the deferral method) view the receipt of a prepayment as being analogous to the receipt of a loan.[29] These commentators generally argue that there is no substantive distinction between a loan and a prepayment; each amount is a cash receipt that carries with it an offsetting liability to repay either in cash (in the case of a loan) or in kind with property or services (in the case of a prepayment). Accordingly, the receipt of a | prepayment, like a loan, does not increase the recipient's wealth in the year of receipt because it is offset by the recipient's reciprocal obligation.

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For reasons similar to those set out above, in my view, the foregoing argument is not particularly compelling. The reason why a loan is not included in a borrower's income, at least in theory, is that the borrower has an unconditional obligation to repay, and the present value of the amount of that repayment obligation (the principal amount of the loan plus the interest thereon) is known with certainty—it exactly equals the amount of the loan. Accordingly, a borrower enjoys no net increase in wealth upon the receipt of the principal amount of a loan. For instance, turning to our previous example, if the $100 amount advanced to the recipient were a two-year loan at 10 percent interest, the present value of the obligation to repay the $100 principal plus the accumulated $21 interest expense in two years' time would exactly equal the $100 amount advanced. In this way, the receipt of a prepayment is fundamentally different from the receipt of a loan. Unlike a borrower, a recipient of a prepayment will often enjoy an increase in wealth in the year in which the prepayment is received. As discussed above, if the recipient in our example had no future costs associated with the rendering of the future services, he would enjoy a $100 net increase in wealth on receipt of the prepayment. In those cases where a recipient of a prepayment has future costs, the recipient should, in theory, be allowed an upfront deduction equal to the present value of the future costs of performing. However, the main point for the purposes of this discussion is that such costs will almost invariably differ from, and typically will be lower than, the "cost" of repaying a loan with cash. (In those cases where it is known from the outset that a "loan" will be "repaid" with property or the rendering of services, the "loan" should instead be considered and treated as a prepayment for the property or services, as the case may be.)

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Some commentators argue that a prepayment can be replicated by a loan that is coupled with a contract governing the future performance obligations of the recipient.[30] For instance, assume that the parties in our example structured the transaction as a two-year loan from the payer to the recipient, coupled with a forward agreement under which the payer agreed to pay for the recipient's services at the time of performance. Under this structure, instead of a prepayment made for services, the $100 payment in year 0 would be a two-year loan at 10 percent interest advanced from the payer to the recipient and repayable in year 2. In year 2, the aggregate payment of principal plus accumulated interest ($121) would not be required to be paid by the recipient, because it would be offset by the payer's obligation to pay $121 for the service at that time. (Alternatively, the parties could just exchange cheques for $121 at that time.) If the transaction were structured in this manner, the $100 payment in year 0 would not be included in the recipient's income because it would be a loan as a matter of law and not a prepayment.[31] However, this type of transaction is economically equivalent to a prepayment, and the two types of transactions are virtually identical in every other way. Accordingly, some commentators argue that an actual prepayment should similarly be excluded from the recipient's income in the year of receipt.[32] It is argued that an upfront | inclusion rule for prepayments would elevate the legal form of such payments over their economic substance. If a prepayment were included in income upon receipt, taxpayers would simply structure their transactions as loans or something other than prepayments (such as so-called refundable deposits), without changing the economic or commercial effects of the transactions.

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Although it is probably correct to say that the foregoing types of loan transactions should be taxed in the same manner as actual prepayments, it is not evident that both should be treated like "real" loans. The reason why the loan transaction described above "works" under current law to defer the recipient's income inclusion to the year of performance is that the transaction is not taxed correctly in economic terms. Although the amount of the loan in this type of transaction equals the present value of the recipient's cash repayment obligation (as is the case with any "real" loan), the cash repayment in turn equals the amount of the cash payment that the recipient will be entitled to receive from the payer for the services as they are rendered. Thus, the repayment of the loan by the recipient will exactly offset the payment received for the services; furthermore, as noted, the parties would likely agree to a contractual offset of those amounts without actually exchanging any cash. Accordingly, from the recipient's perspective, the receipt of the "loan" in this type of transaction is really offset only by the present value of the recipient's future costs of performing. If, as in our example, the recipient's future costs in such a transaction were nil, the full amount of the $100 "loan" would represent an accretion to wealth in the year in which it was received. In other words, this type of loan transaction is really a disguised prepayment. Since the parties to the transaction intend that the amount advanced will effectively be "repaid" by the delivery of the property or the rendering of the services, and not by cash, the amount advanced should be taxed in whatever manner is deemed appropriate for "actual" prepayments.

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Thus, for example, if it were determined that the deferral method was the appropriate method for taxing prepayments, the loan transaction discussed above should be treated in a similar manner. The deferral method could be replicated in the loan transaction by deferral of the deduction of the recipient's interest expense (assuming it was deductible) until the year of performance. Thus, if our example involved a loan transaction instead of an actual prepayment, such an approach would defer the deduction of the recipient's aggregate interest expense of $21 ($10 in year 1 and $11 in year 2) entirely to year 2. That $21 deduction would serve to partially offset the recipient's income inclusion of the $121 received for the service in year 2. The recipient would therefore include the net amount of $100 in year 2, as would occur in the "actual" prepayment example if the deferral method were applied. (Under the deferral method, the $100 prepayment received in year 0 would simply be included in income in year 2.)

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Notwithstanding the foregoing analysis, it is generally accepted that a prepayment should be treated as a notional loan for the purposes of taxing the *payer* of the amount.[33] Thus, the deduction of a prepayment for services (assuming that it is otherwise deductible) should be deferred until the year in which the service is | rendered, and imputed interest should be included in the payer's income in the interim. Under this view, the payer of the prepayment in our example would include $10 of imputed interest income in year 1 and a further $11 of imputed interest income in year 2, and would deduct $121 in year 2 when the service was rendered. The reason for deferral of the deduction in this situation is that the payer does not sustain a decrease in wealth in the year in which the payment is made. The prepayment is exactly offset by the present value of the service to which the payer is entitled (or, viewed another way, the prepayment is offset by the present value of the market cost of those services that the payer has saved by making the prepayment). Also, imputed interest should be included in the payer's income each year because the present value of the future service to which the payer is entitled will increase each year owing to the time value of money and the passage of time. This approach therefore treats the prepayment as a notional original issue discount loan made from the payer to the recipient; the performance of the service by the recipient constitutes the repayment to the payer of the principal amount and the accrued interest on the "loan." The loan analogy works from the payer's perspective because the recipient's costs of performing and fulfilling his contractual obligations, whether in cash (loan) or in kind (prepayment), are simply not relevant in determining the payer's change in wealth. For reasons discussed above, the same cannot be said of the recipient's change in wealth resulting from the receipt of a prepayment. In the case of an actual prepayment, the recipient often enjoys an increase in net wealth upon receipt; in the case of an actual loan, the recipient does not realize an increase in net wealth upon receipt.

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Prepayments Versus Deposits and the Recipient's Obligation To Refund

The increase in wealth represented by a prepayment will often be accompanied by a partial decrease in wealth owing to the recipient's potential obligation to refund the prepayment if the recipient does not perform as promised. In theory, this potential obligation should be valued by

multiplying the probability of refund by the present value of the amount that is potentially refundable. The value of the potential obligation, along with the present value of the recipient's future costs, would be subtracted from the amount of the prepayment in order to compute the recipient's net worth in the year of receipt. Obviously, such an approach would be highly impractical; the calculation would be difficult, if not impossible, to make in most circumstances, and it would require taxpayers to make highly subjective estimates. It would be much simpler and more practical to adopt either the upfront inclusion method or the deferral method, on the basis of some judgment as to average future costs associated with prepayments and/or the probability that a refund may be required. It is probably safe to say that in the vast majority of cases, the parties to a prepayment transaction fully intend that the recipient will retain the payment in consideration for performance under the contract, and that prepayments are typically retained rather than refunded. (So-called refundable deposits are discussed below.) If, on the other hand, the parties do not intend that the recipient will retain | the prepayment, the transaction is probably not a "true" prepayment. If it is intended that the amount will revert to the payer, the transaction arguably is either a temporary parking of the payer's cash or an attempt at a disguised loan.[34]

Interestingly, under the Canadian common law, whether or not a prepayment is included in income upon receipt is determined by reference to the recipient's obligation to refund—or, expressed another way, the recipient's right to retain (and not refund)—the prepayment. The issue of the recipient's future costs has not been advanced as justification for deferral in particular, or as an issue relevant to the tax treatment of prepayments in general. The Canadian courts have instead determined that a prepayment should be included in income upon receipt only if it has "the quality of income." An amount has the quality of income if the recipient's right to retain it is unconditional or is subject only to a condition subsequent. On the other hand, an amount does not have the quality of income if the recipient's right to retain it is subject to a condition precedent. From a policy perspective, a strict reliance upon the legal distinction between conditions precedent and subsequent in this regard is not particularly satisfying, since it can lead to the result that taxpayers in similar, if not identical, economic positions are taxed differently depending on the legal form of their respective transactions. For example, if a recipient's right to retain an amount received were conditional upon some element of performance under the contract, the amount would be retained if that performance occurred, and it would presumably be required to be refunded if the performance did not occur. Similarly, if non-performance were a condition subsequent, the amount would be retained if performance occurred, and it would be refundable if performance did not occur. However, under the quality-of-income concept, only in the latter case would the amount be included in income upon receipt.

Furthermore, the legal distinction in this regard is not necessarily dependent upon the likelihood that the underlying event will occur or not occur, and, as noted, the quality-of-income test is unconcerned with the recipient's anticipated future costs. Therefore, for example, it is entirely plausible that an amount received by one taxpayer could have the quality of income whereas an

amount received by another taxpayer would not have the quality of income, even if the latter had lower anticipated future costs coupled with a lower probability of refund. Perhaps more significantly, it is relatively easy for lawyers to massage the terms of a contract to create a condition precedent instead of a condition subsequent (or vice versa) without affecting the commercial or economic effects of the contract. The distinction between the types of conditions often appears to be a legal fiction that is not necessarily borne out in fact.

2002 CTJ 4 p.1260/1 The Taxation of Prepaid Income (Frankovic, J.)

It is sometimes argued that the income tax treatment of a deposit on account of a purchase of goods or services should differ from that of a prepayment for goods or services. Deposits are sometimes refundable unless and until the recipient performs and meets stipulated conditions under the contract or the payer breaches the contract. In these cases, where the recipient's liability to refund the deposit is unconditional or is subject only to a condition subsequent, the Canadian courts have held that the deposit is not included in the recipient's income upon receipt.[35] | As with prepayments, however, the difficulty with this approach is that the recipient's right to retain the deposit can often be characterized equally as a vested right subject to a condition subsequent (that the recipient breaches or does not perform satisfactorily) or a conditional right subject to a condition precedent (that the payer breaches or the recipient performs satisfactorily).[36]

2002 CTJ 4 p.1261 The Taxation of Prepaid Income (Frankovic, J.)

In some cases, a deposit may be refundable even if the recipient performs satisfactorily, so long as the payer has not breached the contract. Typically, however, if the recipient of such a deposit performs satisfactorily and renders the services (or delivers the property), the payer will be obligated either to apply the deposit toward the consideration for the services or, if the deposit is in fact refunded, to make an equivalent reciprocal payment for the services. (In the latter case, the parties would presumably agree to a contractual offset of the two amounts, rather than actually exchange cheques.) A distinction between prepayments and deposits is especially illusory in those cases where a deposit meant to secure a payer's commitment to pay for a service when it is rendered is ultimately applied toward such payment. As a general rule, most deposits, including so-called security deposits, are economically similar if not identical to prepayments.[37]

2002 CTJ 4 p.1261 The Taxation of Prepaid Income (Frankovic, J.)

As a matter of policy, there appears to be little reason why the foregoing types of payments should be taxed differently solely on the basis of their characterization as either deposits or prepayments. If the recipient of a deposit is reasonably assured of retaining the amount or receiving its financial equivalent upon satisfactory completion of the obligations under the contract, the deposit should be treated in the same manner as a "true" prepayment. In these circumstances, the differences between a deposit and a prepayment are negligible; the label attached to the amount received has nothing to do with the likelihood that the amount (or its equivalent) will ultimately be retained. On the other hand, a distinction can be made in those cases where the payer of a deposit has the right to "walk away" from the contract before performance and have the deposit fully refunded without making a reciprocal payment to the recipient. For example, some contracts might allow for a "cooling-off" period, during which the payer can demand a full refund of the deposit without consequence. In these cases, the deposit

should be treated in the same manner as a prepayment once this initial period has expired and it is reasonable to conclude that the recipient is assured of either retaining the deposit or receiving an equivalent reciprocal payment upon satisfactory performance under the contract.

2002 CTJ 4 p.1261/2 The Taxation of Prepaid Income (Frankovic, J.)

The Unique Cases of Prepaid Interest and Rent

Some commentators have used the examples of prepaid interest and prepaid rent in an attempt to illustrate that the upfront inclusion method is inappropriate.[38] In a typical example used in this regard, an investor/recipient purchases a five-year $1,000 bond bearing 10 percent annual interest and the issuer of the bond immediately prepays all five years' worth of interest for a total prepayment of $379 (the present value of the five years' interest discounted at 10 percent). After the prepayment, the recipient is left with $379 in cash plus the right to receive $1,000 in five | years, the latter of which has a present value of $621. Accordingly, the recipient's net worth after the prepayment exactly equals the recipient's net worth before the prepayment ($1,000). Viewed another way, the $379 prepayment is a partial return of the recipient's invested capital; on a net basis, only $621 of the recipient's capital remains invested in the bond. Accordingly, it is argued, it would be inappropriate to include the $379 payment in the recipient's income upon receipt. Instead, the $379 payment should be treated as a tax-free return of capital that would reduce the recipient's cost of the bond to $621. The annual increase in the present value of the $1,000 face amount of the bond (current present value of $621) would then be accrued into the recipient's income as interest over the course of the five years until the $1,000 amount was paid. In other words, the remaining portion of the bond (the right to receive $1,000 in five years) would be treated as an original issue discount loan that was issued for $621 and was repayable in five years at $1,000. The recipient would include in income 10 percent interest per year on the $621 amount over the five years, compounded annually, for a total amount of $379 of interest included over that period.[39] Effectively, the $379 prepayment would be amortized and included in the recipient's income in the five years in respect of which the interest was prepaid. By the end of the fifth year, the total amount of $379 of interest included in the recipient's income would have been added to the recipient's cost of the bond, which would then equal $1,000, and that amount could then be recovered as a tax-free return of capital as the $1,000 face amount of the bond was repaid.

2002 CTJ 4 p.1262 The Taxation of Prepaid Income (Frankovic, J.)

A similar analysis would apply to a prepayment of rent, for example, where a taxpayer purchases for $1,000 land that can earn a 10 percent annual rental return, rents out the land for five years at $100 per year, and immediately receives a prepayment of $379 on account of all five years' rental payments. The full amount of the $379 prepaid rent would not be included in the taxpayer's income upon receipt but rather would be spread over the five years in respect of which the rent was prepaid.

2002 CTJ 4 p.1262/3 The Taxation of Prepaid Income (Frankovic, J.)

Although the above analysis appears to support the deferral and/or notional loan methods of taxing prepaid income, it is actually rationalized under the theoretical method described earlier.

Recall that under that method, the (implicit or explicit) inclusion of a prepayment in the year of receipt is "offset" by the present value of the recipient's costs incurred in respect of the prepayment. A full offset of a prepayment is warranted only in the special case where the present value of the recipient's costs equals the amount of the prepayment. The prepaid interest and rent situations described above are examples of this special case. With prepayments of interest and rent, the analysis is unique because, unlike costs incurred in respect of other prepayments, the recipient's costs are incurred before both the receipt of the prepayment and the time at which the prepayment is earned. However, the key point, at least in each of the above examples, is that the recipient's costs equal the amount of the prepayment. Turning back to the five-year bond example, when the investor/recipient purchased the bond, he purchased the right to receive five annual $100 interest receipts plus the $1,000 principal receipt at the end of five years. | The aggregate $1,000 cost of the bond was simply the sum of the consideration paid for all of those cash receipts. Effectively, the cost of the right to receive five $100 annual payments was $379 and the cost of the right to receive the $1,000 in five years' time was $621 (for a total of $1,000). Thus, when the recipient received the $379 prepayment on account of the future interest, it was fully offset by the recipient's $379 cost of the right to receive that interest. Furthermore, since the recipient had no future costs in respect of the prepayment—the costs were incurred before receipt of the prepayment—there would be no imputed interest deduction each year on account of future costs, as would be the case with the theoretical treatment accorded to "regular" prepayments. A similar analysis can be applied to the prepaid rent example. The aggregate cost of the land to the recipient ($1,000) can be allocated between the right to earn rental income over the first five years (with a present value of $379) and either the right to earn 10 percent rental income from the land in perpetuity after the initial five-year period (with a present value of $621) or the right to repossess the land at the end of the five-year period (also with a present value of $621). The $379 prepayment of the five years' rent could therefore be viewed as being exactly offset by the recipient's "cost" of earning that rent.[40]

2002 CTJ 4 p.1263 The Taxation of Prepaid Income (Frankovic, J.)

Unlike other types of prepayments, prepaid interest and rent transactions are classic temporal "carveout" transactions. In either type of transaction, the recipient has disposed of a temporal right in respect of the underlying property (the right to receive interest or rent over the initial five-year period) while retaining the "reversionary interest" in the property (the right to the principal amount of the bond or the possession of the land at the end of the five-year period). For example, in the prepaid interest situation described above, the recipient effectively disposed of the right to receive interest income over five years (at a cost of $379) and received the prepayment (in the amount of $379) as consideration for that disposition. As with the disposition of any other asset, the recipient's cost of the right should be deducted from the proceeds of disposition in order to compute the recipient's net gain or profit on the transaction in the year of receipt, which in this case is nil. The recipient is left with a reversionary interest in the $1,000 principal amount of the bond, with a "cost" and a present value of $621. As discussed, it is appropriate to treat the reversionary interest as if it were an original issue discount obligation that was issued at a cost of $621 and was repayable in five years for $1,000. This treatment would see

the recipient include imputed interest on $621 at 10 percent per year, compounded, for a total of $379 of interest over the five-year period. The $379 amount would be added to the cost of the reversionary interest, leaving a total cost of $1,000 at the end of five years when the bond was redeemed.

2002 CTJ 4 p.1263/4 The Taxation of Prepaid Income (Frankovic, J.)

As illustrated above, if a recipient's cost of a bond is equal to the value of the bond at the time that interest thereon is prepaid, the recipient's "cost" of the prepaid interest should serve to "offset" the receipt of that interest. Since bonds and other debt instruments are generally non-appreciating assets, a taxpayer's cost of a bond will often be equal to, or at least approximately equal to, the value of the bond. Accordingly, it would be justifiable as a matter of policy to apply either the deferral method or the notional loan method to all prepayments of interest. (An exception | could apply for those rare cases where the taxpayer's cost of the bond or other debt instrument was significantly less than its value.) Paradoxically, under the Act, prepaid interest is fully included in income in the year of receipt, and, in contrast to the treatment of prepayments for goods and services, no reserve is available to defer the recognition of prepaid interest.[41] As discussed, a reserve would be more justifiable in the case of prepaid interest (since the recipient's costs will typically "offset" the prepayment in full) relative to prepayments for property and services (since the recipient's costs will not typically "offset" the prepayment in full). However, the exact opposite is true under the Act.

2002 CTJ 4 p.1264 The Taxation of Prepaid Income (Frankovic, J.)

In the case of other "carved-out" properties, such as land and other rental property for which rent has been prepaid, the recipient's cost of the carved-out asset will typically differ from its value.[42] Accordingly, in these cases, the prepaid rent should be recognized in whatever manner is deemed appropriate for other prepayments (since, with most other prepayments, the recipient's costs will also differ from the value of the property or service and the amount of the prepayment). Interestingly, under the Act, a reserve is allowed for prepaid rent only if the rent is included in the recipient's income from a business; the reserve does not apply to rent that is received as income from property. However, in the past, the CCRA has indicated that the recognition of prepaid rent that is income from property may be deferred to the year in which it is earned, in accordance with the GAAP treatment.[43]

2002 CTJ 4 p.1264 The Taxation of Prepaid Income (Frankovic, J.)

Taxation of the Investment Income Earned on a Prepayment

Some critics of the deferral and notional loan methods have argued that the application of either method effectively allows a recipient to invest a prepayment and earn a tax-exempt return thereon between the time of receipt and the time of the deferred income inclusion.[44] This view is based on the well-known principle, described earlier, to the effect that the deferral of the recognition of an amount received or accrued (the prepayment) is the equivalent of "properly" including that amount in income (upon receipt) but then permanently exempting from tax the return earned on that amount over the period of deferral (from the time of receipt to the time of the deferred inclusion).[45] These commentators argue that the investment return earned by the

recipient will be taxed properly only if the prepayment is fully included in income upon receipt and all of the investment income generated thereon is subject to tax.

Although these commentators raise a valid point in this regard, they are not entirely correct if they are asserting that all of the income earned by investing a prepayment should be taxed to the recipient. As discussed earlier, if a prepayment were taxed in the theoretically correct manner, the recipient would be taxed on the investment income earned on the after-tax profit portion of the prepayment up to the time of performance, but would be allowed to invest the non-profit portion of the prepayment and earn a tax-free return on that investment owing to the imputed interest deduction reflecting the recipient's future costs. Accordingly, as illustrated earlier, the notional loan method would "incorrectly" exempt from tax | only the recipient's investment income earned on the profit portion of the prepayment, whereas the deferral method would "incorrectly" exempt from tax only the simple investment income earned on the profit portion.[46] Under the theoretically correct approach, the investment income earned on the non-profit portion would be exempt from tax in any event.

In contrast to the above argument, some commentators argue that the upfront inclusion method results in double taxation of the investment income earned on a prepayment.[47] It is generally accepted that the payer of a prepayment should be taxed on imputed interest on the prepayment until the underlying services are rendered or the property is delivered. (For instance, according to this view, the payer of the $100 prepayment in our example would include $10 of imputed interest income in year 1 and a further $11 of imputed interest income in year 2.) Assuming that the payer should be taxed in the foregoing manner, it is argued that the upfront inclusion method must be incorrect because it would effectively impose double tax on the imputed interest and/or the actual investment income earned on the prepayment, since both the payer and the recipient would be taxed on that interest or income.

For reasons discussed above, the position adopted by these commentators is also not entirely accurate. If the recipient of a prepayment were taxed under the theoretically correct approach, the recipient would be taxed on the income earned by investing the after-tax profit portion of the prepayment, but not on the income earned by investing the non-profit portion of the prepayment. Accordingly, the upfront inclusion method would "incorrectly" tax the recipient's investment income only to the extent that it was earned on the non-profit portion of the prepayment. If both the payer and the recipient were taxed in the theoretically correct manner, there would be so-called double taxation in respect of the investment income earned on the after-tax profit portion of the prepayment in any event.

Furthermore, the foregoing "partial double taxation" is arguably consistent with the taxation of transactions other than prepayments, in any case where the payer of an amount is required to capitalize his cost and the recipient is required to include the entire amount in income in the year of receipt. That is, where the cost of an outlay is capitalized and depreciated so as to coincide

(more or less) with the loss in its economic value, it can be shown that the payer of the outlay is effectively taxed on imputed interest computed on the amount of the outlay until the deduction is claimed in full.[48] Assuming that the recipient of the outlay is required to include such amount in income upon receipt and that the recipient makes a profit on the transaction, the recipient will be taxed on any income earned by investing the after-tax profit. In other words, the partial double taxation appears to apply equally to unearned receipts such as prepayments and earned receipts that are received upon performance, to the extent of the recipient's profit portion of the receipt.

2002 CTJ 4 p.1265/6 The Taxation of Prepaid Income (Frankovic, J.)

Although Johnson does not make the profit/non-profit distinction that is made here, he advances a similar argument that the tax position of the recipient of an amount who then invests that amount should not depend on whether the payer of the amount was required to capitalize or to immediately deduct the amount: |

> There can be no general principle that a recipient of a capital expenditure should exclude the receipt on the ground that the payment was capitalized on the other side. The government makes revenue from the tax system only because, when recipients pay tax on a receipt, the payers do not immediately deduct the payment. There certainly can be no general proposition that a dollar bill is tax-exempt because somebody has already paid tax on the dollar as it circulated. If there is a tax burden on the prepayment, it is no different from the tax on earned amounts that are capital expenditures on the payer's side.[49]

2002 CTJ 4 p.1266 The Taxation of Prepaid Income (Frankovic, J.)

Nonetheless, in the case of prepayments, the so-called double taxation issue is a concern because the taxation of the investment income earned by the recipient up to the time of performance would not have occurred had the payment instead coincided with the performance. For example, assume that, instead of agreeing to a prepayment, the taxpayers in our example entered into a contract in year 0 under which the payer agreed to pay $121 for the recipient's services in year 2 when they were rendered. In such case, the payer would be taxed on the investment income earned from year 0 to year 2 on the amount set aside to fund the payment. The recipient would simply include the $121 in income in year 2 and obviously would not be taxed on any investment income in respect of that amount from year 0 to year 2. Accordingly, as between the prepayment case and the payment-upon-performance case, the double taxation issue is real and problematic. In the prepayment case, assuming that the upfront inclusion method were applied, all of the investment income in respect of the prepayment could be subject to taxation twice; in the payment-upon-performance case, all of that investment income would be subject to tax only once, in the hands of the payer.

2002 CTJ 4 p.1266/7 The Taxation of Prepaid Income (Frankovic, J.)

Interestingly, the reason why there is no double taxation concern in the payment-upon-performance case is that the recipient is not taxed correctly in economic terms. That is, since the recipient under that scenario entered into a contract in year 0 entitling him to be paid $121 for services in year 2, the recipient's net worth has increased as of year 0, probably by an amount somewhere in the vicinity of $100 (the present value of the $121 amount) and by a

further $10 in year 1 and $11 in year 2.[50] If the recipient were required to include these changes in wealth in his income, the same double taxation concern would arise as seen in the prepayment/upfront inclusion case, since both the payer and the recipient would be taxed on imputed interest or investment income earned on the $100 amount from year 0 to year 2. Obviously, under our income tax system, the recipient in the payment-upon-performance case is not subject to taxation in this manner. Furthermore, it is probably safe to say that our tax laws will never require a taxpayer to recognize income upon entering into a valuable contract for future services so as to "crystallize" the present value of future income. As a result, if our income tax system employed the upfront inclusion method for prepayments, the double taxation issue would discourage taxpayers from entering into prepayment transactions owing to the fact that they would be taxed more heavily relative to payment-upon-performance transactions. Similarly, the upfront inclusion method would raise tax equity concerns, | since recipients of prepayments would be treated differently from recipients in a similar economic position who received payments upon performance.

Assessment of the Three Methods on the Basis of Neutrality

For reasons discussed in the preceding section, and ignoring for the moment the taxation of the payer of a prepayment, both the deferral and the notional loan methods appear to be more neutral than the upfront inclusion method.[51] As noted, if our example were a payment-upon-performance case, the recipient would simply include $121.00 in income in year 2 when the service was rendered, which would net the recipient $60.50 after tax in year 2. In the prepayment case, this after-tax result could be replicated if the notional loan method were applied (net $60.50 after tax in year 2)[52] and could be closely replicated if the deferral method were applied (net $60.25 after tax in year 2).[53] In contrast, if the upfront inclusion method were applied to the prepayment case, the recipient would end up significantly overtaxed relative to the payment-upon-performance case (net $55.12 after tax in year 2).[54] Accordingly, the application of the upfront inclusion method would potentially discourage taxpayers from entering into prepayment transactions, even if such transactions made sense from a commercial perspective relative to payment-upon-performance transactions.

Accounting for the Payer

Deductible Prepayments

Of course, whether neutrality is achieved also depends on the method by which the payer of the prepayment is taxed. For example, assume that prepayments were both fully deductible to the payer and fully taxable to the recipient in the year of receipt, and that the payer was also in a 50 percent tax bracket. If such an upfront deduction/upfront inclusion approach applied to our example, the $100.00 prepayment would net the recipient, and cost the payer, $50 in terms of year 0 after-tax dollars or $55.12 in terms of year 2 after-tax dollars.[55] As a result, relative to the

payment-upon-performance case, the recipient would be overtaxed and the payer would be undertaxed by $5.38 (the difference between $60.50 and $55.12), and thus, tax equal to such amount would effectively be shifted from the payer to the recipient. However, in order to compensate for this shift in taxation, the recipient would likely request, and the payer would likely be willing to provide, a payment in excess of the before-tax present value of the future service. Presumably, the parties would agree to adjust the year 0 prepayment upward to $109.75 (the present value of $121.00 discounted using the *after-tax* discount rate of 5 percent) from the previous $100.00 amount (the present value of $121.00 discounted using the *before-tax* discount rate of 10 percent). After such an adjustment, the application of the upfront deduction/upfront inclusion approach would provide the same result as that seen in the payment-upon-performance scenario: the prepayment would net the recipient, and cost the payer, $60.50 in terms of year 2 after-tax dollars.[56] Thus, in this circumstance, the upfront inclusion method would be neutral. Unfortunately, | the problem with the upfront deduction/upfront inclusion combination, as illustrated, is that the payer's tax burden would effectively be shifted to the recipient. As a result, this approach would be completely neutral only if the payer and the recipient were in similar taxable positions from the time of prepayment to the time of performance. It would not provide an appropriate result if the recipient were in a lower tax bracket than the payer or if the recipient could employ unused tax losses. In these instances, some income would escape taxation and the savings in tax could be shared between the parties. Conversely, if the recipient were in a higher tax bracket, the transaction would be overtaxed on the whole relative to payment upon performance. In these cases, neutrality presumably would not be achieved.

2002 CTJ 4 p.1268 The Taxation of Prepaid Income (Frankovic, J.)

In contrast, if the notional loan approach applied to both the payer and the recipient, none of the payer's tax burden would be shifted to the recipient relative to the payment-upon-performance case.[57] If such an approach were applied to our example, the $100.00 prepayment would net the recipient, and cost the payer, $60.50 in terms of year 2 dollars,[58] the same result that occurs with payment upon performance. Under such an approach, owing to the fact that no income would be shifted to the recipient, neutrality could be achieved whether or not the payer and the recipient were in similar tax positions.

2002 CTJ 4 p.1268 The Taxation of Prepaid Income (Frankovic, J.)

Under the Act, a deferral/deferral approach is employed with respect to the deduction/inclusion of most prepayments. Under subsection 18(9) ¨ ¨, the deduction by the payer of most types of prepayments is deferred until the year of performance, and, as discussed, the inclusion by the recipient of most prepayments for goods and services may similarly be deferred to the year of performance. If this deferral/deferral approach were applied to our example, the prepayment would net the recipient, and cost the payer, $60.25 in terms of year 2 dollars.[59] Accordingly, relative to the payment-upon-performance case, the recipient would be overtaxed and the payer would be undertaxed by $0.25, so that tax equal to such amount would effectively be shifted from the payer to the recipient. (The parties might agree to gross up the $100.00 prepayment by a nominal amount in order to compensate for this shift in taxation.) Therefore, although neutrality

can often be achieved using the deferral/deferral approach, the approach is slightly imperfect owing to the fact that some taxation is shifted to the recipient. (For example, if the recipient were in a lower tax bracket than the payer, neutrality would not always be achieved.) However, owing to the fact that less taxation is shifted from the payer to the recipient under this approach relative to the upfront deduction/upfront inclusion approach (in our example, a $0.25 shift versus a $5.38 shift), the deferral/deferral approach is superior in terms of achieving neutrality.

2002 CTJ 4 p.1268/9 The Taxation of Prepaid Income (Frankovic, J.)

Non-Deductible Prepayments

The above discussion assumes that the prepayment is deductible for the payer. In the case of non-deductible prepayments, such as those for personal consumption, the upfront inclusion method appears to be more neutral in many circumstances. For instance, if the $100.00 prepayment in our example were non-deductible, it would simply cost the payer $100.00 as of year 0, which is equivalent to $110.25 in | year 2 after-tax dollars.[60] Therefore, relative to payment upon performance, the payer would be undertaxed by $10.75 in year 2 dollars ($121.00 minus $110.25). As noted, if the upfront inclusion method applied to the recipient, the $100.00 prepayment would net the recipient $50.00 in year 0, which would grow to $55.12 after tax as of year 2. Accordingly, relative to payment upon performance ($60.50 as of year 2), the recipient would be overtaxed by $5.38 in year 2 dollars. Therefore, tax in the amount of $5.38 would effectively be shifted from the payer to the recipient. However, owing to this shift in taxation (and the related fact that the payer would be not taxed on any imputed interest or investment income earned on the prepayment), the payer would likely be willing to prepay up to $109.75 in year 0.[61] In other words, a non-deductible prepayment of $109.75 would put the payer in the same after-tax position as in the $121.00 payment-upon-performance case.[62] If the prepayment were in fact increased to $109.75, the payer would net $54.87 after tax in year 0 and $60.50 after tax as of year 2,[63] also the same result as in the case of payment upon performance. Accordingly, neutrality would be achieved in these circumstances. However, owing to the effective shift in taxation, neutrality would not always be achieved if the payer and the recipient were in different taxable positions.

2002 CTJ 4 p.1269 The Taxation of Prepaid Income (Frankovic, J.)

Nonetheless, the results under the upfront inclusion method would generally be superior to those under the deferral and notional loan methods. As noted, a non-deductible $100.00 prepayment in our example would undertax the payer by $10.75 in year 2 dollars relative to payment upon performance. If the notional loan method applied to the recipient, the $100.00 prepayment would net the recipient $60.50 in year 2 after-tax dollars, the same result that occurs with payment upon performance. Accordingly, since the payer would be undertaxed without any corresponding shift of taxation to the recipient, the prepayment would always be tax-preferred relative to payment upon performance (unless the payer was non-taxable). Since the prepayment would result in overall tax savings ($10.75 in our example), the recipient might be able to negotiate a higher prepayment in order to share in those savings.

2002 CTJ 4 p.1269 The Taxation of Prepaid Income (Frankovic, J.)

If the deferral method applied to the recipient, the $100.00 prepayment would net the recipient $60.25 in year 2 after-tax dollars, so that the recipient would be slightly overtaxed (by $0.25) relative to payment upon performance. Thus, as noted earlier, there would be a slight shifting of taxation ($0.25) from the payer to the recipient. Since the payer would otherwise save $10.75 in year 2 dollars on the transaction, the parties might again negotiate a higher prepayment than $100.00 in order to share the tax savings. However, the net result would still be tax-preferred relative to payment upon performance.

2002 CTJ 4 p.1269/0 The Taxation of Prepaid Income (Frankovic, J.)

In the above analysis, I have assumed that it is unlikely that our income tax system would ever require payers of non-deductible prepayments, and in particular those of a personal nature, to include imputed interest in income in respect of such prepayments. As the reader may appreciate, if payers in these circumstances were in fact taxed on the imputed interest, an analysis similar to that provided in the preceding section on deductible prepayments would demonstrate that both the deferral and the notional loan methods would be more neutral than the upfront inclusion | method. In a similar vein, both methods would be superior to upfront inclusion if the prepayments was not discounted and the payer received (actual) interest on the prepayment. For instance, if the prepayment in our example equalled $121, the recipient would presumably pay 10 percent annual interest to the payer on such amount owing to the fact that the payment was not discounted to reflect the time value of money. If this were the case, the payer would include the interest in income in each of years 1 and 2, and, for reasons similar to those provided in the preceding section, both the deferral and the notional loan methods would be more neutral than the upfront inclusion method.

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Payments by a Tax-Exempt Payer

Finally, if the payer of a prepayment were a tax-exempt entity, both the notional loan and the deferral methods would be more neutral than the upfront inclusion method. Owing to the payer's tax-exempt status, there would never be any "shifting" of taxation from the payer to the recipient, so that any overtaxation of the recipient of a prepayment relative to payment upon performance—such as that seen under the upfront inclusion method—could not be offset by the undertaxation of the payer. Accordingly, under upfront inclusion, the prepayment would always be taxed more heavily relative to payment upon performance. (It can similarly be shown that, if the recipient were tax-exempt, the application of either a notional loan or a deferral method to the *payer* would be more neutral than an upfront deduction.)

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Summary

In summary, for prepayments that are deductible for the payer (or are made by a tax-exempt payer), the notional loan and deferral methods would be significantly more effective in achieving neutrality relative to the upfront inclusion method. In the case of non-deductible prepayments, the upfront inclusion rule often would be more neutral. However, it would be somewhat impractical

for an income tax system to adopt an approach whereby it applied the more apposite rule on the basis of whether the prepayment was deductible to the payer. Such an approach would impose upon the recipient the unfair burden of assessing the tax treatment of the prepayment to the payer. The government might attempt to categorize prepayments depending on whether they were normally of a personal nature (non-deductible) or a commercial nature (deductible), and apply the upfront inclusion method to the former and either the deferral or the notional loan method to the latter. Of course, it would be simpler to apply one method across the board, perhaps on the basis of some judgment as to whether or not prepayments are usually deductible and which method would least influence taxpayers' behaviour. As discussed above, our income tax system generally employs a deferral approach for both payers and recipients of prepayments, so that the tax treatment is presumably relatively neutral in respect of most types of deductible prepayments. Furthermore, as noted above, the deferral approach should be relatively neutral (and more neutral than upfront inclusion) in the case of non-discounted prepayments that bear interest, whether or not the prepayment is deductible for the payer. |

Deferral as the Second-Best Alternative

Assuming that the theoretical approach cannot be reasonably employed, the deferral method is arguably justified as the second-best alternative for reporting prepaid income. The argument in favour of deferral presupposes that in most cases, the present value of the recipient's future costs equals or exceeds one-half of the prepayment received. Under this assumption, the deferral method will generally provide the second-best measure of the recipient's net change in wealth from the time of the receipt of the prepayment to the time of performance. Furthermore, the deferral approach is generally more neutral than upfront inclusion. The notional loan approach would be more neutral if it applied to both recipients and payers, although nominally so. However, the deferral method is simpler and generally provides a better approximation of the recipient's income position.

The Taxation of Prepaid Income Under Canadian Law

Overview of the Common Law and Statutory Rules

Under the Canadian common law, an amount received may be included in income if the recipient's right to the amount is absolute and unconditional as to its disposition, use, or enjoyment.[64] Such an amount is said to have "the quality of income," which apparently is another way of saying that the amount has been realized.[65] The Canadian courts have determined that an amount received has the quality of income if the recipient's right to retain it is unconditional or is subject only to a condition subsequent. Expressed another way, an amount received is included in income if the recipient's obligation to repay the amount (if there is such an obligation) is conditional. On the other hand, if the recipient's right to retain the amount is conditional, the amount will be included in the recipient's income only once the right vests unconditionally, an

event that normally coincides with the moment at which the recipient no longer has an unconditional obligation to repay.

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Accordingly, under the common law, the issue of whether prepaid income should be included in income upon receipt is determined by reference to the recipient's potential obligation to repay or refund. In contrast, under paragraph 12(1)(a) ¨ ¨ of the Act, it appears that prepaid income is included in income in the year of receipt regardless of the recipient's potential obligation to refund.[66] However, a reserve is provided under paragraph 20(1)(m) ¨ ¨ which effectively allows the recognition of the amount to be deferred to a future year if the amount is in respect of goods to be delivered or services to be rendered in that future year, or in respect of rent for that future year. Therefore, in many cases, the recognition of prepaid income may be deferred to the year in which it is in fact earned. As discussed earlier, the reserve was enacted to bring the income tax treatment of prepaid income in line with the financial accounting treatment, which similarly defers the recognition of prepaid income until it is earned. The apparent objective of the statutory treatment is to match the prepaid income to the expenses incurred in earning the income. Accordingly, in contrast to the common law rationale that looks to the potential obligation | to refund, the statutory treatment appears to be premised on the notion that the "net income" of the recipient of a prepayment is best measured by deferring the recognition of the prepayment to the year in which the recipient will incur the costs of performance.

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This part of the article discusses the income tax treatment of prepaid income both under the common law and under the Act. As noted, the quality-of-income test is essentially based on the existence of conditions precedent versus conditions subsequent, and in particular, whether the recipient's right to retain the amount received is conditional or unconditional. Unfortunately, there has been considerable confusion over the meaning and application of the quality-of-income concept. Although the early case law indicated that an amount could have the quality of income before it was earned, subsequent cases have held that once an amount is found to have the quality of income, it is earned as a matter of law. In other words, these later cases have equated the quality-of-income test with the earning requirement. Under this view, which is apparently accepted by the CCRA, once an amount has the quality of income, it is included in income in the year of receipt in the computation of profit under section 9 ¨ ¨ and the reserve under paragraph 20(1)(m) ¨ ¨ is not available. Other prepaid amounts, presumably those without the quality of income, are included in income in the year of receipt under paragraph 12(1)(a) ¨ ¨; and in many (but not all) cases, the reserve under paragraph 20(1)(m) effectively allows the recognition of the amount to be deferred until the year in which it is earned.

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The Judicial Development of the Quality-of-Income Requirement

The quality-of-income concept originated in the *Robertson* case, where Thorson J of the Exchequer Court laid down the following test to determine whether amounts received by a taxpayer should be included in income:

> 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 (1934)]. 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?[67]

The taxpayer in the *Robertson* case was an insurance agent that earned commissions in respect of workers' compensation premiums written with an underwriter. The insured employers were required to pay both a "minimum fee" and an "advance fee" to the underwriter in respect of the insurance premiums. The advance fee was based on an employer's estimates of its payroll over the insured period. The underwriter held the advance fee as a deposit until the employer's actual payroll | (which would determine the underwriter's "earned premiums" in respect of that payroll) was in fact ascertained. If, upon final audit of the employer's payroll, the earned premiums exceeded the advance fee, the employer was required to pay the difference to the underwriter; if the earned premiums were less than the advance fee, the underwriter was required to refund the difference to the employer. However, the underwriter was entitled to retain the minimum fee regardless of the audit of the payroll and the amount of the earned premiums. The taxpayer received commissions in respect of both the advance fees and the minimum fees received by the underwriter. The issue before the court was whether the commissions should have been included in the taxpayer's income in the year of receipt or in the year in which the employer's payroll, and thus the earned premiums of the underwriter, were finally ascertained.

Thorson J held that the commissions earned in respect of the minimum fees should be included in the year of receipt. He held that both the right of the underwriter to retain the minimum fees and the corresponding right of the taxpayer to retain the commissions earned on those fees were absolute and unrestricted when the fees were received. Accordingly, these commissions had the quality of income at the time of their receipt by the taxpayer. However, Thorson J held that the commissions in respect of the advance fees should not be included in the taxpayer's income upon receipt. Thorson J held that the right of the underwriter to retain an advance fee for its own use did not arise until the employer's payroll was in fact ascertained. Accordingly, until that right of retention arose, neither the advance fee nor the commissions earned in respect of that fee had the quality of income in the hands of the underwriter or the taxpayer, respectively.

The quality-of-income rationale employed in *Robertson* was applied by the Federal Court of Appeal in the *Commonwealth Construction* decision.[68] In that case, the taxpayer received certain amounts pursuant to a court judgment to which the opposing party filed an appeal. Until the appeal was resolved, the taxpayer was under no restrictions as to the use of the funds, although it

would be obliged to repay them in whole or in part in the event that the appeal was successful. The appeal was ultimately settled in a taxation year subsequent to the year in which the funds were received. The Federal Court of Appeal held that the amounts were included in the taxpayer's income in the year in which they were received because they had the quality of income in that year. The court interpreted and applied the principles from the *Robertson* case as follows:

> To apply phrases from that quotation [the quality-of-income test in the *Robertson* case] to the case at bar, the record discloses that the rights of the appellant to the amounts paid to it in 1974 and 1975 were "absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment." They were not held subject to any specific and unfulfilled conditions. Once the conditions precedent imposed in the letter agreements between the parties, supra, had been fulfilled, as they were, the right to receive the moneys and to retain them had accrued and was absolute. True, it might be necessary to return the moneys in whole or in part if the | appeal were successful. But, as I see it, that was a condition subsequent which did not affect the unrestricted right of the appellant to use them until such a requirement occurred. It did not, as I see it, affect their quality as income upon receipt.
>
> As to the difference in effect of a condition precedent from a condition subsequent on the question of an accrual to income, the learned trial judge relied on a quotation from *Meteor Homes Ltd. v. Minister of National Revenue*, 61 DTC 1001 at 1007 & 1008 which substantiates the view which I expressed, *supra*:
>
> > . . . Mertens, Law of Federal Income Taxation, Vol. 2, c. 12, p. 127, considers "the problem of when items are . . . deductions to the taxpayer on the accrual basis," and deals with it at p. 132 in these terms:
> >
> > Not every contingency prevents the accrual of income: the contingency must be real and substantial. A condition precedent to the creation of a legal right to demand payment effectively bars the accrual of income until the condition is fulfilled, but the possible occurrence of a condition subsequent to the creation of a liability is not grounds for postponing the accrual.[69]

The Federal Court of Appeal reproduced this quotation and applied the same rationale in its decision in the *Foothills Pipe Lines* case.[70] The taxpayer in that case sustained substantial costs in planning and designing the second phase of a pipeline project. In order to enable the taxpayer to recover these costs before the second phase, the National Energy Board allowed it to levy special charges to shippers that used the pipelines during the first phase. The charges were to be repaid upon completion of the second phase, on such terms as would be determined by the board. (At the time of trial, the second phase had not been completed and the board had not made any such determination of repayment.) The minister assessed the taxpayer and included the charges in the taxpayer's income in the year in which they were received. The taxpayer argued that the charges should not have been included in its income, because it had a current and existing obligation to repay them, albeit in the future. The court agreed with the minister and held that the

charges were to be included in income in the year in which they were received. The court found that the taxpayer's right to retain the charges was absolute and unconditional, and accordingly, they had attained the quality of income; the obligation to repay them was a contingent liability. In reaching its decision, the court noted the significance of the contractual terms as between the payer and the recipient of an amount received:

> If an amount received is, as here, in the nature of income, the fact that in the future the recipient may be under an obligation to repay it does not change the character of the receipt from income to a liability whether deferred or otherwise. In reaching such a conclusion it is important to have regard to the terms of the contract under which the amounts in question were paid.
>
> Here the shipper was obligated by its agreement with the Respondent to pay a monthly cost of service charge for the gas it transmitted through the pipeline during that month. . . . It is crystal clear from that agreement, that the right of receipt of payment for the provision of service is absolute and unconditional. The fact that a | portion of it relating to the Special Charge may some time be subject to repayment does not, in my view, change the character of the payment, which is income, to that of a liability.[71]

More recently, in the *Ikea* case,[72] the Supreme Court of Canada applied the quality-of-income test and held that a tenant inducement payment received by the taxpayer should be included in income in the year of receipt. The court found that the sole condition precedent to the receipt of the payment under the tenant inducement contract was the assumption of the taxpayer's obligations under the lease agreement. The court thus concluded that the right to the inducement payment became absolute when the taxpayer entered into the lease. On a more general level, the court held that the quality-of-income concept is synonymous with the realization principle and that it applies equally to amounts received and amounts not yet received by a taxpayer. The court quoted from the *Robertson* and *Foothills Pipe Lines* decisions with approval and held:

> The combined effect of these passages is to confirm what in the law of income tax has become known as the "realization principle," given that an amount may have the quality of income even though it is not actually received by the taxpayer, but only realized in accordance with the accrual method of accounting. The ultimate effect of this principle is clear: amounts received or realized by a taxpayer, free of conditions or restrictions upon their use, are taxable in the year received, subject to any contrary provision of the Act or other rule of law. The T.I.P. [tenant inducement payment] received by Ikea in the present case fits this description perfectly. The tenant inducement agreement made it clear that the sole condition precedent to receipt of the payment was the assumption of Ikea's obligations under the lease agreement, and further stipulated that the payment was to be made within seven days of Ikea's commencing business in the premises, pursuant to the lease. Thus, Ikea's right to the payment became absolute at that time. There were no further strings attached such as to postpone actual realization or receipt into a subsequent taxation year, and the payment was received in full by Ikea in 1986. Therefore, I conclude

that the entire amount was taxable in that year.[73]

On occasion, when considering the quality-of-income requirement, the courts have taken into account the likelihood that the recipient will be required to refund the amount received.[74] However, it seems clear that the likelihood of repayment or refund is not determinative. The decisive factor remains the existence or non-existence of a legal contingency. For example, in the *Imperial General Properties* case, where the Federal Court of Appeal held that a deposit received by the taxpayer on a sale of land was not included in income in the year of receipt, the court concluded:

> Admittedly, the likelihood of repayment of the deposits was higher in the *Atlantic Engine Rebuilders* case than it is in the instant case, *but the critical factor is the contingency itself*. I would therefore hold that the $70,000 on deposit is not income received in 1968 [emphasis added].[75] |

In the *Northern and Central Gas Corporation* case,[76] the taxpayer was required to include in income the "inventory gain" portion of proceeds received on the sale of its gas. In the taxation year in question, the Ontario Energy Board increased the rates that could be charged to the taxpayer's customers. The inventory gain represented a portion of the proceeds received in the year by the taxpayer on the sale of its stored gas at these increased rates (the stored gas had been purchased previously, when prices were lower). The inventory gain was included in the taxpayer's income even though it was virtually certain that it would be passed on or "refunded" to the taxpayer's customers in the following taxation year, when the board intended to delay the implementation of a subsequent rate adjustment. (It was the board's policy to ensure that the taxpayer did not benefit from the inventory gain, and that the gain was instead passed on to the taxpayer's customers.) Despite this near certainty, the court held that the inventory gain had the quality of income. The court held that, unlike the advance fee in the *Robertson* case (one of the "deposit cases" referred to below), the taxpayer's right to the gain was absolute when it was received and the taxpayer's liability to refund the gain was conditional even though it was most likely to materialize:

> It is clear that the sums in question cannot be brought within the scope of the deposit cases cited by the Plaintiff. The Plaintiff had a legal and absolute right to the use of the money when it was received. There were no restrictions in its right to the money; there were no unfulfilled conditions precedent. The money was clearly income in the hands of the Plaintiff when received. . . .
>
> There is no doubt that the Plaintiff could anticipate that it would be required to "refund" the inventory gain to its customers by virtue of a February 1978 decision. There is no doubt that an accountant would deem it necessary to reflect this fact in the books of the company but it cannot be said to be an expense for tax purposes. It was a reserve for a contingent liability. The fact that the amount of the liability was ascertainable and that the probability of it not becoming payable was very small (almost infinitesimally small) does

not affect the nature of the liability (refer: *Guay* case (*supra*)). There was no legal liability on the Plaintiff at the end of 1977 to "refund" the sum to its customers.[77]

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In summary, the Canadian courts have established that an amount received by a taxpayer should not be included in the taxpayer's income if there is a condition precedent to the taxpayer's ultimate entitlement to retain the amount. On the other hand, if the taxpayer's entitlement to the amount is subject only to a condition subsequent, the amount should be included in the year of receipt. Thus, for example, in the context of prepaid income, if a recipient's right to retain the prepayment is conditional upon some element of performance under the contract, the payment does not attain the quality of income unless and until that performance occurs. On the other hand, the fact that a prepayment will have to be refunded if the recipient does not perform as promised does not necessarily mean that it lacks the quality of income in the year of receipt. That is, the failure to perform could be a condition subsequent, in which case the prepayment would be included in the year of receipt. | As discussed in the first part of this article, the legal distinction between conditions precedent and subsequent in this regard can be problematic, particularly since it can lead to different treatment of taxpayers in similar economic positions, depending on the legal form of their respective transactions.[78] Difficulties in this regard have arisen in the case law, where virtually identical transactions have been taxed differently owing to the legal distinction between conditions precedent and subsequent. For example, in the *Sinnott News*[79] and *Harlequin Enterprises*[80] cases, the taxpayers distributed periodicals (*Sinnott News*) and books (*Harlequin*) to dealers and wholesalers who had the absolute right to return for full credit those publications that they did not sell within a specified period. In the *Sinnott News* decision, the Supreme Court of Canada held that the taxpayer's distribution of the periodicals did not constitute outright sales but rather sales on a "sale or return" basis. The court concluded that title to the periodicals did not pass to the dealers except to the extent that they sold the periodicals or retained them beyond the specified period. Until one of those events occurred, the taxpayer had no legal right to enforce payment of the sale price of the periodicals and such amounts were not required to be included in the taxpayer's income. In contrast, in the *Harlequin Enterprises* decision, the Federal Court of Appeal held that the taxpayer was required to include the sale price of all books in income at the time of their distribution. The court distinguished the case from *Sinnott News* on the grounds that, pursuant to the written agreements between the taxpayer and the wholesalers, the sales were "outright" sales whereby title to the books vested in the wholesalers at the time of their delivery. Accordingly, the taxpayer's entitlement to payment was absolute and its obligation to accept and provide a full credit for any unsold books was conditional.

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The application of the quality-of-income concept can result in certain recipients being subject to a greater tax burden relative to other recipients who enjoy greater accessions to wealth (or a lesser tax burden relative to other recipients who enjoy less wealth). As discussed, the distinction between conditions precedent and subsequent is not dependent upon the likelihood that the underlying event will occur, nor, in the case of prepaid income, is it dependent upon the

recipient's future costs. Therefore, for example, an amount received by one taxpayer could have the quality of income whereas an amount received by another taxpayer might not have the quality of income, even if the latter had lower future costs coupled with a lower probability of refund. In the context of prepaid income, these issues would not be particularly problematic if the paragraph 20(1)(m) ¨ ¨ reserve were always available. However, the reserve does not apply to all forms of prepaid income, nor does it apply to receipts that are similar to, though not strictly, prepaid income (for example, the amounts received by the taxpayers in the *Foothills Pipe Lines*, *Ikea*, and *Northern and Central Gas* cases). Perhaps more significantly, as discussed later in the article, it appears that the reserve does not apply to any amount received (whether prepaid income or not) that has the quality of income.

On the positive side, one might argue that the quality-of-income approach has a relatively high degree of certainty, in that the legal tests on contingencies are well | established and understood by judges and lawyers. The approach is simple to administer; there is no need to estimate the probability of refund or the recipient's anticipated costs of performance. The quality-of-income concept appears to be better suited to receipts that are not prepaid income in the true sense—that is, receipts that are coupled only with a potential obligation to refund, and not those that are received on account of goods or services or other future performance to be provided by the recipient. As discussed in the first part of the article, in principle, the timing of the recognition of prepaid income is generally best resolved by reference to the recipient's future costs of performance rather than the potential obligation to refund.

The Judicial Distinction Between Deposits and Prepayments

In addition to establishing the quality-of-income concept, the *Robertson* decision is authority for the proposition that a deposit that is meant to secure the completion of the contract by the payer of the deposit is not included in the recipient's income upon receipt. In *Robertson*, Thorson J held that the advance fee paid to the underwriter in that case was in the nature of a security deposit and thus lacked the quality of income until such time as the recipient became unconditionally entitled to retain the amount:

> The nature of a "deposit" paid by one of the parties to a contract to the oiler [sic] was fully discussed by the English Court of Appeal in the leading case of *Howe v. Smith* [(1884), 27 Ch. D 89]. In that case, a sum was paid as "a deposit in part payment of the purchase price." The court gave the term "deposit" the same meaning as that of "earnest," and regarded it as security for the completion of the contract by the payer of the deposit. It should, in my opinion, have a similar meaning in the present case, that of security by the employer that he would perform his part, of the contract, namely, pay 25% or 30% of the normal premium when it could be ascertained.
>
> Where an amount is paid as a deposit by way of security for the performance of a contract and held as such, it cannot be regarded as profit or gain to the holder until the

circumstances under which it may be retained by him to his own use have arisen and, until such time, it is not taxable income in his hands, for it lacks the essential quality of income, namely, that the recipient should have an absolute right to it and be under no restriction, contractual or otherwise, as to its disposition, use or enjoyment.[81]

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Subsequent courts have therefore attempted to differentiate between deposits and prepayments for property or services (since the former are apparently not included in income upon receipt whereas the latter may be included in income upon receipt). Unfortunately, the courts have not clearly differentiated between the two types of payments, nor have they provided a convincing rationale as to why they should be treated differently for income tax purposes.

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In the *Diamond Taxicab* case,[82] the taxpayer provided certain services to taxicab owners and operators pursuant to written service contracts with those parties. For each contract, the taxpayer received an initial fee upon entering into the contract | in addition to monthly fees that were payable during the term of the contract. The issue was whether the initial fees should have been included in the taxpayer's income upon receipt. The Exchequer Court found that the contracts required the taxpayer to furnish its services in return for both the initial fees and the additional monthly fees. The court reasoned that since no one could obtain the services from the taxpayer without a contract and without having paid the initial fee, the initial fee was part of the consideration paid by the purchaser in order to obtain the services from the association. Accordingly, the initial fee was included in the taxpayer's income upon receipt. The Supreme Court of Canada upheld the decision without reasons.

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In a similar fact situation in the *Dominion Taxicab* case,[83] again the taxpayer was a taxicab association that received amounts from its members upon entering into service contracts. However, the amounts were described in the contracts as "deposits." Following the decision in *Diamond Taxicab*, whose facts were said to bear a close similarity to those in the case at hand, the Exchequer Court held that the deposits should be included in the taxpayer's income upon receipt. However, upon appeal, the Supreme Court of Canada held that the deposits should not be included in the taxpayer's income. The Supreme Court determined that, pursuant to the terms of the contracts, each deposit would become property of the taxpayer only if the depositing member left the association and the parties failed to agree on a satisfactory successor to the retiring member. The court held that unless and until the necessary conditions were fulfilled to give absolute ownership of a deposit to the taxpayer, such deposit could not properly be regarded as a profit from the appellant's business. Interestingly, the court also held that each deposit received by the taxpayer was offset by a corresponding contingent liability on the part of the taxpayer to return the deposit.[84] In other words, the court held that although the taxpayer's entitlement to each deposit was conditional, the taxpayer's requirement to refund the deposits also was conditional. The court acknowledged that the contracts did not stipulate when or even if the members would be entitled to a refund of the deposits. However, the court did not find it necessary "to decide under what circumstances a member might require the return of his deposit

as I think it clear that the moneys deposited did not become the absolute property of the Association."[85] The court went on to distinguish the *Diamond Taxicab* decision on the grounds that the circumstances of that case showed that the amounts in question had been paid "outright" as part of the consideration for future services, and that no question of a deposit arose.

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The *Dominion Taxicab* case illustrates the difficulty with the state of the common law as it relates to deposits and similar receipts. The deposits in the case could easily have been characterized as either amounts that did not vest in the taxpayer until certain conditions were fulfilled, or amounts that vested in the taxpayer upon receipt and which the taxpayer had a conditional obligation to repay. Yet, as discussed, the Supreme Court held that even though the deposits did not vest in the taxpayer, the taxpayer's liability to repay the deposits to its members was conditional. Although | the position is not entirely clear, the decision in *Dominion Taxicab* therefore appears to stand for the proposition that an amount received may be considered a non-taxable deposit if it is not part of the consideration paid for the services (or property) and the recipient's entitlement to the amount is conditional, notwithstanding that the taxpayer's liability to refund also may be conditional. Yet, by virtue of the quality-of-income requirement, an advance payment made as part of the consideration for future services (or property) would similarly be excluded from the recipient's income if the recipient's entitlement to the amount were conditional, say, upon performing adequately under the contract. Accordingly, it would appear that little, if anything, should turn on the issue of whether such a receipt is characterized as either a deposit or a prepayment.

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In the *Atlantic Engine Rebuilders* case,[86] the taxpayer rebuilt engines for automobile dealers. When a rebuilt engine was shipped to a dealer, the dealer was charged the invoice price of the rebuilt engine plus a monetary deposit, which was refunded once the dealer delivered a used "rebuildable" engine to the taxpayer. The amount of the deposit was typically three times higher than the market value of a used rebuildable engine. The deposit was deliberately set at a high figure in order to ensure that a used engine would be delivered to the taxpayer as soon as possible. However, there was no fixed time limit for the delivery of the used engine, and there was no provision for the forfeit of the deposit or for its application in discharge of the dealer's obligation to deliver an engine. The issue in the case was whether deposits that had not been refunded to dealers by the end of the relevant taxation year should have been included in the taxpayer's income in that year.

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Thurlow J of the Exchequer Court held that the deposits were security deposits rather than partial payment of the consideration for the rebuilt engines. Despite this finding, Thurlow J held that the deposits should be included in the taxpayer's income because they were receipts of an income nature, in that they arose from and formed part of the taxpayer's trading transactions. However, the judge allowed the taxpayer to recognize the liability to refund the deposits that arose on their receipt, on the grounds that this liability was not contingent and thus not prohibited by the predecessor to paragraph 18(1)(e) ¨ ¨. Therefore, the net effect of the decision was to exclude the

deposits from the taxpayer's income, since the deduction of the liability served to offset the inclusion of the deposits. The Supreme Court upheld the result on appeal, although, contrary to the rationale provided by Thurlow J, it did not agree that the deposits should be included in income. The court simply concluded that, having regard to the "all the realities of the situation," there was no basis upon which the deposits could properly be treated as trading receipts of the taxpayer. The court also noted that the taxpayer's "legal ownership" of the deposits was irrelevant in this regard:

> The question of substance in this case appears to me to be whether in stating what its profit was for the year the respondent could truthfully have included the sum in question. To me there seems to be only one answer, that it could not. It knew that it might not be able to retain any part of that sum and that the probabilities were that | 96% of it must be returned to the depositors in the near future. The circumstance that the respondent became the legal owner of the moneys deposited with it and that they did not constitute a trust fund in its hands appears to me to be irrelevant; the same may be said of moneys deposited by a customer in a Bank which form part of the Bank's assets but not of its profits. To treat these deposits as if they were ordinary trading receipts of the respondent would be to disregard all the realities of the situation.

> The grounds upon which Thurlow J. based his decision appear to me to be supported by the reasoning of the majority of this Court in *Dominion Taxicab Association v. Minister of National Revenue*, *supra*, at p. 85, where it is stated that as each deposit was received by the Association and became a part of its assets there arose a corresponding contingent liability equal in amount. This was one of the grounds on which it was held that the deposits formed no part of the profits of the Association. Since that decision there has been no substantial change in the wording of the sections of the *Income Tax Act* on which the appellant relies.
>
> What appears to me to be decisive is the fact that there is no basis, having regard to the realities of the situation, on which these deposits can properly be treated as ordinary trading receipts of the respondent which it was entitled to include in calculating its profits for the year. . . .
>
> In my opinion, nothing in the *Income Tax Act* requires these deposits to be treated as profits of the respondent.[87]

It is not apparent what "realities of the situation" were so decisive in the court's decision. The court did not expressly rule on whether the deposits were received conditionally (although it agreed that the taxpayer became legal owner of them) or whether the taxpayer's obligation to refund was conditional. The court noted that the decision by Thurlow J appeared to be supported by the reasoning in the *Dominion Taxicab* decision, where it was held that the taxpayer's deposit carried with it a corresponding contingent liability. However, as noted above, Thurlow J held that the taxpayer's liability to refund in the case at hand was not contingent. Presumably, the

"realities" that swayed the court included the 96 percent probability that the deposits would be required to be returned to customers upon the presentation of used engines. In any event, despite the lack of substantive analysis in the case, the court's decision to exclude the full amount of the deposits from the taxpayer's income was likely the correct one. It is relatively clear that the deposits simply secured the purchasers' commitment to deliver used engines and that the used engines, and not the deposits, were meant to be part of the consideration paid to the taxpayer for the rebuilt engines. Although the decision to exclude the deposits from income had the effect of understating the taxpayer's income position (the taxpayer had no future costs, having already delivered the rebuilt engines), the inclusion of such deposits in income upon receipt would have seriously overstated that position, owing to the fact that they were three times the value of the used engines ultimately provided as consideration (in 96 percent of cases) for the rebuilt engines.

The taxpayer in the *Imperial General Properties* case,[88] upon entering into an agreement of purchase and sale of one of its properties, received $70,000 ostensibly | as part of the purchase price of the property. The remainder of the purchase price was payable after the end of the year in which the agreement was made. The agreement provided that if certain conditions were not fulfilled within a specified period of time, the purchaser was required either to complete the transaction and waive the conditions, or to terminate the transaction, in which event he would be entitled to the return of all monies paid to the taxpayer under the agreement. The Federal Court of Appeal held that the $70,000 amount should not be included in the taxpayer's income in the year of receipt. Referring to this amount as a "deposit," the court held that the critical factor in this regard was the contingency relating to the amount; apparently, the taxpayer would not become absolute owner of the funds until one of the above-noted conditions was fulfilled. Unfortunately, the court did not explain why the $70,000 was considered a deposit rather than a partial prepayment for property, or whether such a distinction was relevant to the decision.

In summary, the distinction made by the courts between deposits and prepaid consideration for property or services is not particularly compelling. It is not even clear why the distinction is relevant for income tax purposes; the applicable common law rule—the quality-of-income concept—looks to the recipient's entitlement to the amount received, presumably whether it is considered a deposit or a partial prepayment. On the other hand, the courts' decisions might be interpreted as implying that a receipt to which the recipient is not unconditionally entitled may be considered a non-taxable deposit, whereas a receipt to which the recipient is unconditionally entitled (subject only to a possible condition subsequent) may be considered a taxable prepayment. In other words, perhaps the courts are implicitly saying that an amount received under a contract for future performance will be considered a prepayment only if it has attained the quality of income; if it has not attained the quality of income, it may be considered a non-taxable deposit. However, as discussed in the first section of this article, such a legal distinction is rather illusory in those cases where a deposit that is meant to secure a payer's commitment under a contract to pay for services when they are rendered is ultimately applied toward the purchase price of the services, and in similar cases where the deposit is refunded by

the recipient upon the payer's providing a reciprocal payment in consideration for the services (or where the two amounts are simply offset).[89] In these cases, it is reasonable to conclude that where the recipient of a deposit is assured of retaining the amount or of receiving its financial equivalent upon satisfactory completion of the obligations under the contract, the deposit should be treated in the same manner as a "true" prepayment. As a general rule, there is little or no substantive difference between deposits on account of goods or services and prepayments for goods or services.

In spite of the above concerns and the ambiguity found in the cases, much of the discussion herein would be of only academic interest if the statutory rules relating to deposits, prepayments, and similar receipts were applied consistently to all such receipts. Unfortunately, as discussed below, there is considerable confusion surrounding the application of these rules. |

The Statutory Rules Governing the Taxation of Prepaid Income

Inclusion and Deferral Under Paragraphs 12(1)(a) and 20(1)(m)

The statutory scheme relating to the taxation of prepayments, deposits, and other unearned amounts received by a taxpayer appears, on its face, to be straightforward and uncontroversial. Under paragraph 12(1)(a) ¨ ¨, any amount received in a taxation year in the course of a business which is on account of services not rendered or goods not delivered by the end of the year, or which for any other reason may be regarded as not having been earned in the year, is included in income in the year.[90] The provision thus appears to apply to any amount received in the course of a business which is unearned as of the end of the year of receipt. As discussed earlier, a reserve is available under paragraph 20(1)(m) ¨ ¨ for such amount to the extent that it relates to property that will have to be delivered or services that will have to be rendered after the end of the year, or, in the case of prepaid rent, to the extent that the amount relates to periods after the end of the year for which the rent was prepaid.[91] The reserve is allowed in respect of the gross amount received that relates to such future performance or future period,[92] presumably because the recipient's profit on the transaction (prepayment in excess of costs) will typically not be known until the year of performance (when the costs are actually incurred).[93] Under paragraph 12(1)(e) ¨ ¨, the reserve claimed in a particular year is added back into income in the following year. An additional reserve is allowed in the following year in respect of goods to be delivered or services to be rendered (or prepaid rental periods) in a subsequent year, and the pattern continues until that subsequent year, at which point the reserve is no longer allowed. Accordingly, the taxation of the amount received can normally be deferred to the year in which it is in fact earned.[94] If the amount is repaid, a final deduction is available under paragraph 20(1)(m.2) ¨ ¨ in the year of repayment. As discussed earlier, the recognition of such prepaid amounts for income tax purposes generally parallels the treatment under GAAP.

Interestingly, the paragraph 20(1)(m) ¨ ¨ reserve does not apply to all unearned receipts. For

example, the reserve does not apply to prepaid rent that is income from property or prepaid interest that is income from either property or a business. In the past, the CCRA has indicated that the inclusion of prepaid rent that is income from property—and thus included in income under section 9 ¨ ¨ rather than paragraph 12(1)(a) ¨ ¨—may be prorated over the periods in respect of which it is prepaid, in accordance with the GAAP treatment.[95] Unfortunately, it is not clear whether this position is correct as a matter of law.[96] Prepaid interest, on the other hand, is fully included in the recipient's income in the year of receipt, under either paragraph 12(1)(c) ¨ ¨ or subsection 12(3) ¨ ¨, so that the GAAP treatment is clearly irrelevant. Paradoxically, as discussed earlier, it would be more defensible as a matter of policy to defer the recognition of prepaid interest than to allow deferral for most other forms of prepaid income.[97]

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It is not clear whether a "security deposit" in respect of a purchase of goods or services is included in income under paragraph 12(1)(a) ¨ ¨.[98] As discussed earlier, | some contracts will call for such a deposit as a way of guaranteeing the purchaser's commitments under the contract or at least affirming the purchaser's intentions to fulfill the terms of the contract. Whether and when the deposit is refundable to the purchaser will depend on the terms of the contract and any relevant laws that have a bearing on such amount. For example, the contract may provide that the purchaser is entitled to a refund of the deposit unless he withdraws from the contract or otherwise breaches the contract. In other cases, the purchaser may be entitled to a refund of the deposit if the goods or services do not meet certain specifications under the contract. Arguably, such deposits should be considered as being "on account of" the goods not delivered or the services not rendered, even though they may not be the consideration ultimately given for the goods or services. Regardless of the validity of that position, these types of deposits presumably fall within the category of unearned receipts, and as such, they should be included under paragraph 12(1)(a), even if they are not strictly considered to be "on account of" goods not delivered or services not rendered. However, in the *Imperial General Properties* case,[99] the Federal Court of Appeal found that the predecessor to paragraph 12(1)(a) did not apply to a deposit received by the taxpayer from the prospective purchaser of some real estate from the taxpayer. As described earlier, the purchase and sale agreement provided that if certain conditions were not fulfilled within a specified period of time, the purchaser was required either to complete the transaction and waive the conditions, or to terminate the transaction, in which event he would be entitled to the return of the deposit. The court concluded that the predecessor to paragraph 12(1)(a) could not have been intended to apply to deposits other than the deposits that were contemplated by the predecessor to subparagraph 12(1)(a)(ii) ¨ ¨ (deposits for returnable containers). The court went on to hold that the deposit should not be included in the taxpayer's profit in the year of receipt under general principles, because one of the conditions of the agreement remained unfulfilled as of the end of that year.

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If a deposit is not included in the year of receipt under paragraph 12(1)(a) ¨ ¨, it will be included in the computation of profit under section 9 ¨ ¨ if and when it attains the quality of income. As

discussed above, a deposit will attain the quality of income once any conditions precedent to the recipient's entitlement to the deposit have been fulfilled. Presumably, in most cases, this will occur when the subject property is delivered or the service is rendered—in other words, when the deposit is in fact earned. If it is not earned and it is subsequently refunded, the amount will never be included in the recipient's income. These results are generally the same as those that would have occurred had the deposit instead been included under paragraph 12(1)(a). That is, the reserve under paragraph 20(1)(m) ¨ ¨ would have allowed the recipient to defer the recognition of the amount unless and until it was earned; and if the amount were refunded—that is, it was never earned—a final deduction under paragraph 20(1)(m.2) ¨ ¨ would have been allowed. However, the paragraph 20(1)(m) reserve is optional, so that an inclusion under paragraph 12(1)(a) (as opposed to section 9 ¨ ¨) provides the recipient with more flexibility in this regard. For example, if the recipient had expiring loss carryforwards, the recipient might choose to recognize all or part of the prepayment in the year of receipt. |

The CCRA has taken the position that paragraph 12(1)(a) ¨ ¨ applies equally to prepayments and deposits.[100] However, on one occasion, the CCRA stated that deposits are not included under paragraph 12(1)(a) if they do not have the quality of income.[101] Under this view, it appears that deposits and unearned receipts without the quality of income are not included in income under either section 9 ¨ ¨ or paragraph 12(1)(a). However, on other occasions, the CCRA has stated that receipts with the quality of income are considered "earned" and are included under section 9, whereas receipts that do not have the quality of income are unearned and are therefore included under paragraph 12(1)(a).[102] These issues, and in particular the relevance of the quality-of-income concept to amounts described in paragraph 12(1)(a), are discussed below.

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The Quality-of-Income Requirement Applied to the Statutory Scheme of Taxing Prepaid Income

An interesting and rather contentious issue is the applicability of the quality-of-income test to the unearned amounts described in paragraph 12(1)(a) ¨ ¨. In the *Robertson* case, Thorson J held that an unearned receipt would nonetheless be included in income if it exhibited the quality of income:

> It seems equally clear that if income is received in any one year it is taxable in that year, *even although* [sic] *it has not yet been earned*, and it follows that the appellant was not entitled to make any deduction from income received by it in any year on the ground that it was not earned in such year.
>
> This does not, however, dispose of this appeal, *for 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. . . .* Is his right to it absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment

[emphasis added]?[103]

It is evident from this passage that Thorson J viewed the issue of whether a receipt had the quality of income as separate and distinct from the issue of whether the receipt was earned. The statement clearly indicates that a receipt may attain the quality of income even if it is not earned.[104]

The above passage also clearly indicates that an unearned receipt that lacks the quality of income should not be included in income. Accordingly, one might argue that only unearned receipts with the quality of income should be included under paragraph 12(1)(a) ¨ ¨. Under this view, paragraph 12(1)(a) would apply to an amount received where the recipient's right to retain the unearned amount was absolute and, if subject to any condition, subject only to a conditional obligation to refund the amount. The provision therefore would not apply to an unearned amount such as a deposit, if the recipient's right to it were conditional upon the fulfillment of specified conditions under the contract, the approval of the payer, or any other event.

In my view, it is questionable whether the quality-of-income test is relevant in determining whether an amount should be included in income under paragraph 12(1)(a) ¨ ¨. | At the time of the *Robertson* decision, which was decided under the *Income War Tax Act*,[105] the provision did not exist and there was no comparable provision dealing specifically with unearned receipts. The statutory provision at issue was a general one that defined income as (among other things)

> the net annual profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount . . . or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling or from any trade, manufacture or business, as the case may be . . . and also the annual profit or gain from any other source.[106]

Thorson J used the quality-of-income test in the *Robertson* case to determine whether the amounts at issue could be regarded as "profit or gain" from the taxpayer's business under general principles and thus be recognized as income under the above provision. Analogously, under the current Act, the quality-of-income test has been employed to determine whether an amount received should be included under general principles in the computation of profit under section 9.[107] It is, however, questionable whether the quality-of-income concept is relevant to the application of paragraph 12(1)(a) ¨ ¨, which expressly includes all unearned amounts received in the course of a business, whether or not (one would think) such amounts would otherwise be considered "gain," "profit," or indeed "income" under general principles. In this regard, when the predecessor to paragraph 12(1)(a) was introduced into the Act, a renowned commentator at the time stated that it was "beyond doubt" that the provision extended to all of the prepayments described therein.[108]

On the other hand, given the events leading up to the enactment of the predecessors to current paragraphs 12(1)(a) ¨ ¨ and 20(1)(m) ¨ ¨, one could argue that paragraph 12(1)(a) was not intended to expand the category of unearned receipts beyond those that were included in income under the common law. In a series of prepaid income cases in the early 1950s that involved the 1948 *Income Tax Act*,[109] the Tax Appeal Board held that the prepaid amounts should be included in income in the year of receipt.[110] In these cases, the Tax Appeal Board distinguished the prepaid amounts from the advance fees in the *Robertson* case (those that had not attained the quality of income), on the grounds that the taxpayers in these cases were under no obligation to refund the amounts and were free to deal with the funds as they pleased; in other words, the amounts had the quality of income.[111] Furthermore, the taxpayers were not allowed deductions on account of their future obligations to perform, since these obligations were conditional and such deductions would be tantamount to claiming reserves that were not allowed under the 1948 Act. The applicable provisions of the 1948 Act were section 4 ¨ ¨, which was virtually identical to current section 9 ¨ ¨, and paragraph 12(1)(e) ¨ ¨, which disallowed a deduction for reserves and contingent accounts and was the predecessor to current paragraph 18(1)(e) ¨ ¨. It is therefore relatively clear that prepaid income that had the quality of income was | to be included in profit under the predecessor to section 9, and that no deduction or reserve was allowed in respect of such income, owing to the restriction in the predecessor to paragraph 18(1)(e).

As a result of these cases and others that effectively prohibited the deduction of reserves in respect of unearned income and deferred income, the accounting profession lobbied for changes to the legislation.[112] The government responded to the accountants' concerns by introducing certain "special reserves" in section 85B of the 1952 *Income Tax Act*,[113] which included the predecessor provisions to paragraphs 12(1)(a) ¨ ¨ and 20(1)(m) ¨ ¨ and stated that the predecessor to paragraph 12(1)(a) was enacted for greater certainty. Accordingly, it might be assumed that these provisions were enacted to provide that the recognition of certain types of prepaid income that would otherwise be included in income as profit (on the basis of the common law at that time) could be deferred pursuant to the newly enacted reserve. Assuming that this was the case, the predecessors to paragraph 12(1)(a) and paragraph 20(1)(m) were apparently intended to cover prepaid income that was otherwise included in profit under the predecessor to section 9 ¨ ¨, namely, prepaid income that had the quality of income. (In other words, the government introduced the provisions as relieving measures and did not intend to expand the ambit of the taxation of unearned receipts.) On the basis of this interpretation, it appears that only prepaid income with the quality of income should be included under paragraph 12(1)(a) (and presumably also under section 9) and that prepaid income without the quality of income should not be included in income at all.

To complicate matters further (or perhaps simplify them, depending on your point of view), courts in recent years have held that the quality-of-income requirement is synonymous with the earning requirement. According to this interpretation, if an amount received has the quality of

income, it is earned as a matter of law and included in income under section 9 ¨ ¨ and not paragraph 12(1)(a) ¨ ¨. In other words, under this view, prepayments cannot be unearned and exhibit the quality of income at the same time. Accordingly, the amounts described and included in income under paragraph 12(1)(a) are only such amounts without the quality of income.

In the *Burrard Yarrows* case,[114] for example, the taxpayer was a shipbuilder hired to construct two ferries for the federal Crown. The contract called for progress payments payable to the taxpayer as various stages of the work were completed. The contract also specified that property in the ferries, as well as all machinery, equipment, and materials, vested in the Crown as soon as they were intended for use. The taxpayer included the progress payments in income in the year of receipt under paragraph 12(1)(a) ¨ ¨ and claimed a reserve under paragraph 20(1)(m) ¨ ¨ on the basis that the progress payments would not be earned until a subsequent year. The essence of the taxpayer's position was that the contract was for the sale of goods, namely, the two ferries, so that the progress payments received in the year were received on account of goods that were not delivered before the end of that year. Joyal J of the Federal Court Trial Division disagreed and held that the progress payments were earned in the year of receipt and therefore included in income under section 9 ¨ ¨. In his view, the taxpayer, upon completing each of the various | stages of construction, became absolutely entitled to the progress payments received in respect thereof. Accordingly, the payments attained the quality of income in the year of receipt, which, according to Joyal J, meant that they were earned. Since paragraph 12(1)(a) applied only to unearned amounts, that provision did not apply. The payments were therefore included in income under section 9 and were not eligible for the paragraph 20(1)(m) reserve. In reaching his conclusion, Joyal J interpreted the *Robertson* quality-of-income test as an earning test:

> Therefore, to determine whether a paragraph 20(1)(m) ¨ ¨ reserve is available with respect to the progress payments in question, it must be determined whether they were brought into income pursuant to subparagraph 12(1)(a)(i) ¨ ¨, *which in turn requires a determination of when they were "earned" or, in other words, when they took on the quality of income*.
>
> A great many cases have dealt with this issue. One test which has been relied upon frequently (see for example *Commonwealth Construction Co. v. The Queen*, 84 DTC 6420 (F.C.A.)) is found in *Robertson Ltd. v. M.N.R.*((1944), 2 DTC 655 (Ex. Ct.)). There, Thorson, J., as he then was, stated:
>
> > . . . 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*. . . .In my judgment, the language used by him . . . 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?
>
> In the present case, the plaintiff, upon completing each of the various stages of

construction, became absolutely entitled to receive the progress payments which had been agreed upon. Its right to those amounts was under "no restriction, contractual or otherwise, as to its disposition, use or enjoyment." The contract did not even contain a provision requiring refunding of the progress payments in the event of the plaintiff defaulting. *As a result, I find that the progress payments had the quality of income when received and, hence, were earned amounts. It follows, therefore, that subparagraph* 12(1)(a)(i) ¨ ¨ does not operate to bring the payments into income, and, further, that the Minister was correct in denying the plaintiff's claim for a paragraph 20(1)(m) ¨ ¨ reserve. The plaintiff must bring the progress payments into income in the year they are received [emphasis added].[115]

For reasons discussed earlier, this interpretation of the *Robertson* decision must be considered incorrect; in that case, Thorson J viewed the earning requirement as separate and distinct from the quality-of-income requirement. Nonetheless, the *Burrard Yarrows* decision was upheld by the Federal Court of Appeal, and unfortunately, the appellate court simply stated that it agreed with the reasons given by the trial judge. The decision thus leaves opens the possibility that an amount received in a year on account of goods not yet delivered or services not yet rendered could nonetheless be earned in the year by reason of its having attained the quality of | income. By virtue of the *Burrard Yarrows* decision, such amount would presumably be included in income under section 9 ¨ ¨ rather than paragraph 12(1)(a) ¨ ¨ and the application of the paragraph 20(1)(m) ¨ ¨ reserve would thus be precluded. One could argue that such an interpretation would contradict the clear inference from the wording of paragraph 12(1)(a) that the delivery of goods and the rendering of services are considered "earning events" for income tax purposes. The provision refers to an amount received in a year "on account of services not rendered or goods not delivered before the end of the year *or that, for any other reason, may be regarded as not having been earned in the year* [emphasis added]." Accordingly, it appears that the drafters of the provision considered that amounts received on account of goods not delivered or services not rendered constituted amounts not earned. However, one could also argue that the fact that the provision of goods or services is considered an earning event does not necessarily lead to the conclusion that a prepayment is always unearned until the provision of the goods or services.[116] In other words, it is conceivable that a prepayment could become earned before the occurrence of the "normal" earning event of the provision of the goods or services.

It is also unfortunate that the *Burrard Yarrows* decision did not rule on the issue of whether the contract was a sale of goods, as contended by the taxpayer, or a sale of materials coupled with the rendering of services, as contended by the Crown. If the contract was for services, the progress payments were apparently received for services already completed, and if so, they were likely earned upon receipt. Similarly, if the contract involved the rendering of services coupled with a sale of "goods" that included the machinery, equipment, and materials that vested in the Crown as soon as they were intended for use, the progress payments were presumably earned upon receipt. Accordingly, under either of these interpretations, the court likely came to the correct

conclusion in deciding that the payments were earned and included in income under section 9 ¨ ¨ rather than paragraph 12(1)(a) ¨ ¨. However, if the contract was for a sale of the ferries themselves, the payments presumably were on account of goods not yet delivered. Under this interpretation of the contract, the payments should have been included in income under paragraph 12(1)(a) and eligible for the paragraph 20(1)(m) ¨ ¨ reserve.

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The *Burrard Yarrows* case illustrates the difficulty of characterizing the nature of the income-earning activities carried on under typical construction or manufacturing contracts. Under most such contracts, the income received by the contractor could be considered income from the rendering of services, income from the sale of goods and materials used in the construction process, or, most likely, income partly from the rendering of services and partly from the sale of goods and materials. Under any of these interpretations, progress payments received on account of services rendered and/or goods and materials "delivered" (title to the goods passing to the purchaser during construction) presumably would be earned upon receipt. If, on the other hand, such a contract were construed as a sale of the completed product, then, as noted, any payments received before the year of completion would presumably be included under paragraph 12(1)(a) ¨ ¨ and would be eligible for the paragraph 20(1)(m) ¨ ¨ | reserve (since the final product would not yet be "delivered"). Paradoxically, under this latter interpretation, the recognition of the revenues would be deferred until the product was completed, as it would be under the completed contract method of accounting that has been rejected by the courts as an inappropriate method of reporting income under general principles.[117]

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Subsequent to the decision in the *Burrard Yarrows* case, other courts have similarly held that the quality-of-income requirement is only a restatement of the earning requirement. In the recent *Huang and Danczkay* decision, the Federal Court of Appeal reached such a conclusion based on its interpretation of the *Robertson* and *Ikea* decisions:

> Both *Robertson* and *IKEA* are cases involving the treatment of amounts actually received, and the issue was whether the amounts received had the character of income in the hands of the recipient at the time of receipt, or whether the recognition of the amount as income could be deferred. The principle that emerges from these cases is that an amount that has actually been received has the character of income at the time of receipt if the recipient has done what is required to earn it, and thus has an immediate and unrestricted right to dispose of it.[118]

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For reasons discussed earlier, the Federal Court of Appeal's interpretation of the *Robertson* decision in this regard is likely incorrect. Furthermore, the Supreme Court's decision in the *Ikea* case did not explicitly deal with the issue of earning. In that case, the Supreme Court held that a tenant inducement payment included in the taxpayer's profit under section 9 ¨ ¨ should be recognized entirely in the year of receipt because it attained the quality of income in that year. The Supreme Court reached this conclusion without ruling on the issue of earning. It is possible

that the court tacitly concluded that the inducement payment was earned at the time that it achieved the quality of income, but it is also possible that the court considered the earning issue to be irrelevant. Unfortunately, other leading decisions dealing with section 9 and the quality-of-income requirement have similarly failed to rule explicitly on the earning issue.[119]

As discussed earlier, on several occasions the CCRA has held that unearned receipts that lack the quality of income are included in income under paragraph 12(1)(a) ¨ ¨, whereas receipts that have the quality of income are considered earned (and not on account of goods not delivered or services not rendered) and therefore are included in income under section 9 ¨ ¨.[120] It has been noted that one of the practical concerns in this regard is the availability of the paragraph 20(1)(m) ¨ ¨ reserve. This particular concern would be alleviated if paragraph 20(1)(m) were amended to ensure that it applied to amounts described in paragraph 12(1)(a), whether they were included in income under paragraph 12(1)(a) or under section 9. Although the wording of paragraph 20(1)(m) appears to indicate that this is already the case,[121] the court in *Burrard Yarrows* held otherwise:

> Therefore, to determine whether a paragraph 20(1)(m) reserve is available with respect to the progress payments in question, it must be determined whether they | were brought into income *pursuant to* subparagraph 12(1)(a)(i) ¨ ¨, which in turn requires a determination of when they were "earned" or, in other words, when they took on the quality of income [emphasis added].[122]

It could be argued that the court was only providing a convenient summary of the provisions in this regard and that this statement was not intended to represent a holding in the decision.[123] Unfortunately, other courts have made comments to the same effect, and the CCRA appears to have adopted this position.[124] In fact, the CCRA made this argument in the recent *Blue Mountain* case.[125] The taxpayer received proceeds on the sale of season passes near the end of its taxation year which entitled the holders to use the taxpayer's skiing and indoor tennis facilities for the season that began after the end of the taxation year. The taxpayer included the proceeds in income under paragraph 12(1)(a) ¨ ¨ and deducted the same amount under paragraph 20(1)(m) ¨ ¨, on the grounds that all of the taxpayer's services would be rendered after the end of the year. The CCRA reassessed the taxpayer, holding that the proceeds were earned in the year in which they were received so that paragraphs 12(1)(a) and 20(1)(m) did not apply. In support of its position, the CCRA argued that the taxpayer was under no restriction, contractual or otherwise, as to the disposition, use, or enjoyment of the proceeds—in other words, the proceeds had the quality of income—and the taxpayer was under no obligation to refund them. The Tax Court of Canada disagreed and held in favour of the taxpayer. The court simply held that the case could be decided by reference to the wording of the statutory provisions at issue. The proceeds were included in income under paragraph 12(1)(a) because they were received by the taxpayer in the course of a business on account of services not rendered before the end of the year. Similarly, paragraph 20(1)(m) allowed a deduction for the full amount of the proceeds received in the year

because it could be reasonably anticipated that all of the services would be rendered after the end of the year. Unfortunately, however, the court did not expressly rule or comment on the quality-of-income or earning issue.

2002 CTJ 4 p.1291/2 The Taxation of Prepaid Income (Frankovic, J.)

Prepayments for the Conditional Provision of Goods or Services

The paragraph 20(1)(m) ¨ ¨ reserve for prepayments is available in respect of "goods that it is reasonably anticipated will have to be delivered after the end of the year" and "services that it is reasonably anticipated will have to be rendered after the end of the year." Although this wording is relatively broad, the reserve will often not be available if the recipient's undertaking or obligation to provide goods or services is contingent upon the occurrence or non-occurrence of some future event, even if the payment is shown to be in respect of goods or services that can reasonably be anticipated to be delivered or rendered after the end of the year. That is, an amount received on account of a contingent undertaking will typically be on account of a guarantee, warranty, or indemnity, the deduction of which is specifically prohibited under paragraph 20(7)(a) ¨ ¨. Thus, for example, a retailer or manufacturer may sell an extended warranty in respect of its products that covers replacement parts and repairs in the event that the products break down or become defective. Although | the amount received for the warranty might be regarded as consideration given for goods or services (the parts and repairs) that it is reasonably anticipated will have to be delivered or rendered after the end of the year, the reserve would not be allowed owing to the paragraph 20(7)(a) restriction. The rationale for the restriction in respect of payments received on account of guarantees, warranties, and indemnities appears to be based on the degree of contingency relating to the recipient's obligation to perform and to incur costs.[126] This contingency might be contrasted with that arising in the case of a "regular" prepayment for goods or services, under which the recipient will generally have an unconditional obligation, or perhaps a relatively *less contingent* obligation, to provide the goods or services and incur costs.

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Accordingly, the courts have generally looked to the nature of the recipient's obligation to perform in consideration for the payment received. For example, in the *Mister Muffler* case,[127] each of the taxpayer's customers, when purchasing a muffler, was provided with a "guarantee" that the taxpayer would replace the muffler with another muffler and subsequent replacement mufflers so long as the customer owned his car. The purchase price of each original muffler included an extra charge ostensibly to cover the costs of the additional mufflers; the taxpayer attempted to deduct such amount as a reserve under the predecessor to paragraph 20(1)(m) ¨ ¨ on the grounds that it was on account of goods not yet delivered. Walsh J of the Federal Court Trial Division held that the taxpayer's "guarantee" to replace its mufflers was a contingent undertaking, in that it was carried out only if the purchased muffler wore out or became defective. Accordingly, the undertaking was in the nature of a guarantee, and the reserve was not allowed.

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A similar issue arises in the case of so-called maintenance agreements, under which vendors or

manufacturers of property agree to provide repairs to and maintenance of the property over the term of the agreement. If the provision of these services is contingent upon some event, such as the deterioration of or a defect in the property, the reserve will not normally be allowed. However, if the provision of the services is unconditional—for example, they are to be performed at specified times during the agreement regardless of the state of the property—the reserve should be available for the portion of the payment that relates to those services. For example, in the *Paul Burden* case,[128] the taxpayer sold office machines and offered its customers service contracts in respect of the machines. The contracts provided that the taxpayer would repair the machines when requested to do so by the customers; the contracts did not provide for scheduled preventive maintenance services. The taxpayer attempted to claim a reserve in respect of the fees received for the service contracts. The Tax Review Board, relying largely on the "contingent undertaking" rationale used in the *Mister Muffler* decision, disallowed the deduction on the grounds that it was far from certain that the taxpayer would be called on to fulfill its obligation to repair under any particular contract or in respect of any particular machine. Similarly, in the *Sears Canada* case,[129] the taxpayer was not allowed to deduct a reserve in respect of the amounts it received under maintenance agreements that were offered in conjunction with the sales of its appliances. Under the maintenance agreements, the taxpayer was obliged to make all repairs | that became necessary owing to normal "wear and tear" of the appliances; however, there was no predetermined maintenance for the appliances except with regard to its air conditioners. (Since the CCRA allowed a reserve for the amounts received for maintenance of the air conditioners, such amounts were not at issue.) McNair J of the Federal Court Trial Division held that the maintenance agreements were in the nature of indemnities, so that the paragraph 20(1)(m) ¨ ¨ reserve was not allowed by virtue of the restriction in paragraph 20(7)(a) ¨ ¨. The Federal Court of Appeal upheld the decision. According to the court, by undertaking to maintain appliances sold to its customers, the taxpayer became obliged to incur expenses that the customers would otherwise have had to bear; therefore, these obligations were in the nature of indemnities.

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Interestingly, McNair J in the *Sears Canada* case held that the contingent nature of the taxpayer's obligation to provide maintenance services did not, in itself, preclude the application of the paragraph 20(1)(m) ¨ ¨ reserve. (As noted, he held that paragraph 20(7)(a) ¨ ¨ precluded the application of the reserve.) In his opinion, the reserve could be claimed for amounts that were "contingent both as to amount and liability so long as the amounts are reasonable."[130] Furthermore, McNair J held that the availability of the paragraph 20(1)(m) reserve was not affected by the restriction in paragraph 18(1)(e) ¨ ¨ (which disallows the deduction of contingent amounts and liabilities), since the latter restriction applied "except as expressly permitted by this Part" of the Act. Accordingly, this particular finding by McNair J leaves opens the possibility that the paragraph 20(1)(m) reserve can be claimed in respect of an amount received for a contingent undertaking to provide goods or services in a future taxation year, as long as the obligation is not in the nature of a guarantee, warranty, or indemnity. Unfortunately, the Federal

Court of Appeal did not express an opinion on this possibility.

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In contrast to the *Paul Burden* and *Sears Canada* decisions, the taxpayer in the *Office Concepts* case,[131] an office equipment vendor, was allowed to claim the paragraph 20(1)(m) ¨ ¨ reserve in respect of amounts received under service maintenance agreements. Pursuant to these agreements, the taxpayer was obliged to provide preventive maintenance inspections in respect of the equipment twice a year; if adjustments or repairs of the equipment were required, they were then made without charge. The court distinguished the *Paul Burden* decision on the grounds that the taxpayer's obligation in that case to maintain and repair office machines was contingent; the obligation arose only if and when the customer required and requested such service. By contrast, in the case at hand, the preventive maintenance program was an existing obligation requiring the taxpayer to perform services at determined intervals. The court thus found that there was no indication of a contingency. Interestingly, the court did not differentiate between the taxpayer's obligation to provide inspection and maintenance services at predetermined intervals and the taxpayer's obligation to make repairs that materialized only as a result of those inspections; instead, the court viewed them as one unconditional obligation imposed on the taxpayer. The court simply concluded that "there is a definite schedule of inspections with concomitant repairs if necessary. There is no connotation of | contingency."[132] Despite the court's conclusion in this regard, one would think that an obligation to make repairs "if necessary" is a contingent obligation.

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In the recent *Redhead Equipment* case,[133] the taxpayer was a distributor for a corporation that offered a five-year warranty program with respect to certain graders sold to municipalities. The taxpayer was required to make an inspection of each grader every six months and to make a report to the owner specifying the required repairs or replacement of parts. The owner could then request such repairs or parts under the warranty. The Tax Court of Canada allowed the taxpayer to claim a reserve under paragraph 20(1)(m) ¨ ¨ in respect of the amount it received for the inspections that would occur after the year of receipt. The court reasoned that the inspections were to take place every six months and there was no contingency involved; the inspections therefore did not constitute warranties, indemnities, or guarantees. Effectively, the court held that the inspections were separate and distinct from the goods and services that might be provided under the warranty.

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In a recently published position, the CCRA stated that it would not allow taxpayers to defer and prorate the inclusion of fees under computer software and hardware maintenance agreements on the basis of the duration of each maintenance contract.[134] The CCRA held that, considering the indemnity nature of the maintenance contracts, no reserve could be taken in respect of a portion of the amount included in income under paragraph 12(1)(a) ¨ ¨ because of the combined effects of paragraph 20(7)(a) ¨ ¨ and paragraph 20(1)(m) ¨ ¨. Alternatively, if the taxpayer had a right to the amount received that was absolute and under no restriction as to the taxpayer's use or

enjoyment, section 9 ¨ ¨ would apply because the amount would be considered earned and paragraph 12(1)(a) would not apply. If the amount received were included in income under section 9, paragraph 18(1)(e) ¨ ¨ would not permit a reserve because of the contingent nature of the obligation. Furthermore, as noted earlier, it appears that the paragraph 20(1)(m) reserve does not apply to amounts included in income under section 9.

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A similar and interesting issue arises in the context of premiums received on the sale or issuance of option-based notional principal contracts. For example, financial institutions sell interest rate caps and floors, typically to firms that require hedges for their interest-bearing assets or liabilities. An interest rate cap agreement obliges the seller of the cap to make a payment to the purchaser if the market interest rate (usually referenced to the LIBOR[135] or the US or Canadian prime rate) exceeds the cap interest rate on the relevant settlement date under the contract. Conversely, an interest rate floor agreement obliges the seller to make a settlement payment to the purchaser if the market interest rate is below the floor interest rate on the settlement date. Because future interest rates are not known with certainty at the time such a contract is entered into, it is not known whether or when the financial institution will be required to render its "services" to the purchaser. In other words, the institution's obligation to "perform" under the contract will be contingent on future events, namely, whether future interest rates exceed the cap or go below the floor, as the case may be. Nonetheless, the CCRA has held that the portion of the premium that is attributable to taxation years after the year in which | the contract is sold should be included in the financial institution's income under paragraph 12(1)(a) ¨ ¨, and that such portion is eligible for a reserve under paragraph 20(1)(m) ¨ ¨, since it is on account of services that it is reasonably anticipated will have to be rendered after the end of the year.[136] It is difficult to rationalize a distinction between this type of contract and a warranty; each is essentially a form of insurance that the purchaser acquires to protect and indemnify himself in the event of an unfavourable eventuality. The contingencies in both cases relate to events that are beyond the control of both parties to the transaction and that appear to have similar degrees of unpredictability.

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The paragraph 20(1)(m) reserve is allowed in the case of "prepaid" tickets, coupons, vouchers, or trading stamps that entitle the holders to goods or services at unspecified times after the end of the relevant taxation year.[137] The reserve is allowed in these cases even though, in certain respects, they resemble obligations under warranties. That is, it will not typically be known with certainty whether and when the issuer of such items will be required to provide goods or services (since some tickets will undoubtedly be lost or expire before redemption), and the provision of the goods or services will normally be "contingent" upon the presentation or redemption of the tickets by the issuer's customers.[138] Perhaps the reserve is allowed because it is relatively more certain in these cases that the taxpayer will be called upon to provide goods or services. It has also been suggested that the critical distinction may be that with a warranty, the contingency relates to an event that is normally outside the control of the purchaser (such as breakdown of the

product), whereas in the case of a ticket or coupon, the only contingency is presentation or redemption, which is completely within the control of the purchaser.[139]

As noted above, the disallowance of the paragraph 20(1)(m) ¨ ¨ reserve for amounts received on account of guarantees and warranties appears to be premised on the contingency relating to the recipient's obligation to perform. However, from a policy perspective, and as with "true" prepayments for goods and services, the central issue should be whether and to what extent the amount received can reasonably be regarded as reflecting the recipient's increase in net wealth. As discussed in the first part of the article, if it is concluded that, on average, the present value of recipients' future costs of performance is more than one-half of the amounts received, the deferral method (application of reserve) can be justified as a better approximate measure of income relative to upfront inclusion. A similar analysis should apply to guarantees and warranties. Assuming that recipients' future costs of performance in these cases do not, on average, differ significantly from those seen in the "true" prepayment cases, an argument can be made in favour of repealing paragraph 20(7)(a) ¨ ¨.

"Prepayments" Relating to Services Not Rendered to the Payer

Generally speaking, the paragraph 12(1)(a) ¨ ¨/20(1)(m) ¨ ¨ reserve mechanism, as it applies to goods and services, is intended to apply to amounts received on account of goods to be delivered or services to be rendered in future taxation years *by the recipient to the payer*. It is unlikely that the reserve is intended to apply, for example, to amounts received on account of the current provision of goods or services which | the recipient subsequently expends on other goods or services in the future. For instance, if a taxpayer sold and delivered goods in the current taxation year and incorporated into the sales price its anticipated storage costs of future taxation years, it is unlikely that the reserve would apply to any portion of the sales price of the goods sold. It is doubtful that any of the proceeds received on the current sale of the goods by the taxpayer could reasonably be considered to be "on account of" (paragraph 12(1)(a)) or "in respect of" (paragraph 20(1)(m)) the storage services to be rendered by another party to the taxpayer after the end of the year. The sales proceeds would simply be the consideration received by the taxpayer on account of goods delivered in the current year.

Thus, the taxpayer in the *Pedersen* case[140] was not allowed to claim the reserve in respect of amounts received as consideration for current services on the basis that the taxpayer would in the future apply such amounts toward the payment for reclamation services. The taxpayer operated a waste landfill site under a licence granted by the Ontario Ministry of the Environment. Under the terms of the licence, the taxpayer was obligated to reclaim and rehabilitate the site after its closure. The taxpayer argued that a significant portion of the waste collection fees received from its customers during the site's operating phase was required to fund the reclamation of the site during its closed phase. Therefore, according to the taxpayer, this portion of the fees was on account of services to be rendered after the taxation year in which it was received, and the

paragraph 20(1)(m) ¨ ¨ reserve ought to apply. The Tax Court of Canada disallowed the deduction of the reserve. The court held that the contracts between the taxpayer and its customers indicated that the fees were consideration for the concurrent collection of the customers' waste only, and that there was no evidence that suggested that a portion of the fees was on account of the future reclamation services. The court also noted that the reclamation services would be provided to the taxpayer and not to the taxpayer's customers.

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In the more recent *Meloche* case,[141] however, the taxpayer was allowed to claim the reserve in similar circumstances for Quebec provincial income tax purposes. The taxpayer operated a waste landfill site and was obligated, under provincial regulations, to ensure that reclamation services were rendered on the site for 30 years after its closure. The regulatory authorities established the waste collection fees that landfill operators could charge, and such fees were set expressly by reference to both the concurrent waste collection services and the post-closure reclamation services. The Quebec Court of Appeal held that the portion of the fees that related to the reclamation services was unearned when received by the taxpayer. The court reasoned that the taxpayer was obligated to incur reclamation costs after the site was closed and that this portion of the fees was intended to meet those costs. Accordingly, such portion was included in the taxpayer's income for provincial income tax purposes pursuant to the provincial statutory equivalent of paragraph 12(1)(a) ¨ ¨ and it was eligible for the reserve under the provincial statutory equivalent of paragraph 20(1)(m) ¨ ¨.

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The *Meloche* and *Pedersen* decisions appear to be distinguishable on their facts. In the *Pedersen* case, neither the regulatory system nor the taxpayer's contracts with | its customers provided that the waste collection fees were to be applied toward the reclamation services. In contrast, in the *Meloche* case, the regulatory authorities expressly determined that a portion of the fees collected by the taxpayer was required to meet the taxpayer's obligations in respect of the reclamation services. The CCRA has agreed that the decisions can be distinguished on their facts.[142]

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As noted, it is doubtful that the paragraph 20(1)(m) ¨ ¨ reserve was intended to apply in these circumstances. However, the result in *Meloche* may be justifiable as a matter of policy. Assuming that the portion of the fees targeted toward the reclamation services more or less equalled the present value of the costs to be incurred on the services, the taxpayer presumably enjoyed no increase in net worth upon the receipt of that portion of the fees. If so, and as would be the case with any "regular" prepayment for services that carried such future costs, it would be appropriate to defer the recognition of the inclusion of the fees to the year in which the recipient incurred the costs of reclamation. However, a potentially significant difference between the reclamation case and the regular prepayment case is that the taxpayer in the former may enjoy a future benefit when its costs are incurred. That is, as a result of the reclamation, the value of the taxpayer's land may appreciate beyond its original value (the value before the waste collection was carried on). To the contrary, in the regular prepayment case, there is no future benefit that inures to the

recipient; the recipient's sole benefit is the prepayment itself.

Conclusion

In this article, it was concluded that the deferral of the recognition of prepaid income to the period in which it is earned is justifiable under fundamental income tax principles and policy. Although the deferral approach is not theoretically correct, in that it provides only a crude measure of a recipient's change in wealth from the time of the receipt of prepaid income to the time of performance, it appears to be the best practical method of accounting for prepaid income. The deferral approach is generally superior to the upfront inclusion approach, under which prepaid income is fully included in income in the year of receipt. Despite its shortcoming in terms of measuring the recipient's increase in wealth, deferral often provides a better result in this regard relative to upfront inclusion, and deferral is generally much more neutral.

This article also discussed the common law and statutory treatment of prepaid income and criticized the discrepancies and uncertainties that exist under the Canadian income tax system. Much of the uncertainty relates to the common law principle known as "the quality of income." An amount received has the quality of income if the recipient's right to retain the amount is unconditional or subject only to a condition subsequent; an amount does not have the quality of income if the recipient's right to it is subject to a condition precedent. As discussed in some detail, such a distinction is generally unacceptable from a policy perspective, particularly in the context of prepaid income, since it can result in taxpayers in similar or identical economic positions being subject to different tax burdens solely because | of the differences in the legal forms of their respective transactions. This concern would be largely academic if the Act provided the same treatment for all forms of prepaid income. Unfortunately, it is not clear whether prepaid income with the quality of income should be included in income under section 9 ¨ ¨, in which case the prepaid amount would apparently be recognized in full in the year of receipt, or under paragraph 12(1)(a) ¨ ¨, in which case the paragraph 20(1)(m) ¨ ¨ reserve would be available and the recognition of the amount could be deferred until the period in which it was earned. Recent cases indicate that prepaid amounts with the quality of income are included under section 9 ¨ ¨, whereas prepaid amounts without the quality of income are included under paragraph 12(1)(a). As a further concern, the reserve does not apply to certain unearned receipts and amounts that are similar to, though not strictly, prepaid income, whether or not they have the quality of income. To complicate matters further, on the basis of the history of the enactment of the predecessors to paragraphs 12(1)(a) and 20(1)(m), one could argue that prepaid income without the quality of income should not be included in income under either section 9 or paragraph 12(1)(a). Interestingly, the foregoing issues are avoided in prepayment-type transactions that are structured as loans; not only is the recognition of the amount received in this type of transaction deferred until the period of performance, but the recipient is often allowed to deduct interest expense on the amount received until the performance occurs. As a result, recipients in these transactions are often accorded more favourable tax results than recipients in

"true" prepayment transactions (even where the paragraph 20(1)(m) reserve applies), despite the fact that the transactions are equivalent in economic terms. Some but not all of the foregoing issues could be resolved by the courts, although there is no indication that the courts will provide such resolution in the foreseeable future. In any event, the Department of Finance could easily rectify these concerns by way of legislative amendment. |

2002 CTJ 4 1239 Footnotes The Taxation of Prepaid Income (Frankovic, J.)

FOOTNOTES

2002 CTJ 4 1239 Footnote 1239-1 The Taxation of Prepaid Income (Frankovic, J.)

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

2002 CTJ 4 1239 Footnote 1239-2 The Taxation of Prepaid Income (Frankovic, J.)

2 See, for example, William A. Klein, "Tailor to the Emperor with No Clothes: The Supreme Court's Tax Rules for Deposits and Advance Payments" (1994) vol. 41, no. 7 *UCLA Law Review* 1685-1735; and W. Eugene Seago and Debra Callihan, "Toward a Sound (Neutral) Tax Policy for Prepaid Income from Services" (1997) vol. 74, no. 3 *Tax Notes* 359-67. It should be noted that the main purpose of Klein's article is not to endorse the deferral method, but to criticize the US courts' distinctions between deposits, which the courts have decided should not be included in income upon receipt, and prepayments, which the courts have decided should be included in income upon receipt.

2002 CTJ 4 1239 Footnote 1239-3 The Taxation of Prepaid Income (Frankovic, J.)

3 Calvin H. Johnson, "The Illegitimate `Earned' Requirement in Tax and Nontax Accounting" (1995) vol. 50, no. 3 *Tax Law Review* 373-414.

2002 CTJ 4 1239 Footnote 1239-4 The Taxation of Prepaid Income (Frankovic, J.)

4 Daniel I. Halperin, "Interest in Disguise: Taxing the `Time Value of Money,'" (1986) vol. 95, no. 3 *The Yale Law Journal* 506-52, at 515-16; George K. Yin, "Of Indianapolis Power and Light and the Definition of Debt: Another View" (1991) vol. 11, no. 2 *Virginia Tax Review* 467-92, at 482-83; Robert H. Scarborough, "Payments in Advance of Performance" (1991) vol. 69, no. 12 *Taxes: The Tax Magazine* 798-820; Steven J. Willis, "It's Time for Schulde To Go" (2001) vol. 93, no. 1 *Tax Notes* 127-43; and Steven J. Willis, "Show Me The Numbers . . . Please" (2001) vol. 93, no. 10 *Tax Notes* 1321-31. Seago and Callihan, supra note 2, argue in favour of deferral over upfront inclusion but appear to agree that the notional loan method would be the superior approach. Interestingly, Halperin has changed his view somewhat and now agrees with Johnson, supra note 3, that upfront inclusion is sometimes justified. See Daniel I. Halperin, "Schulde: Further Study Is Needed" (2001) vol. 93, no. 11 *Tax Notes* 1504-5.

2002 CTJ 4 1239 Footnote 1239-5 The Taxation of Prepaid Income (Frankovic, J.)

5 Alan Gunn, "Matching of Costs and Revenues as a Goal of Tax Accounting" (1984) vol. 4, no. 1 *Virginia Tax Review* 1-47, at 37 (footnote 161). In recent years, however, some commentators have defended the GAAP treatment using a neutrality argument. These commentators have correctly argued that the deferral of the recognition of prepaid income generally provides an after-tax result that is closer, relative to the upfront inclusion method, to the result seen in the corresponding payment-upon-performance scenario. See Seago and Callihan, supra note 2; and the articles by Willis, supra note 4. See also the discussion in the text below under the heading "Assessment of the Three Methods on the Basis of Neutrality."

2002 CTJ 4 1239 Footnote 1239-6 The Taxation of Prepaid Income (Frankovic, J.)

6 Gunn, supra note 5, at 12-13, quoting L.L. Fuller and William R. Perdue, "The Reliance Interest in Contract Damages" (1936) vol. 46, no. 1 *The Yale Law Journal* 52-96, at 52.

2002 CTJ 4 1239 Footnote 1239-7 The Taxation of Prepaid Income (Frankovic, J.)

7 Paragraph 20(1)(m.2) " ".

2002 CTJ 4 1239 Footnote 1239-8 The Taxation of Prepaid Income (Frankovic, J.)

8 F.E. LaBrie, *The Principles of Canadian Income Taxation* (Don Mills, ON: CCH Canadian, 1965), 332-33.

2002 CTJ 4 1239 Footnote 1239-9 The Taxation of Prepaid Income (Frankovic, J.)

9 In relation to prepaid income in particular, see Johnson, supra note 3; and Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value" (1998) vol. 15, no. 1 *The American Journal of Tax Policy* 17-166, at 113-39. On a more general level, see Gunn, supra note 5; Glen E. Cronkwright, "The Dilemma of Conformity: Tax and Financial Reporting—A Perspective from the Private Sector," in *Current Developments in Measuring Business Income for Tax Purposes*, 1981 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1982), 22-40; Brian J. Arnold, "Conformity Between Financial Statements and Tax Accounting" (1981) vol. 29, no. 4 *Canadian Tax Journal* 476-88; and Judith Freedman, "Defining Taxable Profit in a Changing Accounting Environment" [1995] no. 5 *British Tax Review* 434-44.

2002 CTJ 4 1239 Footnote 1239-10 The Taxation of Prepaid Income (Frankovic, J.)

10 *Canderel Limited v. The Queen*, 98 DTC 6100, at 6106 (SCC).

2002 CTJ 4 1239 Footnote 1239-11 The Taxation of Prepaid Income (Frankovic, J.)

11 Gunn, supra note 5; and Geier, supra note 9.

2002 CTJ 4 1239 Footnote 1239-12 The Taxation of Prepaid Income (Frankovic, J.)

12 *Schulde v. Commissioner*, 372 US 128 (1963); *American Automobile Assn. v. US*, 367 US 687 (1961); and *Automobile Club v. Commissioner*, 353 US 180 (1957).

2002 CTJ 4 1239 Footnote 1239-13 The Taxation of Prepaid Income (Frankovic, J.)

13 See, for example, the articles cited in notes 2 and 4, supra.

2002 CTJ 4 1239 Footnote 1239-14 The Taxation of Prepaid Income (Frankovic, J.)

14 Scarborough, supra note 4, at 804. Interestingly, Scarborough goes on to conclude that the present value of the recipient's liability to incur the future expenses may be less than the amount of the prepayment, so that the recipient may realize a profit on the transaction. However, in his view, this profit is unrelated to the receipt of the prepayment, and the appropriate tax treatment of it is something that he does not explore. As discussed subsequently in this article, in my view, the profit element is not only relevant—it is the key issue in determining whether prepayments should be included upon receipt or deferred.

2002 CTJ 4 1239 Footnote 1239-15 The Taxation of Prepaid Income (Frankovic, J.)

15 Johnson, supra note 3; and Geier, supra note 9.

2002 CTJ 4 1239 Footnote 1239-16 The Taxation of Prepaid Income (Frankovic, J.)

16 Supra note 3, at 391. Interestingly, some of the proponents of the deferral and notional loan methods also concede that a prepayment will normally contain this profit element. However, they argue that the treatment of the profit component of the prepayment is a separate issue and that the existence of such profit does not justify the full inclusion of the prepayment in income in the year of receipt. This point is discussed in the text below.

2002 CTJ 4 1239 Footnote 1239-17 The Taxation of Prepaid Income (Frankovic, J.)

17 See, for example, Seago and Callihan, supra note 2, at 360-61.

2002 CTJ 4 1239 Footnote 1239-18 The Taxation of Prepaid Income (Frankovic, J.)

18 It is true that if a taxpayer pays for an otherwise deductible expenditure with a payment in kind (property other than cash), the taxpayer is allowed a deduction based on the value of the property at the time of payment and not its original cost. But this is allowed only because the payment of the expenditure triggers a gain or loss on the transferred property, which simultaneously "capitalizes" the fair market value into the new "cost" of the property.

2002 CTJ 4 1239 Footnote 1239-19 The Taxation of Prepaid Income (Frankovic, J.)

19 All changes in the asset's value would be included in income and thus "capitalized" to form the cost of the asset.

2002 CTJ 4 1239 Footnote 1239-20 The Taxation of Prepaid Income (Frankovic, J.)

20 Note that the prepayment case is unique in this regard; an imputed interest expense deduction in respect of a taxpayer's future costs is not otherwise normally justified. For example, assume a non-prepayment case where, as of year 0, a taxpayer is expected to incur costs in year 2 in respect of a service that he will be rendering in that year. Although, similar to the prepayment case, the taxpayer will sustain a decrease in wealth as the time of performance draws nearer, this decrease in wealth will be offset by a commensurate increase in wealth (the increase in the value of the service), which will most likely "crystallize" in year 2 in the form of a cash receipt or receivable provided to the taxpayer in consideration for the service. Accordingly, an imputed interest expense deduction in respect of the future costs is not warranted in this case. In contrast, in the prepayment case, there is no commensurate increase in the value of the service that inures to the benefit of the recipient. In consideration for the prepayment, the recipient has effectively "sold" to the payer both the value of the service and any increase in that value. Thus, in the example in the text, the increase in the value of the service over the course of years 1 and 2 inures to the benefit of the payer and not the recipient. The recipient's benefit in respect of the service, the $100 cash receipt, is enjoyed entirely in year 0; it does not offset the recipient's decrease in wealth in years 1 and 2 resulting from the liability to incur future costs.

2002 CTJ 4 1239 Footnote 1239-21 The Taxation of Prepaid Income (Frankovic, J.)

21 As noted earlier, it is assumed for the sake of simplicity that the rate of imputed interest is equal to the rate of return earned on the recipient's investments.

2002 CTJ 4 1239 Footnote 1239-22 The Taxation of Prepaid Income (Frankovic, J.)

22 The $100.00 receipt in year 0, net of the $40.00 present value of the year 2 costs, equals $60.00.

2002 CTJ 4 1239 Footnote 1239-23 The Taxation of Prepaid Income (Frankovic, J.)

23 In year 0, there is a $70.00 after-tax cash receipt. In years 1 and 2, the recipient enjoys tax savings of $2.00 and $2.20, respectively, owing to the imputed interest expense deduction. Using the after-tax discount rate of 5 percent, the present value of these tax savings as of year 0 is $3.90; the present value of the $48.40 year 2 costs is -$43.90. The total present value of these amounts equals $30.00 ($70.00 plus $3.90 minus $43.90).

2002 CTJ 4 1239 Footnote 1239-24 The Taxation of Prepaid Income (Frankovic, J.)

24 See, for example, Scarborough, supra note 4, at 804-5.

2002 CTJ 4 1239 Footnote 1239-25 The Taxation of Prepaid Income (Frankovic, J.)

25 The principle was first illustrated in E. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* (New York: Norton, 1948), 300-16. The principle can be illustrated using an example similar to that in the text—a taxpayer in a 50 percent tax bracket who receives a $100.00 payment in year 0. If the $100.00 amount were included in the taxpayer's income in year 0, the taxpayer would be left with $50.00 after tax, which, if invested at 10 percent per year before tax, would grow to $55.12 after tax as of year 2 ($50.00 invested at the after-tax rate of return of 5 percent over two years equals $55.12). If, instead, the inclusion of the $100.00 receipt were deferred to year 2, the taxpayer would have $100.00 to invest in year 0, which would grow to $105.00 after tax in year 1 ($5.00 after-tax return on $100.00) and $110.25 after tax in year 2 (a further $5.25 after-tax return on $105.00). The $110.25 amount, when netted against the $50.00 tax payable in year 2 in respect of the $100.00 inclusion in that year, would net the taxpayer $60.25 as of year 2. The deferral treatment is therefore the financial equivalent of properly including the $100.00 in income in year 0, leaving $50.00 after tax, exempting from tax the simple return earned on that $50.00 amount in years 1 and 2 ($5.00 each year, for a total of $10.00, leaving the taxpayer with $60.00), but subjecting to taxation the compound return earned during that period (the compound return equals $0.50, which is 10 percent of the $5.00 simple return earned in year 1; the tax thereon equals $0.25, leaving the taxpayer with another $0.25, for a total of $60.25 as of year 2).

2002 CTJ 4 1239 Footnote 1239-26 The Taxation of Prepaid Income (Frankovic, J.)

26 See supra note 25.

2002 CTJ 4 1239 Footnote 1239-27 The Taxation of Prepaid Income (Frankovic, J.)

27 Applying the deferral method to the modified example in the preceding section of the text (year 2 costs of $48.40), the deduction of the imputed interest of $4.00 and $4.40 on the $40.00 non-profit portion of the prepayment would effectively occur in year 2 when the $48.40 costs were incurred ($48.40 equalling the non-profit portion plus the imputed interest amounts of $4.00 and $4.40). Thus, the deduction of the $4.00 imputed interest expense that accrued in year 1 would "incorrectly" be deferred to year 2.

2002 CTJ 4 1239 Footnote 1239-28 The Taxation of Prepaid Income (Frankovic, J.)

28 To illustrate this principle, assume that a taxpayer in a 50 percent tax bracket incurs but does not pay $100.00 of simple interest expense in year 0 but subsequently pays the $100.00 interest plus 10 percent compound interest thereon, for a total of $110.00, in year 1. If the interest expense were recognized properly, the taxpayer would deduct the $100.00 simple interest in year 0 (tax savings of $50.00) and the $10.00 compound interest in year 1 (tax savings of $5.00). This treatment would leave the taxpayer with a net cash outlay of $52.50 in terms of year 1 dollars ($110.00 cash outlay, net of $5.00 tax savings in year 1, and further net of $52.20 tax savings, being the year 1 after-tax value of the $50.00 tax savings in year 0). If, instead, the deduction of the $100.00 simple interest were deferred to year 1, the taxpayer would have a net cash outlay of $55.00 in terms of year 1 dollars ($110.00 cash outlay net of $55.00 tax savings in year 1). Therefore, the deferral case is the financial equivalent of properly deducting the $100.00 simple interest in year 0, resulting in an after-tax change in wealth in year 0 of $50.00, but then improperly disallowing the deduction of—effectively subjecting to taxation—the compound interest expense in respect of that $50.00 amount ($5.00). Note that 50 percent (the tax rate) of the $5.00 compound interest equals $2.50, which is the difference between the year 1 after-tax cash outlay of $52.50 in the properly taxed case and the year 1 after-tax cash outlay of $55.00 in the improperly taxed deferral case.

2002 CTJ 4 1239 Footnote 1239-29 The Taxation of Prepaid Income (Frankovic, J.)

29 Halperin, supra note 4, at 516-17; and Yin, supra note 4, at 482-83.

2002 CTJ 4 1239 Footnote 1239-30 The Taxation of Prepaid Income (Frankovic, J.)

30 Scarborough, supra note 4, at 803; and Klein, supra note 2, at 1720.

2002 CTJ 4 1239 Footnote 1239-31 The Taxation of Prepaid Income (Frankovic, J.)

31 Note that such a transaction could rarely be recharacterized as a prepayment instead of a loan; the Supreme Court of Canada has held that the recharacterization of a transaction is allowed only in very limited circumstances. In *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669, at 5676-77, the Supreme Court held:

> [A]bsent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect. . . .
>
> [T]his Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. . . . Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.

See also CCRA document no. 2000-0062337, May 31, 2001.

2002 CTJ 4 1239 Footnote 1239-32 The Taxation of Prepaid Income (Frankovic, J.)

32 See, for example, Scarborough, supra note 4, at 803.

2002 CTJ 4 1239 Footnote 1239-33 The Taxation of Prepaid Income (Frankovic, J.)

33 Halperin, supra note 4; Scarborough, supra note 4; and Joseph Frankovic, "The Income Tax Treatment of Prepaid Expenses and Similar Costs: A Time Value Analysis" (2000) vol. 48, no. 5 *Canadian Tax Journal*

1371-1443.

2002 CTJ 4 1239 Footnote 1239-34 The Taxation of Prepaid Income (Frankovic, J.)

34 Johnson, supra note 3, at 390.

2002 CTJ 4 1239 Footnote 1239-35 The Taxation of Prepaid Income (Frankovic, J.)

35 See the discussion below under the heading "The Taxation of Prepaid Income Under Canadian Law—The Judicial Distinction Between Deposits and Prepayments."

2002 CTJ 4 1239 Footnote 1239-36 The Taxation of Prepaid Income (Frankovic, J.)

36 B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983), 145.

2002 CTJ 4 1239 Footnote 1239-37 The Taxation of Prepaid Income (Frankovic, J.)

37 Klein, supra note 2, at 1729-30, provides the following example in this regard: "Consider a typical rental situation. Suppose the rental period is twelve months and the rent is $100 per month, payable monthly at the end of each month. Suppose that, in addition, there is to be a payment in advance of $100. If the payment is called an advance payment of the last month's rent, there will be eleven more payments and that will be the end of the obligation to pay rent. Suppose the tenant causes damage of $150. The landlord will be entitled to collect that $150, but may have some practical difficulty doing so. Suppose the initial $100 payment is called a security deposit. If there is no damage, there will be eleven more payments and at the end of the tenancy there will be an exchange of checks. Alternatively, and more likely, the landlord and tenant will simply call it even and that will be the end of the matter. There will be no difference of any economic significance from the situation where the initial payment is called an advance payment. If there is damage of $150, the landlord will keep the $100 `deposit' and will be entitled to collect an additional $150, which, again, may be easier said than done. Once more, the economic result is essentially the same regardless of the label."

2002 CTJ 4 1239 Footnote 1239-38 The Taxation of Prepaid Income (Frankovic, J.)

38 Klein, supra note 2, at 1697-98; and Seago and Callihan, supra note 2, at 362-63.

2002 CTJ 4 1239 Footnote 1239-39 The Taxation of Prepaid Income (Frankovic, J.)

39 That is, 10 percent interest computed (and compounded) on the $621 amount would equal $62, $68, $75, $83, and $91 of interest in years 1 through 5, respectively, for a total of $379.

2002 CTJ 4 1239 Footnote 1239-40 The Taxation of Prepaid Income (Frankovic, J.)

40 In the case of prepaid rent, the recipient (lessor) might also have some future costs associated with the prepayment, for example, repairs and property taxes during the prepaid rent years, so that, depending on the recipient's cost of the land and those future costs, an economic loss might be sustained as of the receipt year.

2002 CTJ 4 1239 Footnote 1239-41 The Taxation of Prepaid Income (Frankovic, J.)

41 See the discussion below under the heading "The Taxation of Prepaid Income Under Canadian Law—The Statutory Rules Governing the Taxation of Prepaid Income—Inclusion and Deferral Under Paragraphs 12(1)(a) " " and 20(1)(m) " "."

2002 CTJ 4 1239 Footnote 1239-42 The Taxation of Prepaid Income (Frankovic, J.)

42 In these "in-between" carveout cases—where the recipient's costs are greater than nil but less than the value of the property—the application of the theoretical approach is somewhat more complicated, although it probably goes something like the following. Assume that the recipient's cost of the land in the example in the text was $500. In theory, the $500 cost of the land would be allocated between the recipient's right to receive rent over the initial five-year period and the recipient's reversionary interest in the land, on the basis of their present values at the time the prepayment was received. Assuming a 10 percent discount rate, the cost of the right to receive the rent over the first five years would be $189 and the cost of the reversionary interest in the land would be $311. Under the analysis provided thus far, the receipt of the $379 prepayment could be "offset" by $189 (the "cost" of the right to receive the rent over five years), leaving a net income inclusion of $190 in the year of receipt. The recipient would be left with the reversionary interest in the land, with a cost of $311. In this case, since the

original cost of the land was $500, the reversionary interest should be treated as an original issue discount debt obligation issued at its "cost" of $311 and repayable in five years for $500. Effectively, the recipient would include imputed interest on $311 at 10 percent per year, compounded, for a total of $189 of interest over the five-year period. The $189 amount so included would be added to the cost of the reversionary interest, leaving a total cost of $500 at the end of the five-year period, the same as the recipient's original cost of the land.

2002 CTJ 4 1239 Footnote 1239-43 The Taxation of Prepaid Income (Frankovic, J.)

43 *Interpretation Bulletin* IT-261R " ", "Prepayments of Rents," May 10, 1980, paragraph 10.

2002 CTJ 4 1239 Footnote 1239-44 The Taxation of Prepaid Income (Frankovic, J.)

44 See, for example, Geier, supra note 9, at 114-15.

2002 CTJ 4 1239 Footnote 1239-45 The Taxation of Prepaid Income (Frankovic, J.)

45 See the previous discussion in the text at table 1.

2002 CTJ 4 1239 Footnote 1239-46 The Taxation of Prepaid Income (Frankovic, J.)

46 Ibid.

2002 CTJ 4 1239 Footnote 1239-47 The Taxation of Prepaid Income (Frankovic, J.)

47 See, for example, Scarborough, supra note 4, at 810-11.

2002 CTJ 4 1239 Footnote 1239-48 The Taxation of Prepaid Income (Frankovic. J.)

48 See, for example, Joseph M. Dodge, *The Logic of Tax* (St. Paul, MN: West Publishing, 1989), 242-43.

2002 CTJ 4 1239 Footnote 1239-49 The Taxation of Prepaid Income (Frankovic. J.)

49 Johnson, supra note 3, at 413.

2002 CTJ 4 1239 Footnote 1239-50 The Taxation of Prepaid Income (Frankovic, J.)

50 To state the point more accurately, much of the initial increase in wealth ($100) presumably occurred earlier, as the value of the recipient's income-earning capacity increased over time. The wealth was more or less "crystallized" in year 0 when the recipient entered into the services contract, and further in years 1 and 2 owing to the passage of time as the time of performance drew nearer. Of course, as noted in the text, our income tax system does not recognize such wealth in the payment-upon-performance case until the "ultimate" crystallization event, namely, when the services are rendered and the proceeds become receivable as a matter of law.

2002 CTJ 4 1239 Footnote 1239-51 The Taxation of Prepaid Income (Frankovic, J.)

51 See also Seago and Callihan, supra note 2; Willis, supra note 4 (both articles); and W. Eugene Seago, "A Modest Proposal Regarding the Matching Principle" (2001) vol. 90, no. 13 *Tax Notes* 1855-67, at 1861.

2002 CTJ 4 1239 Footnote 1239-52 The Taxation of Prepaid Income (Frankovic. J.)

52 Under the notional loan method, the $100.00 receipt in year 0 would grow tax-free (owing to the imputed interest expense deduction) to $121.00 in year 2, at which point the recipient would pay $60.50 in tax, retaining $60.50 after tax.

2002 CTJ 4 1239 Footnote 1239-53 The Taxation of Prepaid Income (Frankovic, J.)

53 Under the deferral method, the $100.00 receipt in year 0 would grow, after tax, to $105.00 as of year 1 and $110.25 as of year 2 (5 percent after-tax annual compounded return), which, when netted against the $50.00 tax payable in year 2 on account of the $100.00 inclusion in that year, would net the taxpayer $60.25 as of year 2.

2002 CTJ 4 1239 Footnote 1239-54 The Taxation of Prepaid Income (Frankovic, J.)

54 Under the upfront inclusion method, the $100.00 receipt would be subject to tax in year 0, netting the taxpayer $50.00, which would grow after tax to $55.12 as of year 2 (5 percent after-tax annual compounded return).

2002 CTJ 4 1239 Footnote 1239-55 The Taxation of Prepaid Income (Frankovic, J.)

55 See supra note 54.

2002 CTJ 4 1239 Footnote 1239-56 The Taxation of Prepaid Income (Frankovic, J.)

56 The $109.75 receipt would net the recipient $54.87 after tax in year 0, which would grow to $60.50 after tax as

of year 2 (5 percent after-tax annual compounded return). Similarly, the $109.75 payment would cost the payer $54.87 after tax in year 0, which is equivalent to $60.50 in year 2 after-tax dollars. The analysis in the text regarding the "shifting" of taxation from the payer to the recipient is largely derived from the seminal article written by Halperin, supra note 4.

2002 CTJ 4 1239 Footnote 1239-57 The Taxation of Prepaid Income (Frankovic, J.)

57 That is, in either case, the payer would be taxed on imputed interest (in the prepayment case) or actual investment income earned (in the payment-upon-performance case) in years 1 and 2, respectively, whereas the recipient would not be taxed on such amounts in either case.

2002 CTJ 4 1239 Footnote 1239-58 The Taxation of Prepaid Income (Frankovic, J.)

58 See supra note 52.

2002 CTJ 4 1239 Footnote 1239-59 The Taxation of Prepaid Income (Frankovic, J.)

59 See supra note 53.

2002 CTJ 4 1239 Footnote 1239-60 The Taxation of Prepaid Income (Frankovic, J.)

60 In other words, $100.00 in year 0 that earns an annual after-tax rate of return of 5 percent (compounded) grows to $110.25 as of year 2.

2002 CTJ 4 1239 Footnote 1239-61 The Taxation of Prepaid Income (Frankovic, J.)

61 Note that $109.75 is the present value of $121.00 discounted using the after-tax discount rate of 5 percent.

2002 CTJ 4 1239 Footnote 1239-62 The Taxation of Prepaid Income (Frankovic, J.)

62 See supra note 61.

2002 CTJ 4 1239 Footnote 1239-63 The Taxation of Prepaid Income (Frankovic, J.)

63 See supra note 56.

2002 CTJ 4 1239 Footnote 1239-64 The Taxation of Prepaid Income (Frankovic, J.)

64 *Robertson v. Minister of National Revenue* (1944), 2 DTC 655 (Ex. Ct.).

2002 CTJ 4 1239 Footnote 1239-65 The Taxation of Prepaid Income (Frankovic, J.)

65 *Ikea Limited v. The Queen*, 98 DTC 6092 (SCC).

2002 CTJ 4 1239 Footnote 1239-66 The Taxation of Prepaid Income (Frankovic, J.)

66 See, however, the discussion in the text below and under the heading "The Statutory Rules Governing the Taxation of Prepaid Income—The Quality-of-Income Requirement Applied to the Statutory Scheme of Taxing Prepaid Income."

2002 CTJ 4 1239 Footnote 1239-67 The Taxation of Prepaid Income (Frankovic, J.)

67 Supra note 64, at 660-61.

2002 CTJ 4 1239 Footnote 1239-68 The Taxation of Prepaid Income (Frankovic, J.)

68 *Commonwealth Construction Company Limited v. The Queen*, 84 DTC 6420 (FCA).

2002 CTJ 4 1239 Footnote 1239-69 The Taxation of Prepaid Income (Frankovic, J.)

69 Ibid., at 6424.

2002 CTJ 4 1239 Footnote 1239-70 The Taxation of Prepaid Income (Frankovic, J.)

70 *The Queen v. Foothills Pipe Lines (Yukon) Ltd.*, 90 DTC 6607 (FCA).

2002 CTJ 4 1239 Footnote 1239-71 The Taxation of Prepaid Income (Frankovic, J.)

71 Ibid., at 6614-15.

2002 CTJ 4 1239 Footnote 1239-72 The Taxation of Prepaid Income (Frankovic, J.)

72 Supra note 65.

2002 CTJ 4 1239 Footnote 1239-73 The Taxation of Prepaid Income (Frankovic, J.)

73 Ibid., at 6099.

74 For example, in concluding that certain deposits were not included in a taxpayer's income upon receipt, the Supreme Court of Canada in *MNR v. Atlantic Engine Rebuilders Ltd.*, 67 DTC 5155, took into account the 96 percent probability that the deposits would be refunded. This decision is discussed in the text below, at note 86 and following.

2002 CTJ 4 1239 Footnote 1239-75 The Taxation of Prepaid Income (Frankovic, J.)

75 *The Queen v. Imperial General Properties Limited*, 85 DTC 5045, at 5052 (FCA).

2002 CTJ 4 1239 Footnote 1239-76 The Taxation of Prepaid Income (Frankovic, J.)

76 *Northern and Central Gas Corporation Limited v. The Queen*, 85 DTC 5144 (FCTD).

2002 CTJ 4 1239 Footnote 1239-77 The Taxation of Prepaid Income (Frankovic, J.)

77 Ibid., at 5149-50. For a similar finding, see *Westcoast Petroleum Ltd. v. The Queen*, 89 DTC 5153 (FCTD).

2002 CTJ 4 1239 Footnote 1239-78 The Taxation of Prepaid Income (Frankovic, J.)

78 See the discussion above under the heading "The Theoretical Framework and Policy Arguments—Prepayments Versus Deposits and the Recipient's Obligation To Refund."

2002 CTJ 4 1239 Footnote 1239-79 The Taxation of Prepaid Income (Frankovic, J.)

79 *Sinnott News Co., Ltd. v. MNR*, 56 DTC 1047 (SCC).

2002 CTJ 4 1239 Footnote 1239-80 The Taxation of Prepaid Income (Frankovic, J.)

80 *Harlequin Enterprises Ltd. v. The Queen*, 77 DTC 5164 (FCA).

2002 CTJ 4 1239 Footnote 1239-81 The Taxation of Prepaid Income (Frankovic, J.)

81 *Robertson*, supra note 64, at 661.

2002 CTJ 4 1239 Footnote 1239-82 The Taxation of Prepaid Income (Frankovic, J.)

82 *Diamond Taxicab Association v. MNR*, 52 DTC 1100 (Ex. Ct.), aff'd. 53 DTC 1111 (SCC).

2002 CTJ 4 1239 Footnote 1239-83 The Taxation of Prepaid Income (Frankovic, J.)

83 *Dominion Taxicab Assn. v. MNR*, 53 DTC 1106 (Ex. Ct.), rev'd. 54 DTC 1020 (SCC).

2002 CTJ 4 1239 Footnote 1239-84 The Taxation of Prepaid Income (Frankovic, J.)

84 The court stated, ibid., at 1022 (SCC), "I have reached the conclusion that, on the true construction of the contract and on the evidence, none of the payments of $500.00 became the absolute property of the Association in the year 1949; but that as each deposit was received by the Association and became a part of its assets there arose a corresponding contingent liability equal in amount."

2002 CTJ 4 1239 Footnote 1239-85 The Taxation of Prepaid Income (Frankovic, J.)

85 Ibid.

2002 CTJ 4 1239 Footnote 1239-86 The Taxation of Prepaid Income (Frankovic, J.)

86 *Atlantic Engine Rebuilders Ltd. v. MNR*, 64 DTC 5178 (Ex. Ct.).

2002 CTJ 4 1239 Footnote 1239-87 The Taxation of Prepaid Income (Frankovic, J.)

87 Supra note 74, at 5155-56.

2002 CTJ 4 1239 Footnote 1239-88 The Taxation of Prepaid Income (Frankovic, J.)

88 Supra note 75.

2002 CTJ 4 1239 Footnote 1239-89 The Taxation of Prepaid Income (Frankovic, J.)

89 See the example in note 37, supra, and the accompanying text.

2002 CTJ 4 1239 Footnote 1239-90 The Taxation of Prepaid Income (Frankovic, J.)

90 The provision also includes amounts received on account of returnable containers in which the recipient's goods were delivered to a customer (see subparagraph 12(1)(a)(ii) " ").

2002 CTJ 4 1239 Footnote 1239-91 The Taxation of Prepaid Income (Frankovic, J.)

[91] A reserve is also allowed under paragraph 20(1)(m) ¨ ¨ for amounts received on account of returnable containers (see supra note 90) which it is reasonably anticipated will have to be paid after the end of the year on the return or resale of such containers to the recipient.

2002 CTJ 4 1239 Footnote 1239-92 The Taxation of Prepaid Income (Frankovic, J.)

[92] *Interpretation Bulletin* IT-154R ¨ ¨, "Special Reserves," February 19, 1988, paragraph 4.

2002 CTJ 4 1239 Footnote 1239-93 The Taxation of Prepaid Income (Frankovic, J.)

[93] In contrast, the reserve in paragraph 20(1)(n) ¨ ¨ for amounts receivable in respect of property sold is allowed only in respect of the profit portion of the receivable, presumably because the profit is known with relative certainty when the reserve is claimed.

2002 CTJ 4 1239 Footnote 1239-94 The Taxation of Prepaid Income (Frankovic, J.)

[94] The paragraph 20(1)(m) ¨ ¨ reserve in respect of articles of food or drink to be delivered after the end of the year or transportation to be provided after the end of the year is limited to the amounts included in income for that year in respect of that food or drink or transportation. See subsection 20(6) ¨ ¨. In effect, this limitation means that the recognition of such amounts can be deferred only one year and that such amounts must be recognized by the year following the year in which they are received. Apparently, the reason for this limitation is that food or drink coupons and transportation tickets that are outstanding for more than one year are unlikely to be redeemed. See Arnold, supra note 36, at 277.

2002 CTJ 4 1239 Footnote 1239-95 The Taxation of Prepaid Income (Frankovic, J.)

[95] IT-261 ¨ ¨, supra note 43, at paragraph 10.

2002 CTJ 4 1239 Footnote 1239-96 The Taxation of Prepaid Income (Frankovic, J.)

[96] For example, in the *Ikea* case, supra note 65, the Supreme Court held that a tenant inducement payment received by a tenant should be fully included in income in the year of receipt under section 9 ¨ ¨. In reaching its conclusion, the court noted that the consideration for the tenant inducement payment was not the future payment of rent but rather the immediate assumption of the contractual obligations by the taxpayer under the lease. However, in the case of prepaid rent, one might argue that the consideration for the prepaid rent is the continued provision of the rental property in future periods, an ongoing and future obligation of the taxpayer. Accordingly, it could be argued that the income of the taxpayer would be more accurately reported if each portion of the prepaid rent was included in income in the year in respect of which it was prepaid—in other words, if the method of reporting income followed the GAAP treatment.

2002 CTJ 4 1239 Footnote 1239-97 The Taxation of Prepaid Income (Frankovic, J.)

[97] See the discussion above under the heading "The Theoretical Framework and Policy Arguments—The Unique Cases of Prepaid Interest and Rent."

2002 CTJ 4 1239 Footnote 1239-98 The Taxation of Prepaid Income (Frankovic, J.)

[98] Arnold, supra note 36, at 148.

2002 CTJ 4 1239 Footnote 1239-99 The Taxation of Prepaid Income (Frankovic, J.)

[99] Supra note 75.

2002 CTJ 4 1239 Footnote 1239-100 The Taxation of Prepaid Income (Frankovic, J.)

[100] CCRA document no. 9421625, October 31, 1994.

2002 CTJ 4 1239 Footnote 1239-101 The Taxation of Prepaid Income (Frankovic, J.)

[101] CCRA document no. 9800185, February 12, 1998.

2002 CTJ 4 1239 Footnote 1239-102 The Taxation of Prepaid Income (Frankovic, J.)

[102] CCRA document nos. 2001-0110895, December 4, 2001; 9M19160, November 30, 1999 (question 37); 9421625, October 31, 1994; and 9219087, July 22, 1992.

2002 CTJ 4 1239 Footnote 1239-103 The Taxation of Prepaid Income (Frankovic, J.)

[103] Supra note 64, at 660-61.

2002 CTJ 4 1239 Footnote 1239-104 The Taxation of Prepaid Income (Frankovic, J.)

[104] Richard G. Tremblay, "The Meaning of Earned Income in Subparagraph 12(1)(a)(i) " ": Burrard Yarrows Corp. (Versatile Pacific Shipyards Inc.)" (1989) vol. 2, no. 27 *Canadian Current Tax* C127-32, at C129-31.

2002 CTJ 4 1239 Footnote 1239-105 The Taxation of Prepaid Income (Frankovic, J.)

[105] RSC 1927, c. 97, as amended.

2002 CTJ 4 1239 Footnote 1239-106 The Taxation of Prepaid Income (Frankovic, J.)

[106] Ibid., at section 4.

2002 CTJ 4 1239 Footnote 1239-107 The Taxation of Prepaid Income (Frankovic, J.)

[107] *Ikea*, supra note 65; *Foothills Pipe Lines*, supra note 70; and *Commonwealth Construction*, supra note 68.

2002 CTJ 4 1239 Footnote 1239-108 The Taxation of Prepaid Income (Frankovic, J.)

[108] Francis Eugene LaBrie, *Introduction to Income Tax Law Canada* (Toronto: CCH Canadian, 1955), 92.

2002 CTJ 4 1239 Footnote 1239-109 The Taxation of Prepaid Income (Frankovic, J.)

[109] SC 1948, c. 52, as amended.

2002 CTJ 4 1239 Footnote 1239-110 The Taxation of Prepaid Income (Frankovic, J.)

[110] *Capital Transit Ltd. v. MNR*, 52 DTC 287 (TAB); *No. 64 v. MNR*, 52 DTC 295 (TAB); *J.J. Joubert Ltée v. MNR*, 52 DTC 317 (TAB); and *McManus Motors Ltd. v. MNR*, 53 DTC 255 (TAB). The "prepayments" in the first three cases were purchases of milk coupons by the taxpayers' customers that entitled the customers to the delivery of milk products, some of which would occur after the year in which the coupons were purchased. The fourth case involved coupons that entitled customers to certain service station services that would be provided by the taxpayer after the year of purchase.

2002 CTJ 4 1239 Footnote 1239-111 The Taxation of Prepaid Income (Frankovic, J.)

[111] For example, see *Capital Transit*, supra note 110, at 294; and *No. 64*, ibid., at 301.

2002 CTJ 4 1239 Footnote 1239-112 The Taxation of Prepaid Income (Frankovic, J.)

[112] See LaBrie, supra note 8, at 332-33.

2002 CTJ 4 1239 Footnote 1239-113 The Taxation of Prepaid Income (Frankovic, J.)

[113] RSC 1952, c. 148.

2002 CTJ 4 1239 Footnote 1239-114 The Taxation of Prepaid Income (Frankovic, J.)

[114] *Burrard Yarrows Corporation v. The Queen*, 86 DTC 6459 (FCTD), aff'd. 88 DTC 6352 (FCA).

2002 CTJ 4 1239 Footnote 1239-115 The Taxation of Prepaid Income (Frankovic, J.)

[115] Ibid., at 6463 (FCTD).

2002 CTJ 4 1239 Footnote 1239-116 The Taxation of Prepaid Income (Frankovic, J.)

[116] Supra note 104, at C131.

2002 CTJ 4 1239 Footnote 1239-117 The Taxation of Prepaid Income (Frankovic, J.)

[117] *MNR v. Colford Contracting Co. Ltd.*, 60 DTC 1131 (Ex. Ct.), aff'd. 62 DTC 1338 (SCC); and *Wilson and Wilson Limited v. MNR*, 60 DTC 1018 (Ex. Ct.). See also Israel H. Mida, "Deductibility of Reserves: Contractors, Maintenance Contracts, Captive Insurance Arrangements," in *Current Developments in Measuring Business Income for Tax Purposes*, 1987 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1987), 4:1-25, at 4:6-7.

2002 CTJ 4 1239 Footnote 1239-118 The Taxation of Prepaid Income (Frankovic, J.)

[118] *The Queen v. Huang and Danczkay Ltd.*, 2000 DTC 6549, at 6553 (FCA).

2002 CTJ 4 1239 Footnote 1239-119 The Taxation of Prepaid Income (Frankovic, J.)

[119] *Commonwealth Construction*, supra note 68; and *Foothills Pipe Lines*, supra note 70.

120 See supra note 102.

121 The provision refers to amounts *described* in paragraph 12(1)(a) " " that have been included in a taxpayer's income from a business; there is no explicit requirement that the amounts be included pursuant to paragraph 12(1)(a).

122 Supra note 114, at 6463 (FCTD).

123 Tremblay, supra note 104, at C129.

124 *I.B. Pedersen Limited v. The Queen*, 94 DTC 1085, at 1091 (TCC); *The Queen v. J.W. Baker Agency (1976) Ltd.*, 89 DTC 5078 (FCA); and CCRA document nos. 9219087, July 22, 1992; and 2001-0110895, December 4, 2001.

125 *Blue Mountain Resorts Limited v. The Queen*, 2002 DTC 1886 (TCC).

126 However, in the case of a warranty provided by a taxpayer to an arm's-length person in respect of property manufactured by the taxpayer (or a related corporation), a reserve under paragraph 20(1)(m.1) " " is allowed in respect of goods or services that it is reasonably anticipated will have to be provided with respect to property after the end of the year pursuant to the warranty. Generally speaking, this reserve is limited to that portion of the amount paid or payable by the taxpayer to an insurer to insure the taxpayer's liability under the warranty in respect of an outlay or expense made or incurred in respect of the period after the end of the year. Presumably, the paragraph 20(1)(m.1) reserve is allowed in these limited circumstances because it is known with certainty that the taxpayer/manufacturer is incurring costs (the insurance premiums) in respect of goods or services that may have to be provided pursuant to the warranty agreement.

127 *Mister Muffler Ltd. v. The Queen*, 74 DTC 6615 (FCTD).

128 *Paul Burden Ltd. v. MNR*, 81 DTC 651 (TRB).

129 *Sears Canada Inc. v. The Queen*, 86 DTC 6304 (FCTD), aff'd. 89 DTC 5039 (FCA).

130 Ibid., at 6309 (FCTD).

131 *Office Concepts Ltd. v. MNR*, 86 DTC 1621 (TCC).

132 Ibid., at 1622-23.

133 *Redhead Equipment Limited v. The Queen*, 2001 DTC 429 (TCC).

134 CCRA document no. 2001-0110895, December 4, 2001.

[135] The London interbank offering rate.

2002 CTJ 4 1239 Footnote 1239-136 The Taxation of Prepaid Income (Frankovic, J.)

[136] CCRA document no. AC567045, January 29, 1990.

2002 CTJ 4 1239 Footnote 1239-137 The Taxation of Prepaid Income (Frankovic, J.)

[137] *Dominion Stores Ltd. v. MNR*, 66 DTC 5111 (Ex. Ct.).

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[138] For example, before the enactment of the reserve, no deduction was allowed in a series of cases dealing with unredeemed milk coupons at year-end; it was determined that the vendors' obligations to honour the coupons were contingent. See the cases cited in note 110, supra.

2002 CTJ 4 1239 Footnote 1239-139 The Taxation of Prepaid Income (Frankovic, J.)

[139] Arnold, supra note 36, at 243.

2002 CTJ 4 1239 Footnote 1239-140 The Taxation of Prepaid Income (Frankovic, J.)

[140] Supra note 124.

2002 CTJ 4 1239 Footnote 1239-141 The Taxation of Prepaid Income (Frankovic, J.)

[141] *Dep. Min. Rev. (Que.) v. La Compagnie Meloche Inc.*, 2002 DTC 7169 (Que. CA).

2002 CTJ 4 1239 Footnote 1239-142 The Taxation of Prepaid Income (Frankovic, J.)

[142] CCRA document no. 9532845, April 12, 1996.

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