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Statutes Can Delay Income Deductions
Date: September 1, 2011
Vern Krishna

Income from business or property is the “profit” therefrom. Although we generally start the calculation of profit according to accounting principles and commercial practice, the *Income Tax Act* does not rely completely on such principles and practice.

In some cases, the act specifies income inclusion in order to:

- Make timing adjustments,
- Modify the common law concept of income, and
- Clarify uncertain issues in accounting practice.

The statutory variations can accelerate income recognition for tax purposes. The determination of interest, for example, varies from traditional accounting practice and the common law rules. “Interest” is the return or material consideration given for the use of money belonging to another person. Interest must be referable to a principal sum of money or an obligation to pay money. Thus, as stated in *Euro Hotel (Belgravia) Ltd.*, “there must be a sum of money by reference to which the payment which is said to be interest is to be ascertained. A payment cannot be ‘interest of money’ unless there is the requisite ‘money’ for the payment to be said to be ‘interest of.’”

Interest may vary with the gross revenues or profits of the borrower. Amounts payable as a percentage of profit are less likely to constitute interest. Profit percentage arrangements are more usually associated with a partnership relationship among the parties.

Payments on account of interest are generally considered to be for the use of money over a period of time. Thus, in business and commerce, interest is merely the equivalent of a rental charge for the use of someone else’s money. The courts, however, interpreted interest as an expenditure on account of capital. Thus, the act specifically includes interest in income and also specifies the method of inclusion.

There are several ways to account for interest income for tax purposes: the cash basis, modified cash basis, receivable basis, accrual basis, and modified accrual basis. Different rules apply to individuals, corporations, and partnerships.

For tax purposes, the term “receivable” means legally receivable and not “receivable” in the sense that it is used in accounting. Thus, the word has a narrower meaning for tax purposes than it has in general accounting. An amount is “receivable” for tax purposes only when the taxpayer has a clear legal right to it. The right must be legally enforceable.

For example, assume that a taxpayer buys a bond for $1,000 on December 1 and that the bond pays interest at a rate of 12 per cent per year payable at the end of May and November of each year. By December 31, the taxpayer will have earned one-twelfth of his annual interest income. In accrual accounting, the taxpayer is considered to have earned $10 in the month of December, even though he may not have received payment.

The $10 would be accrued as a receivable for general accounting purposes. For tax purposes, however, the $10 is not a “receivable” because there is no legal obligation on the issuer of the bond to pay the interest as at December 31. The legal obligation to pay the interest will arise on the date stipulated in the bond contract, namely May 31.

A taxpayer who selects a particular method of reporting interest income for a particular property must conform to that method from year to year. Although a taxpayer is required to account for interest income on a consistent basis from year to year, there is no requirement that the taxpayer follow the same basis for reporting interest income from all sources.

For example, a taxpayer may report interest income from Canada Savings Bonds on a cash basis and, in the same year, report interest income from a mortgage on a receivable basis.

As a general rule, an individual may report interest income on a cash or an accrual basis. Thus, an individual can use cash basis reporting to defer the recognition of income. There are, however, special restrictions in respect of “investment contracts.” Income from investment contracts must be reported on an annual basis, regardless of whether the income has been paid out in the year. The rule is intended to prevent prolonged deferral of investment income.

An investment contract is a debt such as a note, bond, debenture, or guaranteed investment contract. An investment contract does not include the following:

- Salary deferral arrangements;
- Income bonds and debentures;
- Retirement compensation arrangements;
- Employee benefit plans;
- Small business development bonds;
- Small business bonds; or
- Debt obligations in respect of which investment income is otherwise included in income at least annually.

A taxpayer is not legally obliged to charge interest on money loaned to another. Interest, however, may be blended into principal, in which case it must be segregated and included in income for tax purposes. A blended payment is a single payment in which interest and principal are blended into one amount on repayment of a loan.

Interest and principal may be blended by issuing a debt instrument at a discount and redeeming it at its face value upon maturity. Government treasury bills, for example, do not stipulate any interest rate or amount on their face, but are issued at a discount from their face value. The discount rate is a direct function of the prevailing interest rate, and the substance of the transaction is that the redemption value is, in effect, made up of principal and interest. Thus, the payment on maturity must be broken down into interest and principal components.

Whether an amount represents a blended payment of interest and principal is a question of fact to be determined by the terms of the agreement, the course of the negotiation between the parties, and, of particular importance, the price at which the property is sold.

The statutory rules of income determination always prevail over accounting and common law concepts and can, usually will, accelerate inclusions in income and delay deductions. Thus, commercial loan agreements should pay particular heed to timing of obligations to pay and receive income, such as interest.

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