CHAPTER 5

INCOME FROM BUSINESS

Review Questions

1. In order to earn business income, a taxpayer must be involved in an undertaking that constitutes a business. For tax purposes, briefly define "business."

2. Explain the term "adventure or concern in the nature of trade," and provide an example of such an activity.

3. Can an item of property (such as land) that has the potential to provide a long-term benefit to its owner create business income or a business loss when it is sold? Explain.

4. To what extent, if any, does the tax treatment of property that is classified as inventory, rather than as capital property, affect a taxpayer's financial risk in acquiring such property?

5. A taxpayer's business income for tax purposes is defined simply as "the profit therefrom." Explain what is meant by this.

6. What impact do the accounting concepts of revenue recognition, accrual, and matching have on the determination of business income for tax purposes?

7. To what extent, if any, does the definition of business income for tax purposes deviate from the general definition of profit? (Note: this relates to the answer to question 5.)

8. Explain why the following expenditures are not deductible in arriving at business income for tax purposes, even though they may be consistent with the general definition of profit.

   (a) Small donations to a large number of charitable organizations.

   (b) A fee paid to a real estate consultant for finding an appropriate building for storing the inventory of a wholesale business.

   (c) A reserve for the anticipated cost of product guarantees relating to products sold in the current year.

   (d) The cost of entertaining business clients at the wedding of the child of the owner of the business.

   (e) Fees paid to an architect to draw a set of plans for the expansion of a company's head office building.

   (f) Office rent of $40,000 annually, when the building is valued at $100,000 and is owned by the spouse of the corporation's primary shareholder.

9. Explain why a business, in determining net income from business for tax purposes, can deduct a reserve for potentially uncollectible accounts receivable but cannot deduct a reserve for anticipated sales returns.

10. What is the significance of Sections 18 and 20 of the *Income Tax* Act?

11. A business maintains a policy of providing memberships for senior employees at social clubs and clubs with sporting facilities. In some circumstances, such memberships are provided mainly to improve the business contacts of the employers; in others, they are provided solely as compensation. Explain the tax treatment of this kind of expense. In your answer, refer to the general rules for determining income from business.

12. What is the tax treatment when an item of inventory is sold in a particular year but the customer is required to pay for the item in equal annual instalments over four years?

13. At the end of its taxation year, a business has two unsold items of inventory. Item A has a cost of $10,000 and a market value of $15,000. Item B has a cost of $7,000 and a market value of $4,000. For tax purposes, what valuation methods can be used to determine ending inventory? Determine these amounts based on the information provided.

14. You may have heard the comment "A business keeps two sets of records—one for the bank and one for tax purposes." While this comment has sinister connotations, to what extent is it not sinister? Explain how the failure to maintain separate records for tax purposes may reduce a company's rate of return on business activities.

15. Briefly compare and contrast the general treatment for tax purposes of employment income and business income.

Solutions to Review Questions

R5-1. The term business is generally defined as a profession, calling, trade, manufacture, or undertaking of any kind whatever and includes an adventure or concern in the nature of trade [ITA 248(1)]. Therefore, activities such as manufacturing, mining, exploration, construction, logging, farming, fishing, selling of property as a retailer or wholesaler, transportation, and selling services are obvious business activities. The size of the activity is not relevant in determining whether or not a business activity exists. Therefore, a person providing hockey lessons to one person for a fee is conducting a business activity in the same way that the operation of a large hockey school is a business.

R5-2. An adventure or concern in the nature of trade occurs when a taxpayer acquires property for the purpose of reselling it at a profit, even though that activity is not part of the person's normal business activities. For example, an individual, in an isolated transaction, may acquire a piece of land in the hope of trading it at a profit. This isolated transaction is similar to the normal activity of a real estate development and trading business. Consequently, it is an adventure or concern in the nature of trade and is included as a business activity.

R5-3. Yes. A gain or loss on the sale of property can result in business income (loss) or a capital gain (loss). Property acquired and used for the purpose of providing the owner with a long-term benefit is capital property and its disposition results in a capital gain or loss. However, property, even though it has the ability to provide a long-term benefit, will be treated as inventory and the sale will generate business income (loss) if it was acquired for the purpose of reselling it at a profit. Therefore, it is the property's intended use and actual use which determine its tax treatment and not its ability to be used in a certain manner.

R5-4. The amount of risk a person is willing to accept on a particular investment is influenced, in part, by the potential returns which may be achieved as well as the extent of loss exposure. Therefore, the tax treatment of potential gains and losses is relevant.

On the upside, property that is inventory is fully taxable as business income, whereas property that is capital property is taxable on only one-half of the gain. Therefore, a different classification of the same type of property purchased will result in different after-tax returns even though the pre-tax returns are identical.

On the downside, property classified as inventory results in a business loss which is fully deductible against all other sources of income. Therefore, assuming the taxpayer has other sources of income and has a tax rate of 45%, a $100,000 business loss will reduce taxes on other income by $45,000 leaving a maximum loss exposure of only $55,000. In comparison, if the property is classified as capital property, a $100,000 loss can reduce income by only $50,000 (1/2 of $100,000) reducing taxes by $22,500 (45% of $50,000) leaving a net loss exposure of $77,500. In addition, the capital loss can only be offset against capital gains, which reduces the likelihood of recovering all or a portion of the $22,500 potential tax saving.

An investor may be prepared to take a greater risk if the potential loss is $55,000 from inventory property compared to a loss of $100,000 on capital property (if the loss can't be offset) considering that the investment is the same amount.

R5-5. The term "profit" is not defined in the ITA. It is, therefore, up to the courts to develop guiding principles to assist in determining profit for tax purposes. For many years the courts have given significant consideration to GAAP when dealing with conflicts between taxpayers and CRA. The Supreme Court of Canada reaffirmed that GAAP is not law but rather a significant interpretive aid to help establish an accurate profit. However, it remains that profit from business is normally first determined using GAAP. The actual profit for tax purposes then becomes a question of law, where income per financial statements (GAAP) is modified according to the ITA, established case law ("rules of law") and established business principles. The intent is to provide an accurate picture of revenues and expenses incurred to earn those revenues.

In general terms, profit is a net concept reflecting the revenues earned minus expenses of the entity. Reference to business income, therefore, means the net amount and not the gross income [ITA 9(1)].

R5-6. The accounting concepts of accrual, revenue recognition, and matching affect the time period (taxation year) in which revenues and expenses are recognized for tax purposes.

The accrual concept requires that expenses are recognized when they are incurred and not necessarily when they are paid. Therefore, an expense incurred in year one but not paid until year two will normally be deducted for tax purposes in year one. Similarly, the concept of revenue recognition requires that revenue be recognized when the earning process is substantially complete (usually when title to property is transferred or a service is rendered) and not necessarily when payment is received.

The matching concept may further alter the timing of an expense deduction by delaying its recognition until the year in which it contributes to earning revenue. For example, the purchase of inventory may occur in year one but is not sold until year two. Therefore, the deduction of the inventory cost to arrive at business income is delayed until year two.

Consequently, each of the concepts affects the timing of recognition for determining income and, therefore, affects the timing of the related tax liability.

R5-7. Although business income for tax purposes is the profit in accordance with well accepted business principles using the interpretive aid of generally accepted accounting principles, a number of general limitations are specifically imposed which may alter that determination. In particular, six general limitations are imposed on the deduction of expenses:

- An expense incurred is only deductible if it was incurred for the <u>purpose of gaining</u>, producing or maintaining <u>income</u> from business [ITA 18(1)(a)].
- No deduction is permitted if the expenditure is for, or on <u>account of capital, depreciation</u>, obsolescence or depletion except as specifically permitted [ITA 18(1)(b)].
- An expense is denied as a deduction if it was incurred to earn income that is not taxable [ITA 18(1)(c)].
- No deduction is permitted for a <u>reserve</u> except as specifically permitted [ITA 18(1)(e)].
- Expenses on account of <u>personal or living expenses</u> are denied [ITA 18(1)(h)].
- No expense is deductible unless it is <u>reasonable</u> under the circumstances [ITA 67].

R5-8. Although each item listed may be a reduction of income to arrive at profit in accordance with accounting principles, they are restricted for tax purposes by one of the six general limitations described in the answer to question 7.

a) *Donations* - They are not for the purpose of earning income [ITA 18(1)(a)] as the small contributions to charities will not enhance or maintain the company's ability to earn income. It is a gift.

b) *Finders fee* - The finders fee is on account of capital because it is part of the cost of acquiring the building which is a capital asset [ITA 18(1)(b)]. It will be permitted to be deducted over time as part of the capital cost allowance system which replaces accounting amortization.

c) *Product guarantee reserve* - Although consistent with the accounting concept of conservatism, it is not deductible for tax purposes as the general limitations do not permit the deductions of reserves [ITA 18(1)(e)]. While there are exceptions, this type of reserve is not one of them.

d) *Entertainment* - Although reasonable entertainment expenses are deductible, the cost of entertaining guests who are business clients at a wedding of the daughter of the owner may be restricted because they are personal or living expenses [ITA 18(1)(h)].

e) *Architects fees* - The fees are not deductible because they are a capital expenditure as part of the cost of the building expansion [ITA 18(1)(b)]. It may be deducted over a period of time as part of the capital cost allowance system.

f) *Rent* - the rent payment of $40,000 appears to be unreasonable as it represents a return of 40% to the owner of the building who is related to the owner of the corporation paying the rent. A reasonable portion would be permitted as a deduction. The remainder is denied [ITA 67].

R5-9. One of the general limitations for arriving at income from business prohibits the deduction of reserves except as specifically permitted [ITA 18(1)(e)]. No exception is provided for the cost of anticipated sales returns. Therefore, they are not deductible. Actual warranty costs can be deducted as they occur in accordance with the general rules. In comparison, a reserve for doubtful accounts receivable is, by exception, permitted to be deducted provided that it is reasonable and the creation of the debt was included in income [ITA 20(1)(l)]. Accounts receivable from the sale of goods or services is included as part of sales revenue when originated. Therefore, a reserve for uncollectible accounts receivable is permitted.

R5-10. Although income from business is the profit as determined under ITA 9(1) (see question 5) modified by six general expense limitations, a number of exceptions are permitted. Both Section 18 and 20 are significant because they are the source that identifies many of the items that are exceptions from the general rules.

Section 18 lists a number of items that are not deductible even though the general rules would otherwise permit their deduction. Conversely, Section 20 lists a number of items that can be deducted even though the general rules would prohibit them.

R5-11. The deduction for club dues paid for employees is not denied by the general rules that deny or restrict deductions. The deduction is acceptable for the determination of profit in accordance with generally accepted accounting principles, if they appear reasonable, are not on the account of capital and are not a reserve. In addition, they are incurred for the purpose of earning income either by improving business contacts or as a form of compensation to employees who work to generate income. However, by exception, Section 18 of the *Income Tax* Act specifically prohibits the deduction of club dues for any reason notwithstanding the general rules [ITA 18(1)(l)].

R5-12. Under generally accepted accounting principles, the revenue and the related cost of inventory sold is recognized in the year in which the product is sold even though extended payment terms exist.

However, by exception, paragraph 20(1)(n) permits the deferred portion of the profit to be deducted as a reserve where the property sold is inventory and (except for inventory that is land) all or part of the payment is not due for at least two years from the date of sale. The profit referred to is the gross profit (i.e., selling price minus the cost of the product sold) and the reserve is calculated as:

$$\frac{\text{gross profit}}{\text{gross selling price}} \times \text{amount due after the end of the year} = \text{reserve.}$$

Therefore, a portion of the profit is recognized in proportion to the deferred payments with the additional constraint that all profit must be recognized by the end of year four. The reserve can be claimed for a maximum of three years [ITA 20(8)]. The reserve cannot be claimed where the purchaser of the property is a corporation controlled by the taxpayer or is a partnership of which the taxpayer is the majority interest partner [ITA 20(8)].

A reserve is permitted for inventory that is land as long as an amount is due after the end of the taxation year in which the property was sold [ITA 20(8)].

R5-13. The ending inventory can be valued using two basic alternatives 10(1):

1. All at market [Reg 1801]:

A	$15,000	
B	4,000	
	$19,000	

2. Lower of cost or market:

A	$10,000	(cost)
B	4,000	(market)
	$14,000	

Because the deduction for cost of goods sold is determined as opening inventory plus purchases minus closing inventory, each of the above alternative values will reduce the cost of goods sold (and, therefore, increase profits for tax purposes) by different amounts. Inventory valued at market will increase profits by $19,000. Inventory valued at the lower of cost or market will increase profits by only $14,000. The chosen method must be consistent from year to year except where a change is approved by CRA [ITA 10(2.1)].

R5-14. Because income for tax purposes may be different from profit determined in accordance with generally accepted accounting principles, it is essential that a taxpayer maintain records for normal accounting purposes as well as for tax purposes. For example, inventory can be valued by two alternative methods, one of which deviates from normal accounting principles. Another example is landscaping costs which are capital items for accounting purposes but are deductible for tax purposes when paid [ITA 20(1)(aa)]. The number of variations is significant and a business must have an information system, which highlights this information. The amount of tax payable obviously affects the amount of cash flow, which in turn has an impact on the future return on investment.

The timing of certain deductions is discretionary and, in some cases, it may be advantageous to deduct the expense later than sooner. For example, if next year's tax rate is expected to be significantly higher than the current year, it may be advisable not to claim the current year's reserve for doubtful accounts. A reserve for doubtful accounts can, by choice, be excluded this year but claimed next year when the tax rate is higher. Without both accounting records and tax records, the value of such choices and their impact on the amount and timing of cash flow may not be evident.

R5-15. Based on the general rules for determining employment income and business income the two can be compared as follows:

a) Employment income (income minus deductions) is determined on a cash basis. Income is recognized when received (not necessarily when earned) and permitted expenses are deducted when paid. Business income, on the other hand, uses the accrual method requiring income to be recognized when earned and expenses deducted when incurred.

b) The determination of employment income permits no deductions except those specifically allowed, whereas, the calculation of business income permits the deduction of all expenses incurred to earn income subject to certain exceptions.

c) Employees can earn a specified number of non-taxable and tax deferred benefits. The determination of business income has no specific list of non-taxable income.

Key Concept Questions

QUESTION ONE

Which one of the following transactions is most likely to be treated as business income for tax purposes? Which one will likely be treated as a capital gain?

a) In Year 1, an individual purchased a parcel of land for $100,000 with the intention of building a rental property. In Year 5, they sold the rental property for $500,000.

b) In Year 1, an individual purchased a parcel of land for $100,000 with the intention of holding it until the land increased in value and could be sold at a gain. In Year 5, they sold the property for $500,000.

CPA Competency 6.2.2 Business income vs. capital gain. Income tax reference: ITA 9(1); IT-218R (archived).

QUESTION TWO

Sharp Ltd. incurred the following expenses in the current year:
- $25,000 in legal and accounting fees with respect to the issue of a new class of preferred shares.
- $8,000 for landscaping around the office building.
- $1,200 in interest paid to the CRA for late income tax instalments.
- $2,700 in interest on funds borrowed to finance the purchase of new office equipment.
- $40,000 in scientific research and experimental development expenditures.
- $80,000 in stock-based compensation expense.

Comment on the deductibility for tax purposes of each of the expenses.

CPA Competency 6.2.2 Common Schedule 1 adjustments. Income tax reference: ITA 7(3), 18, 20(1), 37(1), (2).

QUESTION THREE

Gary Amin carries on an accounting business as a sole proprietor. The business is registered for HST purposes. In the current year, he incurred the following expenses, among others:
- $12,312—Lease payment for his car (12 months). 80% of the kilometres driven were for business purposes.
- $1,000—Donation to a registered charity.
- $5,000—Entertaining clients (meals and theatre tickets).
- $2,400—Golf club annual dues; many of Gary's clients are members of the golf club.

Comment on the deductibility of these four expenses and the HST implications.

CPA Competency 6.2.2 Common Schedule 1 adjustments. Income tax reference: ITA 18(1), 67.1, 67.3.

QUESTION FOUR

A Ltd. incurred the following legal fees with respect to its business for the current year:

Representation to the Federal government	$8,000
Review of purchase agreement and title registration for new office building	5,000
Letters with respect to overdue accounts receivable	2,000
Registering the mortgage on the new office building	1,000

Determine the deduction permitted for tax purposes for the current year.

CPA Competency 6.2.2 Legal fees. Income tax reference: ITA 18(1), 20(1)(e), 20(1)(cc).

QUESTION FIVE

The following reserves appear in the financial statements of B Ltd. for the current year:

- allowance for doubtful accounts
- warranty claims
- contingent liability with respect to an upcoming union negotiation
- amounts due after the end of the current year for merchandise sales with a three-year payment term

Which of the above reserves are deductible for tax purposes?

CPA Competency 6.2.2 Common Schedule 1 adjustments. Income tax reference: ITA 18(1)(e), 20(1)(l), 20(1)(n).

QUESTION SIX

In 2022, SPL Ltd. paid tax-free automobile allowances of 57¢ per kilometre to two of its employees. Employee #1 drove 17,000 km and Employee #2 drove 6,000 km in carrying out their duties of employment.

Comment on the deductibility of the car allowance for SPL Ltd.

CPA Competency 6.2.2 Car allowances. Income tax reference: ITA 18(1)(r).

QUESTION SEVEN

To improve the company's cash flow, Brick Inc. sold all its trade accounts receivables to a factoring company for a cash price of $430,000. At the time, the face value of the receivables was $500,000. The selling price of $430,000 was determined as follows:

Face value	$500,000
Deduct:	
Estimated uncollectible	40,000
Fee to factor company	30,000
Net cash price received	$430,000

Stone Inc. closed its business and sold all of its assets to a purchaser who continued to operate the business. The selling price allocated to the accounts receivable was $460,000 determined as follows:

Face value	$500,000
Less estimated uncollectible	40,000
Net cash price received	$460,000

Describe the tax treatment to Brick and Stone of the sale of the accounts receivable.

CPA Competency 6.2.2 Accounts receivable. Income tax reference: ITA 22, 20(1)(l), (p).

QUESTION EIGHT

Canadian Enterprises carries on a tax consulting business in Toronto, Ontario. The income statement for 2022 includes a cost of $4,600 for the owner/operator attending three conventions during the year. Each convention includes a cost of $130 per day for meals. For convention #3, in December, airfare of $900 was included in accounts payable at the end of the year.

	Date	Organization	Location	Amount
#1	Feb 3	Ontario Tax Foundation	Toronto, ON	$1,000
#2	Jul 7 & 8	Canadian Tax Foundation	Gander, Newfoundland	1,600
#3	Dec 14 & 15	Canadian Tax Foundation	Vancouver, BC	2,000
				$4,600

Comment on the deductibility of the convention expenses.

CPA Competency 6.3.2 Conventions. Income tax reference: ITA 18(1)(b), 20(10). Solutions to Key Concept Questions

Solutions to Key Concept Questions

KC 5-1

[ITA: 9(1) – Capital vs. Income]

The intended use of the property on acquisition is the principal factor in deciding its tax treatment on a subsequent sale.

In part (a), the land was acquired to provide a long-term enduring benefit by generating rental income. The sale of the rental property will most likely be treated as a capital gain in which case only one-half of the gain will be taxable.

In part (b), the land was acquired for reselling at a profit. The profit on the sale of the land, like any inventory item, will be treated as business income. 100% of the profit will be taxable.

KC 5-2

[ITA: 18, 20(1), 37(1), (2) – Deductions]

The $25,000 legal and accounting fee incurred with respect to the issue of a new class of shares is a cost of issuing shares and as such is deductible over 5 years [ITA 20(1)(e)]. Therefore, $5,000 is deductible in the current year and in each of the following 4 years.

The $8,000 expense for landscaping is deductible in the current year, provided that the $8,000 was paid in the current year [ITA 20(1)(aa)].

The $1,200 of interest paid to the CRA is not deductible [ITA 18(1)(t)].

The $2,700 of interest paid to finance the purchase of office equipment is fully deductible in the year incurred [ITA 20(1)(c)]. Interest can, at the taxpayer's option, be deducted on a cash basis when paid, rather than by the accrual method. Alternatively, the interest expense can be added to the cost of the equipment and deducted in the form of CCA [ITA 21].

Scientific research and experimental development (SR&ED) carried on in Canada is given preferential tax treatment. The expenditures of a current nature are deductible in full in the year incurred [ITA 37(1)(a) & (b)]. Alternatively, the deduction, or any portion of it, can be saved and deducted in any future year [ITA 37(2)]. In addition, the SR&ED expenditures may also generate an investment tax credit, which reduces tax payable [ITA 127(5)]. Investment tax credits claimed in the year, reduce the SR&ED expenditure pool in the following year or are included in income, if there is no balance in the SR&ED pool [ITA 12(1)(t), 37(1)(e)]. Expenditures of a capital nature are not deductible as SR&ED and are excluded for investment tax credit purposes. These capital expenditures are deductible through CCA claims, like any other capital expenditures.

Stock-based compensation expense is not deductible. The *Income Tax* Act denies an employer a deduction in connection with the sale or issue of shares to an employee [ITA 7(3)(b)].

KC 5-3

[ITA: 18(1), 67.1, 67.3 – Deductions denied or limited; ETA: 123(1), 170(1)(a), 236]

Automobile lease payments for tax purposes are limited to $900 plus tax per month [ITA 67.3]. Since Gary's accounting practice is an HST registrant, he recovers the HST he pays and, thus, HST cannot be included as a cost. Thus, the car lease payments for the year are limited to $900 x 12 = $10,800. Gary uses the car 80% for business purposes - $10,800 x 80% = $8,640. Gary's deductible amount is $8,640.

Donations to registered charities are not for the purpose of earning income. They are gifts. Therefore, no deduction is available [ITA 18(1)(a)]. Donations involve a transfer of money, which is not a supply and, therefore, is outside the scheme of HST. No HST input tax credit is available [ETA 123(1)].

Fifty per cent of entertainment expenses are deductible [ITA 67.1]. Therefore, Gary can deduct $2,500. Although an HST input tax credit is initially allowed on the full amount expended for food and entertainment, there will be a recapture of 50% of the total input tax credit in respect of these expenses [ETA 236].

Membership dues in any club, the main purposes of which is to provide dining, recreational or sporting facilities for its members, are not deductible [ITA 18(1)(l)]. Therefore, the golf club dues are not deductible. HST input tax credits are not allowed in respect of these non-deductible membership fees [ETA 170(1)(a)].

KC 5-4

[ITA: *18(1), 20(1)(e), 20(1)(cc)* – legal fees]

Legal fees - Deductions permitted:

• Representation – fully deductible in the year paid [20(1)(cc)]	$ 8,000
• Review of purchase agreement and title registration [18(1)(b)]	
o Capital in nature. Not deductible	0
• Letter with respect to overdue accounts receivable – fully deductible	2,000
• Registering the mortgage on the new building – 20% deductible [20(1)(e)]	200
	$10,200

KC 5-5

[ITA: *18(1)(e), 20(1)(l), 20(1)(n)* – Reserves]

Reserves – Deductions permitted:

- Allowance for doubtful accounts – fully deductible provided it is a reasonable reserve in respect of doubtful debts [20(1)(l)].
- Reserve for warranty claims - not deductible [18(1)(e)].
- Contingent liability – not deductible [18(1)(e)].
- Reserve for unpaid amounts – deductible [20(1)(n)].

KC 5-6

[ITA: 18(1)(r) – Car allowances]

Since the car allowances are tax-free to the employees, SPL Ltd. is subject to a deduction limit of 61¢ (2022) for the first 5,000 business kilometres travelled by each employee and 55¢ (2022) for the remainder [ITA 18(1)(r)].

	Employee #1	Employee #2
Allowance paid		
• 17,000 km x 57¢	$9,690	
• 6,000 km x 57¢		$3,420
Maximum deductible:		
• 5,000 km x 61¢	$3,050	$3,050
• 12,000 km x 55¢	6,600	
• 1,000 km x 55¢		550
	$9,650	$3,600

Non-deductible portion:	
• Employee #1 ($9,690 - $9,650)	$ 40
• Employee #2	0
Total	$ 40

KC 5-7

[ITA: 22, 20(1)(l), (p) – Accounts receivable]

Brick Inc.

Since Brick Inc. has sold its accounts receivable to a factoring company, in the ordinary course of carrying on its business, the $70,000 discount is considered a deductible business expense, not a capital loss [IT-188R, par 8]. Using a factoring company allows Brick Inc. to speed up its cash inflows and is considered a form of financing.

Stone Inc.

In the case of Stone Inc., the accounts receivable are not sold in the ordinary course of carrying on its business, and thus, the $40,000 loss from the sale is treated as a capital loss rather than a business loss. However, Stone Inc. does have the right to establish that, as of the date of the sale, certain of the accounts receivable were bad debts, deductible as an expense of the year [20(1)(p)].

For the purchaser, in this case, the accounts receivable are considered to be capital property and, thus, if a lesser or greater amount than $460,000 is ultimately collected, the loss or gain will be a capital loss or capital gain. The purchaser is not permitted to claim a reserve for doubtful debts because the receivables were not included in the purchaser's income [ITA 20(1)(l)].

However, since Stone Inc. sold the accounts receivable as part of a sale of all or substantially all the property used in carrying on a business, to a purchaser who proposes to continue the business, Stone Inc. and the purchaser can file a joint election to receive more favourable tax treatment [ITA 22]. If such an election is filed, Stone Inc. will have a business loss of $40,000 and the purchaser, who paid $460,000 for the receivables, is deemed to have purchased them for a cost of $500,000 and to have deducted a reserve of $40,000. So, in the future, the purchaser must add the reserve of $40,000 to income and can claim a new reserve or deduct any actual bad debts as a business loss [ITA 20(1)(l),(p), 22].

KC 5-8

[ITA: 18(1)(b), 20(10) – Conventions]

Convention costs are normally considered capital in nature and therefore not deductible in the year incurred [ITA 18(1)(b)]. However, ITA 20(10) allows a deduction for convention expenses **paid** in the year in attending, in connection with the business, up to **two conventions** held in a year by a business or professional organization at a location consistent with the territorial scope of that organization.

	Total Cost	Non- deductible Meals (50%)	Expenses not paid in the year	Remainder
Convention #1	$1,000	$ 65	$ 0	$ 935
Convention #2	1,600	130	0	1,470
Convention #3	2,000	130	900	970

The location of each convention is within the territorial scope of the organization holding the convention. Since the number of conventions is limited to two in the year, the costs associated with convention #1 (lowest cost) are not deductible.

Convention expenses of $2,440 ($1,470 + $970) are deductible in 2022.