TAXADVISOR

Capital Punishment

As recent tax cases illustrate, writing off business expenses can be an exercise fraught with danger

COURT REPORT

BY JAMIE GOLOMBEK

If you conduct your advisory practice through an employee-employer relationship, as opposed to being self-employed, no doubt you're aware that your ability to deduct expenses is much more restrictive than if you owned your own business.

Each year, several tax cases make their way to Tax Court in which employees attempt to write off otherwise legitimate expenses but are told they can't because of technical rules in *the Income Tax Act*.

The most recent case, *Paes v The Queen* (2007 TCC 311), was released last month and serves as a valuable reminder to employees of the types of expenses that may or may not be deducted.

Ken Paes was a commissioned salesman for Superpages, a company that sells advertising to businesses. In 2003, he earned a base salary of $53,000 and reported commissions of over $42,000.

On his 2003 tax return, he wrote off over $27,000 of employment expenses, most of which the CRA allowed. However, the agency denied about $5,000 of these expenses, including office expenses for the purchase of presentation equipment, a printer, phone and cabinet as well as seminar and training expenses for a real estate sales seminar, a motivational lecture and a basic HTML course.

The CRA claimed that the office expenses should be classified as "capital" and therefore not deductible and that the seminar and training fees were not incurred for business purposes, nor was Paes required to attend these seminars as part of his employment.

OFFICE EXPENSES

Paes argued that in order to earn his income as a salesperson, working out of his home office, he needed to use a "table, chairs, cabinet, computer, printer, telephone among other equipment."

The problem, however, is that under *the Income Tax Act*, an employee who earns commissions can only deduct certain expenses but specifically cannot deduct "outlays, losses or replacements of capital or payments on account of capital," except capital cost allowance on vehicles and airplanes.

Paes testified that he failed "to see any rationale why there is discrepancy in the treatment of deductibility between motor vehicle expenses and office equipment expenses. Both are critical elements in earning income."

This issue has arisen most recently in the *Emmons* case (see my previous column, "Expenses for Advice," *AER* June 2006) in which a broker's computer costs were found to be of a capital nature and therefore not deductible.

Is also received national attention in the 2004 Supreme Court of Canada ruling in *Gifford*, a case involving a broker who was unable to deduct the cost of buying another broker's client list. The Supreme Court publicly highlighted this unfairness, saying that, ". . . employees are treated differently than taxpayers earning income from business . . . is not novel nor readily seen as fair . . . This seemingly inequitable result for [Gifford] is the result of the structure of the [Income Tax] Act."

The judge quoted the Gifford case and found that Paes was not entitled to claim the capital cost of any of his office supplies.

SEMINAR AND TRAINING EXPENSES

Paes also deducted the costs of motivational and a real estate sales seminars he attended. He testified that at these seminars, he learned "sales techniques and sold advertising to real estate agents." Paes felt that the training he received in those seminars "has directly helped [him] in his present position as [a] salesperson."

The Canada Revenue Agency in its Interpretation Bulletin IT-357R2, "Expenses of Training" distinguishes between deductible and non-deductible training costs. The CRA states that training costs are not deductible as a current expense if they are considered "capital expenditures." This occurs "where the training results in a lasting benefit to the taxpayer, i.e., where a new skill or qualification is acquired." By contrast, where "the training is taken merely to maintain, update or upgrade an already existing skill or qualification, the

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ADVISOROPINION

A Bird in the Hand

Investors would rather see one investment vehicle outperfrom, rather than watch many underperform

GUEST COLUMN

BY JOHN DE GOEY

Most advisors I know recommend picking stocks or selecting actively managed mutual funds as a responsible way to build a portfolio. I confess that I haven't heard many compelling reasons as to why. That's especially true in the context of advisors insisting they take a long-term view while aiming to help their clients make "smart" decisions with their money.

Although there are many definitions of "long-term view," let's use 20 years as a time horizon. Over that period, what per cent of actively managed funds end up beating the return of a suitable investment-eligible market proxy? Studies on this subject indicate the consensus answer is "less than 20%." To make matters worse, no one has yet devised a method where the outperformers can be reliably identified in advance. It seems the performance results are random and best explained by chance.

Here's where it gets dicey. If only 20% of the funds available in 2007 have a 20-year track record that beats their benchmark, what percentage of the funds that were available in 1987 fall into the same category? What if, instead of starting at the end and working backward, we reversed the process?

Many people would agree that it is probable to assume that over half the funds that existed in 1987 no longer exist – either merged or closed as a result of poor performance. From the 1987 group, that leaves less than half of less than 20% beating their investable benchmark over a long timeframe.

If you are one of 1,000 people in a marathon and you finish 100th, while 500 others fail to finish, you would normally be said to finish in the top 10% of those who started; not the top 20% of those who finished. My sense is that many advisors ignore survivorship bias when thinking through their product recommendations.

Of course, the story (and the logic) is the same for individual stock pickers, but there's no reliable data on that subject, so the extent to which people using individual securities do better or worse than those using funds will likely never be known. The facts are these:

❶ Most advisors counsel clients to beat the benchmark;

❷ The large majority of those who try to do so fail as a direct result of having tried;

❸ Those that succeed are not reliably identifiable and the outcomes look random.

Do advisors counsel clients to buy lottery tickets or frequent casinos? So would any one of those advisors who recommend actively managed products please give me a rational, research-based reason for doing so?

It seems to me that if you were to recommend ten "bird in the hand" investment vehicles that were all certain to slightly underperform their benchmark over a long timeframe, many investors would find that preferable to trying for "two in the bush." They would rather see one outperform and nine others underperform if some of those nine were likely to underperform by a wide margin.

The question is: do you present that to them? AER

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related costs are not considered to be capital in nature."

The judge determined that Paes' courses were of a capital nature and that he was not entitled to a deduction.

CANADA EMPLOYMENT CREDIT

If you find yourself in the same position as Paes, keep in mind that in last year's budget, the federal government introduced some relief with the new "Canada Employment Credit," designed to give "Canadians a break on what it costs to work, recognizing expenses for things such as home computers, uniforms and supplies."

For 2007 the CEC amount is $1,000, which translates into a non-refundable tax credit of $155 (equal to 15.5% of $1,000). AER

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