REPORT ON THE TAX TREATMENT OF LAWYERS' INCOME ON THEIR APPOINTMENT TO THE BENCH

Business and Publications Division
Income Tax Rulings Directorate
Policy and Legislation Branch

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INTRODUCTION

The purpose of this paper is to update the Report on the tax treatment of lawyers appointed to the Bench, originally published by the Canada Customs and Revenue Agency (the "Agency") in June 1987 and updated several times since. This paper refers to the Income Tax Act (the "Act") consolidated to June 29, 2000. We will also make comments about amendments proposed in the 2000 Budget of February 28, 2000 and in the Economic Statement and Budget Update of October 18, 2000. All references to masculine persons include feminine persons.

This is not intended to be a technical paper. It is written mainly to inform the lawyers appointed to the Bench or who cease to practice their profession as proprietor or a member of a partnership of the tax implications from these transactions. These opinions are of a general nature and may vary depending on the particular circumstances of a specific case. Specific queries may be addressed to the Director General, Income Tax Rulings Directorate, Canada Customs and Revenue Agency, Place de Ville, 16th floor, Tower A, 320 Queen Street, Ottawa, Ontario, K1A OL5.

INCOME EARNING PERIOD

The taxation year of an individual is the calendar year. Therefore, all amounts of income received or deemed to have been received in the calendar year are subject to tax for that calendar year.

An individual is generally required to report income from a business carried on in Canada, for the 1995 and subsequent taxation years, on a calendar year basis. This rule is applicable to business carried on by an individual or a partnership of which at least one individual is a member. In this regard, an alternative method allows an eligible individual to keep a fiscal period that does not coincide with the calendar year.

An eligible individual carrying on a business at the end of 1994, could have deducted, in the computation of his income for a particular year, a transitory reserve for his December 31, 1995 income.

Generally, when an eligible individual ceases to carry on a business in a taxation year he can deduct an amount as a reserve for his December 31, 1995 income in

the computation of his income for that year. However, the amount of the reserve deducted shall be included in his income in the subsequent year and no further reserve can be claimed in that subsequent year.

SALE OF A BUSINESS BY A PROPRIETOR

When a proprietor sells his business, the purchase price must be allocated to the various properties sold, such as accounts receivable, work in progress, depreciable property, capital property other than depreciable property, goodwill, etc. This will have the following consequences:

(a) Accounts receivable: If the vendor and purchaser jointly elect to have the provisions of subsection 22(1) of the Act apply:

(i) the vendor may deduct in computing his income the amount by which the face value of his accounts receivable exceeds the consideration he received for them,

(ii) the purchaser will include that excess in his income, but will be deemed to have included the accounts receivable in his income so that he may thereafter deduct amounts in respect of doubtful accounts and bad debts.

If the election permitted by subsection 22(1) is not made, the sale of the accounts receivable will be a capital transaction so that any losses by the vendor and subsequently by the purchaser will be capital losses.

(b) Work in progress: The amount received in respect of his work in progress will represent income for the year in which he sold it.

(c) Depreciable property: If the proceeds of disposition in respect of any prescribed class of depreciable property exceeds its undepreciated capital cost, the excess up to the capital cost, will represent recaptured capital cost allowance which constitutes income. Any proceeds of disposition in excess of capital cost would possibly be a capital gain. If the proceeds of disposition is less than the undepreciated capital cost, the difference may be deducted if the taxpayer no longer has any assets remaining in the class at the end of the taxation year.

(d) Capital property, other than depreciable property: If the proceeds of disposition exceed the adjusted cost base, 75 % of the excess constitute a taxable capital gain which will be included in the vendor's income. If the adjusted cost base exceeds the proceeds of disposition, 75 % of the excess will be an allowable capital loss which may be deducted from taxable gains for the year. The February 28, 2000 Budget proposes to reduce the inclusion rate for capital gains and capital losses from 75 % to 66 2/3 % for dispositions of capital property made after February 27, 2000. The Economic Statement of October 18, 2000 proposes to reduce the inclusion rate for capital gains and capital losses from 66 2/3 % to 50 % for dispositions of capital property made after October 17, 2000. The excess of

the allowable capital losses over the taxable capital gains is not deductible against sources of income other than capital gains. This excess can be deducted in the three preceding taxation years and the subsequent taxation years to the extent of the aggregate of the net taxable capital gains for these years. Since there is three inclusion rates for capital gains and capital losses that apply for the year 2000, Schedule 3 of the 2000 Income Tax and Benefit Return provides that the total capital gains or capital losses must be calculated for each of these three periods. The last part of Schedule 3 establishes which inclusion rate will applied to the total of these capital gains or capital losses for the year.

(e) Goodwill: For the purposes of the Act, goodwill is part of a pool named "cumulative eligible capital", (CEC). The disposition of goodwill reduces the CEC pool. 75 % of the amount received reduce the CEC. The February 28, 2000 Budget proposes that 66 2/3 % of the amount received reduces the CEC instead of 75 % for disposition of eligible capital property made after February 27, 2000. The Economic Statement of October 18, 2000 proposes that 50 % of the amount received reduces the CEC instead of 66 2/3 % for dispositions of eligible capital property made after October 17, 2000. Where the CEC is negative, the excess must be included in the vendor's income for that calendar year. If the CEC is positive, the vendor may deduct the positive amount against his income for the year in which the business has ceased.

DISPOSITION OF A PARTNERSHIP INTEREST

The interest which a partner has in the net assets of his partnership is referred to as a partnership interest. This is a capital property, and consequently the disposition of it could result in a capital gain or a capital loss. If the proceeds of disposition exceed the adjusted cost base, 75 % of the excess constitute a taxable capital gain which will be included in the vendor's income. If the adjusted cost base exceeds the proceeds of disposition, 75 % of the excess will be an allowable capital loss which may be deducted from taxable gains for the year. The February 28, 2000 Budget proposes to reduce the inclusion rate for capital gains and capital losses from 75 % to 66 2/3 % for dispositions of capital property made after February 27, 2000. The Economic Statement of October 18, 2000 proposes to reduce the inclusion rate for capital gains and capital losses from 66 2/3 % to 50 % for dispositions of capital property made after October 17, 2000.

The excess of the allowable capital losses over the taxable capital gains is not deductible against sources of income other than capital gains. This excess can be deducted in the three preceding taxation years and the subsequent taxation years to the extent of the aggregate of the net taxable capital gains for these years. Since there is three inclusion rates for capital gains and capital losses that apply for the year 2000, Schedule 3 of the 2000 Income Tax and Benefit Return provides that the total capital gains or capital losses must be calculated for each of these three periods. The last part of Schedule 3 establishes which inclusion rate will applied to the total of these capital gains or capital losses for the year.

The disposition of a partnership interest usually occurs in one of two ways:

(a) The interest is purchased by another person who is or becomes a partner. The vendor's capital gain or capital loss on the disposition of his partnership interest would be computed at that time. If the full purchase price is not paid in the year, the vendor would be entitled to deduct from the full capital gain, otherwise determined, a reserve as discussed below.

(b) The partnership "pays out" the interest to the withdrawing partner. The former partner continues to have a residual interest in the partnership where his interest is not satisfied in full at the time of his departure. In this case, the former partner is deemed not to have disposed of his interest in the partnership until such time as his right to receive property in satisfaction of that interest is fully satisfied. Each amount received reduces the adjusted cost base of his interest. Where this results in a negative adjusted cost base at the end of the fiscal year of the partnership, the former partner will have a capital gain equal to the negative amount for his taxation year that includes the end of the partnership's fiscal period. Thereafter, the amount received in satisfaction of his interest in the partnership during its fiscal period will constitute a capital gain for the taxation year in which the fiscal period of the partnership ends.

PAYMENTS TO A FORMER PARTNER IN RESPECT OF GOODWILL AND WORK IN PROGRESS

Work in progress and goodwill, like other properties of a partnership, are considered to be owned by the partnership for tax purposes. Since the withdrawing partner contributed to the creation of those properties, and since they may not be recorded in the accounts of the partnership, arrangements may be made to pay the withdrawing partner in respect of them. Such payments are in satisfaction of the former partner's rights to property of the partnership in satisfaction of his partnership interest and consequently are of a capital nature to both the former partner and the partnership. The payments will thus represent additional proceeds from the disposition, by the former partner, of his interest in the partnership and consequently will enter into the calculation of any capital gain or capital loss he may experience. The payments are not deductible in computing the income of the partnership or of the remaining partners.

Where the principal activity of the partnership is carrying on business in Canada, and its members all agree, a portion of the future income of the partnership may be allocated to the former partner. For example, the portion so allocated could be based on the former partner's proportionate interest in the work in progress. In this case, the amount so allocated would constitute income to the former partner for the year in which the fiscal period of the partnership ended and the amount would be deducted in computing the balance of the income of the partnership to be allocated to the remaining partners.

RESERVE IN RESPECT OF CAPITAL GAINS

Where there is a disposition of a capital property and some of the proceeds of disposition are not due until after the end of the year, a reasonable amount of the capital gain may be deferred to be included in income in the years in which the proceeds are received. At least one-fifth of the capital gain must be recognized in the year of disposition and in each of the four subsequent years.

REGISTERED RETIREMENT SAVINGS PLAN (RRSP)

The RRSP deduction limit for a taxation year is calculated as being the total of:

- the taxpayer's unused RRSP deduction room at the end of the preceding taxation year,
- the lesser of the RRSP dollar limit for the year and 18% of the taxpayer's earned income for the preceding taxation year less the total of:
    - the taxpayer's pension adjustment for the preceding taxation year in respect of an employer,
    - a prescribed amount in respect of the taxpayer for the year,
- the taxpayer's total pension adjustment reversal for the year,

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- the taxpayer's net past service pension adjustment for the year.

Where a judge is in receipt of a salary under the Judges Act (federal judge), the prescribed amount, for years 1997 to 2004, is the lesser of 18% of the salary received as a judge for the preceding year less the PA offset ($ 600) and the money purchase limit for the preceding year.

The money purchase limit and the RRSP dollar limit for years 1997 to 2002 is $ 13,500.

Consequently, federal judges will generally have no new RRSP deduction room available to them for those years.

The amount that an individual may contribute to an RRSP in a given year is indicated on the taxpayer's notice of assessment of the previous year.

PAYMENT OF TAX

Income tax is required to be deducted from salaries, payments from most types of retirement plans, etc. The income tax so deducted is generally based on the amount of the income from which it is deducted.

An individual resident outside Quebec at the end of a taxation year is required to pay quarterly tax instalments during the year if his federal and provincial income taxes payable after deducting federal and provincial income taxes withheld at source is more than $2,000 in both that year and either of the two preceding years. Since the Quebec Government collects provincial taxes directly, the $2,000 amount is adjusted for Quebec residents to $1,200 of federal tax payable after federal tax withholdings.

To determine the amount of instalments payable, the individual can follow any of the prescribed methods or can rely on the notice issued by the Agency. An individual who pays on time the amount indicated on the notice issued by the Agency will not be subject to any interest nor penalty.

REFERENCE DOCUMENTS

The Agency publishes Interpretation Bulletins to set forth the interpretation of specific provisions of the Act. These are available from your local tax services office or from the Communications Branch, Canada Customs and Revenue Agency, 875 Heron Road, Ottawa, Ontario, K1A 0L5. A list of some which may be pertinent follows:

IT-123R6	Transactions Involving Eligible Capital Property
IT-172R	Capital Cost Allowance - Taxation Year of Individuals
IT-172R	Special Release issued June 13, 1986
IT-188R	Sale of Accounts Receivable
IT-188R	Special Release issued September 26, 1994
IT-220R2	Capital Cost Allowance - Proceeds of Disposition of Depreciable Property
IT-220R2	Special Release issued February 11, 1994
IT-236R4	Reserves - Disposition of Capital Property
IT-242R	Retired Partners
IT-278R2	Death of a Partner or of a Retired Partner
IT-287R2	Sale of Inventory
IT-313R2	Eligible Capital Property - Rules Where a Taxpayer Has Ceased Carrying on a Business or Has Died
IT-338R2	Partnership Interest - Effects on Adjusted Cost Base Resulting from the Admission or Retirement of a Partner
IT-457R	Election by Professionals to Exclude Work in Progress from ncome