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A taxpayer (whether an individual or a corporation) must include income and loss from business and property when computing their income for a taxation year. A business is treated under the federal *Income Tax Act* (the "Act") as a source of income different from property, and both differ from employment, which has its own separate set of rules. This article provides a brief overview of some of the primary tax rules pertaining to how business income is subject to income tax.

What Is a Business for Income Tax Purposes?

A "business" includes a profession, calling, trade, manufacture, or undertaking of any kind whatsoever, as well as an adventure or concern in the nature of trade. A business generally involves the sale of goods or services.

Determining Whether There Is a Source of Income

The Act requires a taxpayer to include income from multiple sources, such as business, property, or employment. According to the Supreme Court of Canada, the determination of whether a taxpayer has a source of income from a business or property involves the following two-stage approach:

(i) Is the taxpayer's activity undertaken in pursuit of profit, or is it a personal endeavour?

(ii) If it is not a personal endeavour, is the source of the income a business or property?

The first stage of the test is only relevant when there is some personal or hobby element to the activity. Where the nature of an activity is clearly commercial, the taxpayer's

pursuit of profit is established and there is no need to take the inquiry any further by analysing the taxpayer's business decisions (at that point, the only issue is whether the source is a business or property). However, where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit, the venture will be considered a source of income only if it is undertaken in a sufficiently commercial manner. For an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit and there must be evidence of businesslike behaviour that supports that intention.

Computing Profit From a Business

The profit from a business is determined differently for tax purposes than how it is determined for accounting purposes. In fact, the Supreme Court of Canada has specifically rejected the notion that profit for tax purposes is determined solely by reference to generally accepted accounting principles ("GAAP"). Instead, the Court held that profit is a legal issue, and is to be determined using "well accepted principles of business (or accounting) practice", or "well accepted principles of commercial trading".

According to the Supreme Court of Canada, the following principles apply to the determination of profit for income tax purposes:

(1) The determination of profit is a question of law.

(2) The profit of a business for a taxation year is to be determined by setting against the revenues from the business for that year the expenses incurred in earning said revenues.

(3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.

(4) In ascertaining profit, the taxpayer is free to adopt any method which is not inconsistent with

  (a) the provisions of the Act;

  (b) established case law principles or rules of law; and

  (c) well-accepted business principles.

(5) Well-accepted business principles, which include but are not limited to the formal codification found in GAAP, are not rules of law but interpretive aids. To the extent that they may influence the calculation of income, they will do so only on a case-by-case basis, depending on the facts of the taxpayer's financial situation.

(6) On reassessment, once the taxpayer has shown that they have provided an accurate picture of income for the year which is consistent with the Act, the case law, and well-accepted business principles, the onus shifts to the Minister to show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture.

The term "profit" means net profit, that is to say, the gross income of a business minus the expenditure necessary to earn that income.

There are many income tax rules that govern what expenditures and losses are deductible for tax purposes. Some deductions are sanctioned while others are explicitly prohibited. For example, the deduction of an outlay or expense "except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property" is prohibited. It is implied in this wording that an outlay or expense incurred for the purpose of gaining or producing income from property or

a business of the taxpayer will be permitted as a deduction (unless its deduction is prohibited by some other provision).

You generally cannot deduct capital expenditures, notably except for depreciable property (i.e., "capital cost allowance").

If your deductions claimed when computing income from a business or property exceed your income, you have realized a non-capital loss. The loss can be deducted from your income from other sources (e.g., employment). If you cannot fully deduct the loss from other income sources, the loss may be carried back to any of the three prior years or forward to any of the 20 subsequent years.

Business Income Versus Capital Gains

A capital gain is generally income from the disposition of property, though that income can be characterized as income from a business in certain circumstances. For example, if it is the owner's intention to trade or to realize a profit from the property rather than to hold it for the income it produces, the gain or loss realized may be treated as an ordinary income gain or loss rather than a capital gain or loss.

The amount of the capital gain is equal to the proceeds of disposition minus the property's cost base plus any selling costs. Generally, capital gains were taxed at a lower rate since only half of the gain was included in income for tax purposes. However, the low-tax status of capital gains has potentially diminished due to the capital gains inclusion rate increasing to two-thirds effective June 25, 2024.

In deciding whether the gain from a particular transaction should be treated as income or capital, the following factors are determinative:

(1) The period of ownership — Normally, property held for only a short time will be considered to have been purchased for the purposes of resale and the profits will be treated as income, while property that has been held a long time is more likely to be considered as an investment, thus giving rise to a capital gain.

(2) The frequency of similar transactions — A history of extensive buying and selling of similar properties or of quick turnovers of properties may be taken as evidence indicating that a taxpayer is carrying on a business. Obviously, if you are carrying on a business, it is assumed that any assets forming part of the inventory of the business were purchased for the purpose of resale, and gains or losses on sale of these assets will not be of a capital nature.

(3) Improvement and development work — When an organized effort is made to put property into a more marketable condition it may indicate a business of selling properties.

(4) Reasons for and nature of sale — If a sale of property is the result of an active campaign to sell it rather than the result of something unanticipated at the time of purchase (e.g., expropriation, sudden need of money, frustration of original intentions), the profits may be more likely to be considered business income.

(5) The relationship of the transaction to the taxpayer's ordinary business (e.g., sale of land by persons ordinarily active in the real estate business).

Business Income Versus Property Income

Income from property is generally regarded as the return on invested capital where little or no time, labour, or attention is expended in pro-

ducing the return. Income from property would normally include dividends, interest, rents, and royalties. However, such income might be treated as income from business if sufficient time and effort is expended in earning it. For example, if a person actively trades securities on a full-time basis, income from those securities may be considered income from a business.

There are many subtle differences between how business and property income are taxed. The small business deduction and lifetime capital gains deduction (two especially valuable incentives) are accessible only to those earning business income. The small business deduction reduces the tax rate on income earned by a corporation, but it is only available on income earned from an active business. The lifetime capital gains exemption, which can exempt up to $1.25 million of capital gains from taxation, is only available if the capital gains are from the disposition of qualified small business corporation shares ("QSBCs"). One of the conditions needed to qualify as QSBCs is that the corporation's assets must be principally used in an active business.

Business Income Versus Employment Income

Income from business is treated quite differently compared to income from employment. Because being an independent contractor is generally more advantageous from a tax perspective than being an employee, there are many cases dealing with the question of whether an individual is carrying on business as an independent contractor or as an employee. Some examples of these advantages are:

- An employee is restricted to certain deductions whereas a self-employed individual is entitled to more deductions which are available in computing income from a business.
- An individual's taxation year is simply the calendar year. However, a corporation's taxation year is its fiscal period, which offers more flexibility.
- An employee must include income from an office or employment as it is received. However, income from property or business is normally computed on an accrual basis.

Employers must withhold tax from their employee's wages and other remuneration and remit the same to the CRA. Similar withholding and remittance requirements are found in the Employment Insurance and Canada Pension Plan legislation. On the other hand, there is no general withholding or remittance requirement for amounts paid to independent contractors for services rendered.