TAX FOR THE Owner-Manager

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CRA Audit of "Other Employment Expenses": The Adler Case

In the fall of 2017, the CRA began an audit project targeting "other employment expenses" claimed on line 229 of the T1 tax returns of employee-shareholders. The expenses attacked were vehicle expenses and home-office expenses that are deductible under paragraph 8(1)(h.1) and subparagraphs 8(1)(i)(ii) and (iii), respectively. Under those provisions, the employee must be required, under a contract of employment, to pay the expenses. No written contract is necessary to evidence the agreement. In addition, under subsection 8(10), the expenses are deductible only if a completed form T2200 ("Declaration of Conditions of Employment") signed by the taxpayer's employer is filed with the taxpayer's tax return for the year that the expenses are claimed. However, the CRA's administrative practice (set out at the top of the form) does not require that the form be filed with the return, although the taxpayer must keep it and have it available for review by the CRA.

The CRA was apparently relying on *Adler v. The Queen* (2009 TCC 613) to support its audit project. (The case was litigated under the informal procedure and therefore has no precedential value.) The CRA relied on *Adler* for the proposition that if the employee is also an owner-manager or the spouse of an owner-manager, certain employment expenses cannot be deducted unless the owner-manager or his or her spouse can show that serious negative consequences would have resulted if the employee had failed to pay the relevant expenses.

On or about February 15, 2018, the CRA sent out a message stating that the audit program would be suspended, that the employment expenses disallowed during the review period from September 10, 2017 to February 10, 2018 would be reversed, and that a consultation process would be undertaken to "clarify the requirement of employer certification under subsection 8(10) of the *Income Tax Act* as it relates to shareholder-employees."

It may be instructive to set out the reasoning behind the CRA's former assessment position and to highlight how owner-managers might protect themselves if the assessment position is subsequently restored.

In *Adler*, the taxpayer was the sole shareholder and officer of Island Ink-Jet Manitoba Ltd. ("Island"). The taxpayer was employed by Island and claimed employment expenses under paragraphs 8(1)(h.1) and (i), both of which provided, among other things, that the taxpayer be required under his contract of employment to pay the expenses in question in order to claim the deduction. The Crown was not permitted to allege that the taxpayer had not filed form T2200, apparently because form T2200 was not part of the evidence before the court. Form T2200 requires the employer to, among other things, certify that the employee is required to pay his or her own expenses while carrying out the duties of employment. The judgment in *Adler* does not make it clear whether or not the taxpayer's employment contract specifically required him to pay the disputed expenses.

In *Adler*, the TCC, relying on *The Queen v. Cival* (83 DTC 5168 (FCA)) and *Hoedel v. The Queen* (86 DTC 6535 (FCA)), held that the taxpayer would have to show that "there would be some consequences that would be detrimental to the Appellant if he failed to fulfill the [contractual] obligation." The taxpayer was unable to show that he would suffer any detrimental effects if he failed to abide by the contractual requirements, and consequently the deductions were denied.

With respect, Webb J in *Adler* appears to have read *Cival* and *Hoedel* too broadly: the effect was to read in an additional condition not present in the statutory requirements set out in paragraphs 8(1)(h.1) and (i).

Cival dealt with the taxpayer's 1977 taxation year, in which the taxpayer, who was reimbursed for his mileage, had claimed as a deduction the balance of his expenses above and beyond the mileage allowance. No formal contract specifically required him to pay the expense. Consequently, the FCA constructed a test to determine whether, in the absence of a specific contract governing the payment of expenses, such a condition existed. The court found that the arrangement between Mr. Cival and his employer was not contractually binding and therefore did not meet the requirements of subparagraph 8(1)(h)(ii).

Hoedel involved a taxpayer who was employed by the Regina Police Department and who was responsible for the care of a dog. In computing his income for his 1980 taxation year, the taxpayer deducted certain expenses with respect to the use of his own motor vehicle. His governing collective agreement was silent on the point of whether the work relating to the transport and care of the dog was a condition of his employment. In a passage from *Hoedel* (cited by the TCC in *Adler*), the FCA found that the employee's failure to socialize and care for the dog properly could result in highly undesirable consequences for the employee. This finding, and the

finding that it was mandatory that the employee keep the dog with him when he was off duty, led the FCA to hold that the employee in *Hoedel* was required under his contract of employment to pay the expenses relating to the transport of the dog and therefore was entitled to a deduction.

It is worth noting that subsection 8(10) is applicable for 1988 and subsequent taxation years, and that the decisions in *Cival* and *Hoedel* were in respect of taxation years prior to 1988.

The test articulated by the TCC in *Adler*, which requires a taxpayer to show that he or she would suffer detrimental effects if he or she failed to abide by the contractual requirements, should be relevant only if it is unclear whether the employee is required to pay the employment expenses under the relevant contract of employment. A properly completed form T2200 for the relevant year is evidence of this requirement and in most cases should be sufficient to satisfy the statutory requirement.

However, given the CRA's approach in its audit project, owner-managers should ensure that they have a written employment contract stipulating which expenses must be paid by the shareholder-employee (or a related person). A specific written contract is preferable to an informal oral agreement.

Often, many owner-managers have no written contracts of employment with their key shareholder-employees. In our view, the CRA's audit position was overly aggressive and relied unreasonably on case law that involved situations that were distinguishable from the situations that were being audited. Happily, the CRA has withdrawn this flawed assessment position—for the moment—and one can hope that the CRA will shy away from similar assessment positions in the future.

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