NO.: **IT-104R3** DATE: August 9, 2002

SUBJECT: INCOME TAX ACT
Deductibility of Fines or Penalties

REFERENCE: Paragraph 18(1)(*a*) (also subsections 18(9.1), 40(1) and 127(9), paragraphs 18(1)(*b*), 18(1)(*c*), 18(1)(*h*), 18(1)(*t*) and 20(1)(*c*), and paragraph (*d*) of the definition of "eligible capital expenditure" in subsection 14(5) of the Act and clause 2902(*a*)(i)(H) of the *Income Tax Regulations*)

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The 2004 Budget proposes that, with two exceptions, all fines or penalties imposed by federal, provincial or municipal governments in Canada or by a foreign country are not deductible. This includes any fines or penalties imposed by a government, a government agency, regulatory authority, court or other tribunal, or any other person with a statutory authority to levy a fine or penalty. The two exceptions are:

- Penalty interest imposed under the *Excise Act*, the *Air Travellers Security Charge Act* and the GST/HST portions of the *Excise Tax Act* will continue to be deductible.
- There is to be regulated authority to exclude prescribed fines and penalties. The House of Commons Standing Committee on Finance will be consulted with respect to any recommendation put forward.

Penalties charged pursuant to contracts (e.g., penalties for late performance) are not covered by the proposal. They will continue to be deductible if they meet the general rules under the ITA.

The amendment applies to fines and penalties imposed after March 22, 2004.[1]

Contents

Application

This bulletin replaces and cancels Interpretation Bulletin IT-104R2 dated May 28, 1993.

Summary

The decision from the Supreme Court of Canada in *65302 British Columbia Ltd. v. The Queen* is the leading case concerning the deductibility of fines and penalties.

This bulletin discusses the impact of this decision, and also refers to general and specific provisions in the *Income Tax Act* that could be relevant to the question of the deductibility of certain fines or penalties.

Discussion and Interpretation

Introduction – Types of Fines and Penalties

¶ 1. Fines and penalties can be categorized as follows:

- Judicial – These are imposed by a court of law or other competent tribunal for a breach of any public law, including carrying on an illegal business.
- Statutory – These are imposed as a result of the application of statutes (for example, the *Income Tax Act*, *Customs Act*, *Competition Act* or provincial business practices legislation).
- Levied by professional and similar organizations – Certain organizations recognized by statute as the governing bodies of specific businesses, professions or trades are empowered to levy fines and penalties against their members for infractions of their own rules. Provincial law societies, accounting institutes, colleges of physicians and stock exchanges are examples of such organizations.
- Levied by trade organizations and similar bodies – Associations in which persons with common business or vocational interests participate for the collective benefit of those interests (such as trade associations, farmers' associations and similar bodies) often set standards of performance to be met in the operations of their members and, pursuant to voluntary agreements, impose penalties on infractions.
- Penalties levied under private contracts – A party to a private contract may incur a penalty for failure to fulfil an obligation thereunder.

The 65302 British Columbia Ltd. Decision

¶ 2. The leading decision from the courts with respect to the deductibility of fines or penalties is *65302 British Columbia Ltd. v. The Queen*, [2000] 1 CTC 57, 99 DTC 5799, in which the Supreme Court of Canada allowed as a deductible expense an over-quota levy incurred by the taxpayer in respect of its egg-producing hens. The following general principles are found in the reasons for this decision:

- The characterization of a levy as a "fine" or "penalty" is of no consequence (i.e., does not make it any less deductible), because the income tax system does not distinguish between levies (which are essentially compensatory in nature) and fines and penalties (which are punitive in nature).
- The deduction of a fine or penalty cannot be disallowed solely on the basis that to allow it would be considered contrary to public policy.
- Prohibiting the deductibility of fines and penalties is inconsistent with the practice of allowing the deduction of expenses incurred to earn illegal income.
- In order for a fine or penalty to be deductible in computing income from a business or property, paragraph 18(1)(*a*) of the Act requires that it be incurred for the purpose of gaining or producing income from that business or property.
- Paragraph 18(1)(*a*) contains no requirement that a fine or penalty must be unavoidable in order for it to be deductible.
- Notwithstanding that a fine or penalty may have been incurred for the purpose of gaining or producing income from a business or property within the meaning of paragraph 18(1)(*a*), its deductibility can nevertheless be disallowed by another provision in the *Income Tax Act*.

For further comments on paragraph 18(1)(*a*), see ¶ 3 and also ¶ 8. Other provisions in the Act that can have a bearing on the deductibility of fines and penalties are discussed in ¶ 4 to ¶ 7.

Paragraph 18(1)(*a*)

¶ 3. Paragraph 18(1)(*a*) of the Act provides that, in computing a taxpayer's income from a business or property, no deduction shall be made in respect 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. As stated by the Supreme Court of Canada in the *65302 British Columbia Ltd.* decision: "…if the taxpayer cannot establish that the fine was in fact incurred for the purpose of gaining or producing income, then the fine or penalty cannot be deducted …."

For purposes of establishing whether a fine or penalty has been incurred for the purpose of gaining or producing income:

- the taxpayer need not have attempted to prevent the act or omission that resulted in the fine or penalty; and
- the taxpayer need only establish that there was an income-earning purpose for the act or omission, regardless of whether that purpose was actually achieved.

In the *65302 British Columbia Ltd.* decision, the Supreme Court of Canada also stated: "It is conceivable that a breach could be so egregious or repulsive that the fine subsequently imposed could not be justified as being incurred for the purpose of producing income." The Court did not, however, give any guidelines with respect to this statement other than to indicate that "…such a situation would likely be rare…." It would have to be one in which the egregiousness or repulsiveness of the act or omission giving rise to the fine or penalty is sufficient to refute any allegation that the purpose of the act or omission was to gain or produce income.

Other General Provisions

¶ 4. In addition to paragraph 18(1)(*a*), there are other general provisions in the Act that could apply to disallow the deduction of an outlay for a fine or penalty as a current expense:

- paragraph 18(1)(*b*) – if it is a capital outlay (see, however, ¶ 5);
- paragraph 18(1)(*h*) – if it is a personal expense; or
- paragraph 18(1)(*c*) – if it is incurred to earn tax-exempt income.

Subject to subsection 18(9.1) (see ¶ 7), a penalty paid on prepayment of a mortgage would not be deductible as a current expense, pursuant to paragraph 18(1)(*b*), unless the penalty is incurred in the course of carrying on a business, e.g., trading in mortgages. (See also the discussion of mortgage prepayment penalties in ¶s 5, 6 and 7.)

¶ 5. If a fine or penalty is incurred in connection with the acquisition of an asset for which capital cost allowance (CCA) may be claimed, the cost of the fine or penalty is included in the capital cost of that asset (or the CCA class to which the asset belongs).

If a fine or penalty is incurred in connection with the acquisition of an eligible capital property, the cost of the fine or penalty is an eligible capital expenditure provided all the other tests in the subsection 14(5) definition of "eligible capital expenditure" are met.

If a fine or penalty is incurred in connection with the acquisition or production of inventory, the cost of the fine or penalty is included in the cost of inventory.

If a fine or penalty (e.g., a mortgage prepayment penalty) is incurred in connection with the disposition of a capital property, the cost of the fine or penalty is taken into account under subsection 40(1) for purposes of calculating any gain or loss on that disposition.

Specific Provisions

¶ 6. A fine or penalty may be subject to one of the following specific disallowance provisions in the *Income Tax Act*:

- Paragraph 18(1)(*t*) prohibits a deduction for any amount paid or payable under the *Income Tax Act* (other than tax under Part XII.2 or XII.6). Thus, no deduction is allowed for any interest, penalty or fine imposed under the Act.
- Fines and penalties are listed as "prescribed expenditures" in clause 2902(*a*)(i)(H) of the *Income Tax Regulations*. As a result, any type of fine or penalty is excluded from the definition of "qualified expenditure" for scientific research and experimental development in subsection 127(9) and is not allowable for investment tax credit purposes.
- A penalty paid on prepayment of a mortgage does not qualify as an "eligible capital expenditure", by virtue of paragraph (*d*) of that definition in subsection 14(5).

¶ 7. One of the following specific allowance provisions in the *Income Tax Act* may be relevant:

- Subsection 18(9.1) applies in certain cases to a penalty or bonus payable by reason of the repayment before maturity of all or part of the principal of an outstanding debt obligation. It may also apply to a fee or penalty paid to reduce the rate of interest payable on such an obligation. These amounts are considered prepaid interest and, provided the other requirements of paragraph 20(1)(*c*) are satisfied, are deductible in computing a taxpayer's income from business or property over the period that the interest rate is to be reduced, or over the period that would have been (but for the prepayment) the remaining term of the debt obligation.
- A mortgage prepayment penalty may qualify as an eligible moving expense for the purposes of subsection 62(3); see the current version of IT-178, *Moving Expenses*.

Noteworthy Court Decisions Rendered Prior to the 65302 British Columbia Ltd. Decision

¶ 8. The court decisions discussed below were rendered prior to the *65302 British Columbia Ltd.* decision. Nevertheless, they can still be relied upon, because they did not involve the disallowance of a deduction for a fine or penalty for the sole reason that it was avoidable or contrary to public policy (see ¶ 2).

- In *Clinton W. Roenisch v. MNR*, [1928-34] CTC 69, 1 DTC 199, the Exchequer Court of Canada concluded that income tax paid to the province of British Columbia was not an expense for the purpose of earning income, within the meaning of what has become a predecessor of present-day paragraph 18(1)(*a*):

  "It is self-evident that the amount of the income tax paid to the province is not an expense for the purpose of earning the income, within the meaning of 6(1)(*a*). When such payment of taxes is made to the province, it is not so made to earn the income, it is paid because there is an income showing gain and profit. The word profit is to be understood in its natural and proper sense, in the sense in which no commercial man would misunderstand it."

  Discussion: This decision confirms that a provincial income tax is not an expense incurred for the purpose of gaining or producing income. Any fine or penalty imposed under a province's income tax law is also considered not to be an expense incurred for the purpose of gaining or producing income.
- In *Quemont Mining Corporation Limited, Rio Algom Mines Limited, and MacLeod-Cockshutt Gold Mines Limited v. MNR*, [1966] CTC 570, 66 DTC 5376, the Exchequer Court of Canada, relying on the above-mentioned *Roenisch* decision, concluded that it is clear that a tax on profits imposed by a different or foreign jurisdiction is not an expenditure laid out to earn profit.

Discussion: This decision confirms that a foreign income tax is not an expense incurred for the purpose of gaining or producing income. Any fine or penalty imposed under a foreign jurisdiction's income tax law is also considered not to be an expense incurred for the purpose of gaining or producing income. Nevertheless, it should be noted that an income or profits tax paid to a foreign jurisdiction may qualify, under the provisions of the *Income Tax Act*, for a foreign tax credit or for a deduction in computing income. However, neither a fine nor a penalty paid to a foreign jurisdiction would so qualify because neither is an income or profits tax. (For further particulars, see the current version of IT-270, *Foreign Tax Credit* and IT-506, *Foreign Income Taxes as a Deduction From Income*, respectively.)

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations of the CCRA.

Reason for the Revision

This bulletin has been revised to reflect the decision of the Supreme Court of Canada in *65302 British Columbia Ltd. v. The Queen*, [2000] 1 CTC 57, 99 DTC 5799.

Legislative and Other Changes

The bulletin has been entirely rewritten because of the *65302 British Columbia Ltd.* decision. For further particulars see the *Summary* statement at the beginning of the bulletin.

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[1] Added on September 16, 2004.