LANGIND E
DOCNUM 2015-0575921I7
AUTHOR Posadovsky, Tom
DESCKEY 26
RATEKEY 2
REFDATE 150729
SUBJECT Recapture arising in statute-barred years
SECTION 13(1); 13(21) "undepreciated capital cost", "depreciable property", "total depreciation"
SECTION
SECTION
SECTION
$$$$

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: Whether recapture resulting from the adjustment of the capital cost of property previously included in element “A” of the definition of “undepreciated capital cost” in subsection 13(21) of the Act and acquired in a statute-barred taxation year can be included into the taxpayer’s income in the first non-statute-barred taxation year. Clarification of paragraph 14 in IT-478R2.
POSITION: Yes; Revised position will be reflected in new Folio that replaces IT-478R2 when released.
REASONS: Where, at a point in time, the total of the amounts determined for E to K in the definition of UCC exceeds the total of the amounts determined for A to D.1 in that definition, such excess “shall be included in computing the taxpayer’s income of the year” in order to resolve the negative UCC balance pursuant to subsection 13(1) of the Act.

July 29, 2015

Allison Leek
Technical Section
Small and Medium Enterprises Directorate
Compliance Programs Branch
112 Kent Street, 19th Floor
Ottawa, ON K1A 0L5

HEADQUARTERS
Income Tax Rulings
Directorate
T. Posadovsky

2015-057592

Depreciable property and recapture arising in statute-barred years

We are writing in response to your email request of March 9, 2015, wherein you requested our views concerning misclassified capital property acquired in a statute-barred taxation year. Unless otherwise noted, all references herein are references to the Income Tax Act (the “Act”).

Background

In the hypothetical situation you provided, a taxpayer had added the capital cost of property acquired to a particular class in Schedule II of the Income Tax Regulations (the “Regulations”) for capital cost allowance (“CCA”) purposes. The taxpayer claimed CCA on the property for a number of years, many of which are now outside the taxpayer’s normal reassessment period provided by subsection 152(4) (“statute-barred”). Later, during the course of an audit, it is determined that the particular property was not in fact depreciable property and the CCA deductions claimed for that property were in error.

It is your understanding that Interpretation Bulletin IT-478R2, Capital Cost Allowance – Recapture and Terminal Loss, dated September 17, 1999, outlines the Canada Revenue Agency’s (“CRA’s”) general position on revisions to the capital cost of depreciable property and the recapture of CCA where statute-barred taxation years are involved. Paragraph 14 of IT-478R2 states, in part, as follows:

*	Where a revision is to be made to the capital cost of a depreciable property acquired during a taxation year that is now statute-barred, the amount of CCA actually deducted in respect of the depreciable property in any statute-barred year will not be adjusted. Instead, the UCC as of the beginning of the first non-statute-barred year will be recalculated by using the revised capital cost (rather than the original capital cost) of the property, while continuing to use the actual CCA deducted in each statute-barred year.

*	If the revision to the property's capital cost causes the UCC decreases to exceed the UCC increases as of the end of a year now statute-barred, the recapture of that excess amount under subsection 13(1) will not be added into the taxpayer's income for that year or a subsequent year.

*	If an excess of UCC decreases over increases arises in a non-statute-barred year, the resulting recapture will be included in the taxpayer's income for that year and all CCA claimed in that year, and in subsequent non-statute-barred years, will be reassessed accordingly.

Issue

You want to know whether recapture resulting from the adjustment of the capital cost of property previously included in element "A" of the definition of "undepreciated capital cost" ("UCC") in subsection 13(21) of the Act and acquired in a statute-barred taxation year can be included into the taxpayer's income in the first non-statute-barred taxation year. You are seeking clarification because the comments in paragraph 14 of IT-478R2 seem to suggest the CRA will not add an amount of recapture (to a subsequent open taxation year) that otherwise should have been included in the taxpayer's income for a prior taxation year that is now statute-barred.

Our views

UCC of depreciable property

The UCC of a particular class of depreciable property is used as the base for claiming a CCA deduction and is a cumulative account of all additions, dispositions and CCA claims for that class. The provisions under which UCC is calculated are also used for determining the amount that is to be included in income under subsection 13(1) as a recapture of CCA or the amount to be deducted from income under subsection 20(16) as a terminal loss.

According to the definition of UCC in subsection 13(21), the UCC of a taxpayer's depreciable property of a particular class as at a particular time is equal to the amount, if any, by which the total of the increases to the UCC of the class exceeds the total of the decreases to the UCC of the class, determined by the formula

$$(A + B + C + D + D.1) – (E + E.1 + F + G + H + I + J + K)$$

where (in part and for our purposes),

A	is the cumulative total of all amounts each of which is the capital cost to the taxpayer of a depreciable property of the class acquired before that time;

B	is any recapture in respect of the class that has been included in income in a previous taxation year;

…

E	is the cumulative total depreciation allowed to the taxpayer for property of the class before that time (plus any terminal losses previously allowed); and

F is the total of all amounts each of which is an amount in respect of a disposition before that time of property…of the taxpayer of the class.

Capital cost of depreciable property

Element "A" of the UCC definition includes the original capital cost of all depreciable property included in a particular class since the inception of that class.

The term "depreciable property" of a taxpayer as of any time in a taxation year is defined in subsection 13(21) as "…property acquired by the taxpayer in respect of which the taxpayer has been allowed, or would, if the taxpayer owned the property at the end of the year and the Act were read without reference to subsection (26), be entitled to, a deduction under paragraph 20(1)(a) in computing income for that year or a preceding taxation year".

Paragraph 20(1)(a) permits a deduction (CCA), in computing the income from a business or property, of any amount allowed by regulation in respect of the capital cost of a property that is depreciable property. However, there are a number of properties that are specifically excluded from the classes of depreciable property described in Schedule II and Part XI of the Regulations. For example, paragraph 1102(1)(c) of the Regulations provides that capital property will not be included in a prescribed class unless it was acquired by the taxpayer for the purpose of gaining or producing income. This means that where a capital property has not been acquired for the purpose of gaining or producing income, the taxpayer would not be entitled to any CCA deduction under paragraph 20(1)(a) as the property would not be considered depreciable property for purposes of the Act.

As indicated in paragraph 14 of IT-478R2, where it has been established that a particular property is not depreciable property, such as in the hypothetical situation you provided, we agree the CRA may recalculate and correct the UCC of a prescribed class as of the beginning of the first non-statute-barred year by using the revised capital cost (rather than the original capital cost) of the property for the purposes of element "A" of the UCC definition. The CRA's ability in this regard has been established by the courts and is supported in common law: see, for example, New St. James Limited v. M.N.R., 66 DTC 5241 (Exch.); Coastal Construction and Excavating Limited v. The Queen, 97 DTC 26 (TCC); The Queen v. Papiers Cascades Cabano Inc., 2008 DTC 6264 (FCA); and Leola Purdy, Sons Ltd. v. Canada, 2009 DTC 1042 (TCC).

Total depreciation allowed

Element "E" of the definition of UCC refers to "the total depreciation allowed to the taxpayer for property of the class before that time…" The definition of "total depreciation" in subsection 13(21) of the Act refers to "the total of all amounts each of which is an amount deducted by the taxpayer under paragraph 20(1)(a) in respect of property of that class… in computing the taxpayer's income for taxation years ending before that time."

As explained in paragraph 14 of IT-478R2, the reference to "total depreciation allowed" in paragraph 3(a) of the Bulletin is considered to be a reference to the amount of CCA actually deducted and allowed on assessment in computing the taxpayer's income. This position is based on the Federal Court of Appeal's decision in The Dominion of Canada General Insurance Company v. The Queen, 86 DTC 6154, and is in accordance with the words of the Act.

As such, it remains our view that the meaning of the word "allowed" for the purposes of the respective definitions of UCC, "total depreciation" and "depreciable property" in subsection 13(21), includes the amount of CCA claimed by the taxpayer and allowed as a deduction under paragraph 20(1)(a) for a taxation year that is statute-barred (even though such CCA deductions were unwarranted or otherwise made in error and can no longer be revised). Therefore, as set out in paragraph 14 of IT-478R2, if a revision is to be made to the UCC or capital cost of a depreciable property acquired during a taxation year that is statute-barred, the CRA will continue to use the actual amount of CCA deducted in each statute-barred year for purposes of, among other things, determining the total depreciation allowed to the

taxpayer for that class before the time of the UCC calculation (unless a reassessment to the statute-barred year could be made because one of the conditions described in paragraph 152(4)(a) of the Act applies).

Recapture

If the total of all the decreases exceeds the total of all the increases to the UCC of a class as of the end of a taxation year, subsection 13(1) provides that this excess shall be included in computing the taxpayer's income for the year. The recapture of CCA that was included in the taxpayer's income then becomes a positive component in the calculation of the UCC of the particular class under element "B" in a subsequent taxation year. Unlike element "E", element "B" does not include any amount of recapture that should have been previously included in the taxpayer's income in a previous (including statute-barred) taxation year, but was not, in fact, included in income.

As indicated in paragraph 14 of IT-478R2, the CRA will not add an amount of recapture that otherwise should have been included in the taxpayer's income for a prior taxation year to a year that is beyond the normal reassessment period (unless one of the conditions described in paragraph 152(4)(a) of the Act applies). However, a textual, contextual and purposive analysis of the provisions discussed above as well as the case law in this area leads us to conclude that where element "A" has been revised in the first non-statute-barred taxation year, such that there is an excess of UCC decreases over increases at the end of that year, an income inclusion under subsection 13(1) is necessary in order to resolve the negative UCC balance.

Accordingly, it is our view that in the hypothetical situation you described and for the reasons explained above, the CRA could (re)assess the particular taxpayer to include the appropriate amount of recapture in the taxpayer's income at the end of the first non-statute-barred taxation year in order to resolve the negative UCC balance. It appears to us that the hypothetical situation described would not arise very often. However, while we expect that in the majority of cases the conditions would be such that the CRA could reassess a taxpayer outside the normal reassessment period under paragraph 152(4)(a), our positions on the issues discussed in this letter will be updated and clarified in new Income Tax Folio S3-F4-C1: General Discussion of Capital Cost Allowance, due to replace IT-478R2 in the near future. To the extent that any views expressed in this letter represent a change in position from those described in IT-478R2, such changes will apply on a prospective basis to property acquired or transactions entered into after December 31, 2015.

Unless exempted, a copy of this memorandum will be severed using the Access to Information Act criteria and placed in the CRA's electronic library. After a 90-day waiting period, a severed copy will also be distributed to the commercial tax publishers for inclusion in their databases. You may request an extension of this 90-day period. The severing process removes all content that is not subject to disclosure, including information that could reveal the identity of the taxpayer. The taxpayer may ask for a version that has been severed using the Privacy Act criteria, which does not remove taxpayer identity. You can request this by e-mailing us at: ITRACCESSG@cra-arc.gc.ca. A copy will be sent to you for delivery to the taxpayer.

We hope that these comments will be helpful.

For Director
Business and Employment Division
Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch