

27.9.0 Inducement payments

27.9.1 Introduction

An inducement payment is an economic incentive to persuade a person to take a specific course of action. Government subsidies to a business to establish operations in a particular location or a payment made by a landlord to a tenant to enter into a lease are examples of inducement payments.

The tax treatment of inducement payments has always been difficult to establish. Over the years, however, the situation became continually more complicated as new types of inducement payments appeared as well as the publication of certain legal decisions on the subject.

The government, therefore, introduced paragraph 12(1)(x) of the ITA to clarify the income tax treatment of amounts received by a taxpayer as an inducement. The taxpayer has the right to have the law applied consistently according to the [Taxpayer Bill of Rights](#).

27.9.2 Overview of income tax legislation relating to inducement payments

Paragraph 12(1)(x) of the ITA provides that certain amounts that can reasonably be considered to have been received by a taxpayer in the course of earning income from a business or property as an inducement, refund, reimbursement, contribution, or allowance or as assistance, shall be included in income to the extent that the amount :

- has not otherwise been included in computing the taxpayer's income, or deducted in computing any balance of undeducted outlays, expenses, or other amounts
- does not reduce the cost or capital cost of the property or the amount of the outlay or expense in specified situations

- is not considered to be a payment made in respect of the acquisition by the payer or a public authority of an interest in the taxpayer or the taxpayer's business or property

Paragraph 12(1)(x) applies to amounts (other than a prescribed amount) received by a taxpayer in the course of earning income from business or property from a person or partnership, a government, municipality, or other public authority. A person or partnership who pays the particular amount (the **payer**) must do so in the course of earning income from a business or property, or to achieve a benefit or advantage for the payer or for persons with whom the payer does not deal at arm's length, or it is reasonable to conclude that the payer would not have paid the amount but for the receipt by the payer of amounts from a payer, government, municipality or public authority.

Subparagraphs 12(1)(x)(v) to (viii) specify what amounts may be excepted from an inclusion in income pursuant to paragraph 12(1)(x):

- An amount that was not otherwise included in computing the taxpayer's income, or deducted in computing any balance of undeducted outlays, expenses or other amounts, for the year or a preceding tax year. (An example of a balance of undeducted outlays is the **pool** of expenditures in respect of scientific research and experimental development established under section 37. In such a case, the assistance received is not included in income by virtue of paragraph 12(1)(x), to the extent that it has reduced the **pool**.)
- Except as provided by subsection 127(11.1), (11.5) or (11.6), an amount that has reduced the cost of property or the amount of an outlay or expense.
- An amount subject to an elective provision (subsection 12(2.2) or 13(7.4) or paragraph 53(2)(s)) that reduces the cost of property or an outlay or expense instead of including the amount in income under paragraph 12(1)(x).
- A payment in respect of the acquisition by the payer or public authority of an interest in the taxpayer or the taxpayer's business or property (for example, government assistance offered to a

corporation in the form of a purchase of shares from the share capital of the corporation).

For the definition of **prescribed amount** for purposes of paragraph 12(1)(x), go to section 7300 of the Income Tax Regulations. **Prescribed amount** means **prescribed assistance** within the meaning assigned by section 6702 of the Regulations.

A deduction is available under paragraph 20(1)(hh) of the ITA regarding the repayment of government assistance that was previously included in income under paragraph 12(1)(x), provided that the taxpayer is under a legal obligation to repay such amount. It also provides for a deduction of the repayment (again, pursuant to a legal obligation to repay) of certain other inducements or assistance that were not included in the taxpayer's income under paragraph 12(1)(x), but instead reduced the amount of outlays and expenses that would have been deductible by the taxpayer.

Under subsection 248(16) of the ITA, amounts claimed by a taxpayer as an input tax credit (ITC) or rebate with respect to the GST are deemed to be assistance from a government received by the taxpayer. Consequently, such amounts are either included in income or reduce the cost or capital cost of the related property, or the amount of the related expenditure or expenditure pool for tax purposes. The provision also specifies the time at which the receipt (or credit) of an ITC or rebate is deemed to be received as assistance.

Therefore, for example, the amount of any ITC or rebate which is deemed to be received by a taxpayer:

- is included in income under paragraph 12(1)(x) to the extent that it relates to GST/HST paid for an outlay or expense, unless the expense was already reduced by the ITC
- reduces the capital cost of depreciable property under subsection 13(7.1) to the extent that it relates to GST/HST paid for such property

- reduces the adjusted cost base (ACB) of non-depreciable capital property under paragraph 53(2)(k) to the extent that it relates to GST/HST paid for such property

27.9.3 Depreciable property

Subsection 13(7.1), provides that the capital cost of a depreciable property is reduced by the amount of investment tax credits deducted by the taxpayer under subsection 127(5) or (6) and by the amount of certain other government assistance received or that the taxpayer is entitled to receive in respect of a depreciable property.

The reduction in the capital cost of depreciable property resulting from the application of subsection 13(7.1) applies for the purposes of calculating any recapture, terminal loss, and capital gain on the eventual disposition of the property, with the result that it is the **adjusted** capital cost under subsection 13(7.1) which is utilized.

The tax treatment of repayments of assistance received in respect of depreciable property depends on whether the taxpayer still owns the property at the time the assistance is repaid. When the taxpayer still owns the property and repays all or part of the assistance pursuant to a legal obligation to do so, the amount repaid increases the capital cost of the property under paragraph 13(7.1)(d) (or paragraph 13(7.1)(b) in those cases where the taxpayer has made a subsection 13(7.4) election). A repayment which is made after the related depreciable property has been disposed of, increases the undepreciated capital cost (UCC) of the relevant class of depreciable property, provided that the taxpayer is under a legal obligation to repay that amount.

27.9.4 Capital property other than depreciable property

Paragraph 53(2)(k) of the ITA provides for a reduction of the adjusted cost base (ACB) of a capital property that is not a depreciable property, by the amount of government assistance that the taxpayer

received or is entitled to receive in relation to that property, with the exception of certain specified amounts.

The repayment of assistance received in respect of a capital property (other than depreciable property), under a legal obligation to do so, decreases the amount of the reduction of the ACB of the property pursuant to paragraph 53(2)(k), (or subparagraph 53(2)(s)(ii) where the taxpayer has made an election under subsection 53(2.1)). In effect, the ACB of the property is increased by virtue of the repayment. If the property is disposed of before the assistance is repaid, there is no provision to adjust the capital gain or loss previously realized on the disposition of that property; however, the amount of the repayment is deemed to be a capital loss under subsection 39(13).

27.9.5 Elective provisions

Subsection 13(7.4) of the ITA allows a taxpayer to make an election whereby the capital cost of a depreciable property is reduced by the amount of assistance that would otherwise be included in the taxpayer's income by virtue of paragraph 12(1)(x).

Subsection 12(2.2) of the ITA provides that a taxpayer may elect to reduce the amount of an outlay or expense (other than an outlay or expense in respect of the cost of property) where assistance, which would otherwise be included in income under paragraph 12(1)(x), is received in respect of the outlay or expense. This subsection applies only in those cases where the set-off of an expense or outlay against a related receipt does not otherwise result under the ITA. The provision was introduced in order to allow GST credits and rebates to be treated as reductions in expenses rather than include them in income. The terms of this provision are broad enough to apply to situations other than the GST.

Subsection 53(2.1) of the ITA permits a taxpayer to elect to reduce the adjusted cost base (ACB) of a non-depreciable property acquired by the taxpayer in the year the assistance was received, in the three tax years preceding the year or in the tax year following the year, where the assistance would otherwise be included in the taxpayer's income

under paragraph 12(1)(x). The amount elected under subsection 53(2.1) reduces the taxpayer's ACB under paragraph 53(2)(s). Paragraph 53(2)(s) provides for a reversal of the cost base reduction (that is, an increase to the ACB) to the extent the assistance is repaid by the taxpayer pursuant to a legal obligation to do so.

The elected amount cannot be greater than the least of:

- the ACB at the time the property was acquired
- the amount of the assistance received, and
- nil, in cases where the taxpayer disposed of the property before the year in which the assistance is received

27.9.6 Example of the application of paragraph 12(1)(x)

A Ltd. (the payer) has operated a shopping centre for several years and was finally able to attract B Ltd., a major chain store, as a tenant. The following are the terms of the lease agreement, as proposed and accepted:

- a payment of \$12,000 made to B Ltd. at the end of the first year of the lease, as a refund of part of the monthly rent paid
- a reimbursement payment of \$15,000 by the payer of part of the leasehold improvements made by B Ltd.
- a payment of \$10,000 made to B Ltd. on signing the lease

These payments were made during a single fiscal year of the tenant.

Solution

B Ltd. must include in its income from a business, in the year they were received, the following amounts:

- the amount of \$15,000, which represents a reimbursement in respect of the cost of the leasehold improvements (subparagraph 12(1)(x)(iv))
- the amount of \$10,000, which represents an inducement payment with respect to the signing of the lease (subparagraph 12(1)(x)(iii))

The amount of \$12,000 will also be included in income (subparagraph 12(1)(x)(iv)), unless it was already used to reduce the rental expense otherwise claimed (subparagraph 12(1)(x)(vi)).

27.9.7 Deductibility of inducement payments

General comments

Although the amount received as an inducement payment by the recipient may be on account of capital, this does not necessarily mean that it is an outlay of the same nature for the payer. The tax treatment of a transaction involving an inducement payment must be examined for each party involved in the particular transaction, taking into account the following factors:

- provisions of the ITA and applicable legal precedents
- commercial and business principles governing the transaction (including GAAP)
- agreement between the parties to the transaction
- framework of the legislation under which the assistance is provided and the conditions of eligibility for the payment
- nature of the payment
- nature of the business carried on by each party

The tax treatment of an inducement payment for the recipient and the payer may, therefore, be different or similar, depending on the situation and the facts specific to each case and to each party.

As mentioned previously, an inducement payment can come from government, private, and other public authorities and can take various forms. In general, its tax treatment will vary depending on whether it is received on account of income (payment made to increase the taxpayer's income or to reimburse operating costs) or on account of capital (assistance to acquire a capital property).

Lease inducement payments

The Supreme Court of Canada allowed the taxpayers' appeals in *Toronto College Park Ltd. v The Queen*, (SCC) 1998, and *Canderel*

Ltd. V The Queen, (SCC) 1998. The issue was if lease inducement payments made to induce tenants to enter into leases were fully deductible in the year incurred or had to be deducted over the term of the respective leases (go to 27.9.8 for an overview of the Canderel case).

The CRA argued that the inducement payments should be deducted over the terms of the leases. This was based on well-accepted business principles that expenditures which give rise to future revenues should be amortized and deducted against those revenues (the **matching principle**).

The Court found that the payments of the inducements did not only result in a stream of revenue over the terms of the leases, but also resulted in other benefits to the taxpayer, some of which were realized in the year the expenditures were incurred, including lower financing costs and enhanced reputation. Therefore, the taxpayers could fully deduct the inducements in the year incurred.

After the decisions handed down by the Court, the Income Tax Appeals Directorate stated in Decision 95-32R2 that a taxpayer may be entitled to fully deduct lease inducement payments in the year incurred, if the following three conditions are met:

1. The payments cannot be viewed as having been principally incurred for the specific purpose of earning a discrete and identifiable item of future revenue.
2. Current deductibility of the payments is permissible under GAAP or any other well-accepted business principle, and this gives the most accurate picture of the profit.
3. No portion of the payments is on capital account, such as giving rise to an eligible capital expenditure.

For more information, refer to Appeals Branch Income Tax Decision 95-32R.

27.9.8 Court decisions

Ikea Ltd. v The Queen, 1998 (SCC)

The Supreme Court of Canada dismissed the appeal of Ikea Ltd. The inducement payment received by the appellant to sign a lease was taxable as income. The entire amount had to be included in income in the year the lease was signed, based on the realization principle, since it had been made with no condition or stipulation attached as to its use. This case was decided before the introduction of paragraph 12(1)(x).

Canderel Ltd v The Queen, 1998 (SCC)

The Supreme Court of Canada, which had previously denied the taxpayer's leave application, allowed its appeal.

This case dealt with lease inducement payments, which the appellant had treated as running expenses deductible in the year they were incurred, while the CRA argued that these payments should be deducted over the term of the leases according to the matching principle. It should be noted that the

CRA did not consider these inducement payments as expenditures of a capital nature. The question was, therefore, to determine whether the inducement payments, made to get the tenants to sign leases, were fully deductible in the year they were incurred or whether they should be amortized over the term of the leases.

The Court ruled in Canderel, that the method of computation of income adopted by the taxpayer was not inconsistent with any rule of law. It was determined that the lease inducement payments could not be matched primarily with any particular item of income. Since these payments were allowable as running expenses to which the matching principle does not apply, they could be deducted in full in the year in which they were made and it was not necessary to amortize these payments over the term of the leases signed as a result of these payments.

For more commentary about the Ikea and Canderel court decisions, go to Income Tax Technical News, cancelled Issue No. 16, published by the Policy and Planning Branch.

Other court cases relating to inducement payments

Income tax cases

Trans Canada Glass Ltd. - 93 DTC 1260

The lease inducement payment received by a taxpayer in the auto glass business upon leasing premises for use as a new head office was included in its income, considering that such payment could not be connected with any capital purpose and was directly and inextricably bound up with the economics of the taxpayer's operation.

Canada Safeway Ltd. - 97 DTC 187

The refund that the taxpayer received in 1994 of the federal sales tax paid and deducted by its predecessors between 1985 and 1989 had to be brought into its income for the years in which it was originally deducted rather than in its 1994 income. The ITA was amended to include "refunds" in subparagraph 12(1)(x)(iv) after the Federal Court of Appeal upheld the Tax Court of Canada's decision in this case.

Tioxide Canada Inc - 96 DTC 6296

A tax credit received by the taxpayer under section 1029.7 of the Quebec Taxation Act was an inducement payment for the purposes of paragraph 12(1)(x) of the ITA.

IBM Canada Ltd. - 93 DTC 1266

When a computer-manufacturing corporation received lease inducement payments from different landlords with respect to seven leases, such payments were included in income. In this case, the primary consideration granted by the taxpayer was its acceptance of its obligations under the various leases to pay rent, and these obligations were on revenue account. The inducement payments were just as much revenue payments, as were the periodic rental payments to the landlords.

Supermarché Ste-Croix - 97 DTC 5211

The corporate taxpayer operated a grocery supermarket. It entered into an agreement under which it became obligated to obtain 90% of its supplies from M Inc. Under this agreement, M Inc. was also given a first option to acquire the taxpayer's business should the taxpayer ever decide to sell it.

In assessing the taxpayer, the minister included in its income, as an inducement payment, the \$150,000 cash sum paid to it by M Inc. upon entering into the agreement.

After the Tax Court of Canada confirmed the assessment, the taxpayer appealed to the Federal Court of Appeal and the appeal was dismissed. The payment gave M Inc. no direct interest in the taxpayer's business and no pecuniary right to share any of its profits. The payment, therefore, had to be included in the taxpayer's income.

Woodward Stores Ltd. - 91 DTC 5090

The taxpayer received payments (fixture allowances) intended to induce it to enter into two long-term leases in two shopping centres. The payments at issue were capital-related inducement payments as opposed to a windfall.

Quincaillerie Laberge Inc. - 95 DTC 47

When a taxpayer had agreed to waive its right to collect \$10.5 million under a "giving in payment" clause allowing the taxpayer to take immediate possession of the debtor's property upon default, in consideration for the sum of \$575,000, that amount constituted a taxable inducement payment within the meaning of paragraph 12(1)(x) of the ITA.

Suzy Creamcheese (Canada) Ltd. - 92 DTC 6291

The leasehold inducement payments received by the taxpayer had been applied in accordance with GAAP to reduce the total capital expenditures made by it on its leasehold improvements. Therefore, such payments had been earmarked for capital purposes and were capital in nature.

27.9.9 References

Income Tax Interpretation Bulletins

- [IT257R, Canada Council Grants](#)
- [IT273R2, Government Assistance - General Comments](#)
- [IT359R2, Premiums and Other Amounts with Respect to Leases](#)