

**2009 IFA TRAVELLING LECTURESHIP ON ROYALTIES BY NATHAN BOIDMAN  
APPENDICES TO LECTURE OUTLINE**

---

**APPENDIX 71 (RE SECTION 78 AND RELATED MATTERS)**

**Material:**

Subsection 78(1) of the Income Tax Act

IT-109R2 (April 23, 1993) – Unpaid Amounts

NO IT-109R2

DATE April 23, 1993

SUBJECT INCOME TAX ACT  
**Unpaid Amounts**

REFERENCE Section 78 (also Part XIII, sections 21, 80, 150, subsections 18(9), 66(15), 66.1(6), 66.2(5), 66.4(5), 88(1), 152(4) and 248(1) definition of "salary deferral arrangement", and paragraphs 12(1)(i), 18(1)(e), 20(1)(l), (n), and (p))

At the Canada Customs and Revenue Agency (CCRA), we issue income tax interpretation bulletins (ITs) in order to provide technical interpretations and positions regarding certain provisions contained in income tax law. Due to their technical nature, ITs are used primarily by our staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, we offer other publications, such as tax guides and pamphlets.

While the comments in a particular paragraph in an IT may relate to provisions of the law in force at the time they were made, such comments are not a substitute for the law. The reader should, therefore, consider such comments in light of the relevant provisions of the law in force for the particular taxation year being considered, taking into account the effect of any relevant amendments to those provisions or relevant court decisions occurring after the date on which the comments were made.

Subject to the above, an interpretation or position contained in an IT generally applies as of the date on which it was published, unless otherwise specified. If there is a subsequent change in that interpretation or position and the change is beneficial to taxpayers, it is usually effective for future assessments and reassessments. If, on the other hand, the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date on which the change is published.

Most of our publications are available on our Web site at:  
[www.ccra.gc.ca](http://www.ccra.gc.ca)

*If you have any comments regarding matters discussed in an IT, please send them to:*

**Manager, Technical Publications and Projects Section  
Income Tax Rulings Directorate  
Policy and Legislation Branch  
Canada Customs and Revenue Agency  
Ottawa ON K1A 0L5**

*or by email at the following address:  
[bulletins@ccra.gc.ca](mailto:bulletins@ccra.gc.ca)*

## **Contents**

### *Application*

### *Summary*

### *Discussion and Interpretation*

- Unpaid Amounts (Other Than Unpaid Employee Remuneration and Other Amounts) (¶s 1-5)
- Filing an Agreement (¶s 6-9)
- Unpaid Employee Remuneration and Other Amounts (¶s 10-14)
- Problems Involving Section 78 (¶ 15)

## **Application**

This bulletin replaces and cancels Interpretation Bulletin 109R, dated March 25, 1981. Current revisions are indicated by vertical lines.

## **Summary**

This bulletin deals with the provisions of the Act applicable to accrued expenses that, after a specified period of time, remain unpaid. The commentary below discusses the rules for unpaid expenses arising out of non-arm's length transactions and the special rules for unpaid employee remuneration and other amounts. The tax consequences to both the debtor and the creditor for such unpaid expenses and the Department's position concerning other problems related to these provisions are also discussed.

## **Discussion and Interpretation**

### **Unpaid Amounts (Other Than Unpaid Employee Remuneration and Other Amounts)**

- ¶ 1. Except as noted in 3 below, the provisions of subsection 78(1) apply to a deductible outlay or expense owing by a taxpayer if
- (a) the amount is unpaid at the end of the second taxation year following the taxation year in which the outlay or expense was incurred, and
  - (b) the taxpayer and the person to whom the amount is owing were not dealing at arm's length, both at the time the expense was incurred and at the end of the second

78.

**(1) Unpaid amounts** -- Where an amount in respect of a deductible outlay or expense that was owing by a taxpayer to a person with whom the taxpayer was not dealing at arm's length at the time the outlay or expense was incurred and at the end of the second taxation year following the taxation year in which the outlay or expense was incurred, is unpaid at the end of that second taxation year, either

(a) the amount so unpaid shall be included in computing the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred, or

(b) where the taxpayer and that person have filed an agreement in prescribed form on or before the day on or before which the taxpayer is required by section 150 to file the taxpayer's return of income for the third succeeding taxation year, for the purposes of this Act the following rules apply:

(i) the amount so unpaid shall be deemed to have been paid by the taxpayer and received by that person on the first day of that third taxation year, and section 153, except subsection 153(3), is applicable to the extent that it would apply if that amount were being paid to that person by the taxpayer, and

(ii) that person shall be deemed to have made a loan to the taxpayer on the first day of that third taxation year in an amount equal to the amount so unpaid minus the amount, if any, deducted or withheld therefrom by the taxpayer on account of that person's tax for that third taxation year.

taxation year following the taxation year in which the expense was incurred.

In such cases, the amount owing is included in the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred. This is so even if the amount is paid in that third taxation year, or in a later one, unless an agreement is filed under paragraph 78(1)(b), as discussed in 6 below.

¶ 2. An exception to the above occurs where such an outlay or expense is owing by a corporation that is wound up before the end of the second taxation year following the taxation year in which the expense was incurred. In this case subsection 78(2) applies and the amount owing is included in the corporation's income in the year it is wound up.

¶ 3. For the purposes of subsection 78(1) and (2) a **deductible outlay or expense** does not include an outlay or expense

- (a) for salary, wages or other remuneration (see 11 below),
- (b) for a superannuation or pension benefit, or a retiring allowance (see 14 below),
- (c) for inventory, eligible capital property, or capital property, including depreciable property, or
- (d) qualifying as a Canadian or foreign exploration and development expense under subsection 66(15), a Canadian exploration expense under subsection 66.1(6), a Canadian development expense under subsection 66.2(5), or a Canadian oil and gas property expense under subsection 66.4(5).

¶ 4. Unpaid interest is ordinarily subject to the rules discussed above unless a taxpayer elects to capitalize the interest under section 21. Where a taxpayer so elects, the provisions of section 78 do not apply. Also, if an amount is unpaid at the end of a taxation year and is not deductible in that year by virtue of subsection 18(9), section 78 does not apply.

¶ 5. If an unpaid amount is included in a taxpayer's income under paragraph 78(1)(a), there is no provision in the Act which allows the taxpayer to claim a deduction when the amount is actually paid.

### Filing an Agreement

¶ 6. Where a debtor and a creditor file an agreement in prescribed form, the unpaid amount in question is deemed to have been paid by the debtor and loaned back by the creditor, with all the tax consequences that flow therefrom. For example, if a creditor has claimed a reserve under paragraph 20(1)(l) or (m), the deemed payment disqualifies any subsequent claim for a reserve for that amount. Also, if a creditor has treated an unpaid amount as a bad debt and has claimed a deduction under paragraph 20(1)(p), the deemed payment results in an income inclusion under paragraph 12(1)(i).

¶ 7. An agreement in prescribed form may be filed under paragraph 78(1)(b) provided the necessary reassessments, of both the debtor and creditor, can be made within the period referred to in subsection 152(4). If the agreement is filed after the time period specified in paragraph 78(1)(b), the agreement is still valid. However, in this case, subsection 78(3) requires the debtor to include 25 per cent of the amount owing to the creditor in income for the third taxation year following the taxation year in which the outlay or expense was incurred.

¶ 8. Section 78 may apply to an outlay or expense incurred by a partnership. In such cases the Department will accept an agreement filed on behalf of the partnership only if

- (a) the agreement is filed on or before the first day which is the earliest of the days on which a return is required by section 150 to be filed by one of the partners, **and**
- (b) the return for that partner is for the taxation year that includes the last day of the third taxation year of the partnership following the taxation year in which the outlay or expense was incurred.

¶ 9. If an agreement between a debtor and creditor is filed under section 78, it cannot be withdrawn or rescinded.

### Unpaid Employee Remuneration and Other Amounts

¶ 10. Subsection 78(4) provides specific rules for an expense that is a salary, wage or other remuneration from an office or employment. If such an expense is not paid within 180 days of the end of the taxation year in which it was incurred, subsection 78(4) applies and the amount owing is deemed not to have been an expense incurred in the year and is not deductible. However, if the amount owing is actually paid after that time, it is deductible in the taxation year it is paid as the amount is deemed to be an expense incurred in that year. In applying these rules, the Department considers a payment made on the 180th day to have been made within the time limit and subsection 78(4) does not apply. Also, this subsection applies to both arm's length and non-arm's length transactions.

¶ 11. For the purposes of subsection 78(4) **salary, wages or other remuneration** refers to an amount other than

- (a) a reasonable vacation or holiday pay, or
- (b) a deferred amount payable under a **salary deferral arrangement** as defined in subsection 248(1)

that, if received, would be included in the recipient's income under Subdivision a of Division B of Part I of the Act.

¶ 12. Subsection 78(5) provides that if both subsections 78(1) and 78(4) apply to the same transaction, such as where an unpaid salary is payable to an employee who does not deal at arm's length with the employer, then the rules in subsection 78(4) will apply.

¶ 13. The comments in 10, 11 and 12 above concerning salary, wages or other remuneration apply to taxation years commencing after February 25, 1986. Prior taxation years were governed by rules similar to those for other unpaid amounts under section 78. For example, salaries and wages that were unpaid at the end of a taxation year were required to be paid by the end of the following taxation year; otherwise, the amount owing was included in the creditor's income in the second taxation year following that in which the expense was incurred. To avoid this result a provision existed for filing an agreement in a manner similar to that for other unpaid amounts as discussed above under "**Filing an Agreement.**"

¶ 14. The rules for salaries, wages or other remuneration in subsection 78(4) have been extended to certain other amounts. These rules apply also to amounts incurred after July 1990 that are in respect of a superannuation or pension benefit or a retiring allowance if the expense is not paid within 180 days of the end of the taxation year in which it was incurred. Expenses for such amounts incurred before this date are not subject to these rules. However, the general provisions of 78(1) may apply if the expense arose from a non-arm's length transaction.

### Problems Involving Section 78

¶ 15. Certain problems involving section 78 and the manner in which they are dealt with by the Department are discussed below.

#### (a) Debtor and Creditor on the Accrual Basis

Generally, where an unpaid amount exists between a debtor and creditor who are not dealing at arm's length and both taxpayers account for income on the accrual basis, subsection 78(1) will not be invoked. An exception occurs where the unpaid amount in question appears to be part of a tax avoidance scheme which, for example, may involve transactions such as

- claiming a reserve under paragraph 20(1)(l) or (n), or a deduction under paragraph 20(1)(p), or
- deferring tax under Part XIII of the Act where the creditor is a non-resident.

Also, subsection 78(1) will not be applied to the debtor taxpayer if an unpaid amount is reported as income in the year by a creditor who is on the cash basis of reporting income.

#### (b) Payment by Promissory Note

For the purposes of section 78, an ordinary promissory note is regarded as a promise to pay a debt at a later date, and not as payment of the debt on the date on which the note was issued. This is so unless the agreement between the parties clearly indicates that the note was accepted as absolute payment.<sup>1</sup>

#### (c) Forgiveness of Debt

As discussed in the current version of IT-293, *Debtor's Gain on Settlement of Debt*, if an amount is included in income under section 78, the rules in section 80 will not be applied to that amount.

#### (d) Non-Resident Withholding Tax Requirements

There may be circumstances where an amount owing by a Canadian taxpayer is due to a non-resident with whom the taxpayer does not deal at arm's length, and if paid, the amount owing would be subject to non-resident withholding tax. In these circumstances, if an agreement pursuant to paragraph 78(1)(b) is filed for such an amount, the amount is subject to non-resident withholding tax at the time it is deemed to have been paid by the Canadian taxpayer. Where the agreement is filed within the prescribed time limits, it is not the Department's practice to levy a penalty or interest in respect of the withholding tax requirements provided that the amount of tax is remitted on or before the fifteenth day of the month following the month in which the agreement is filed. As subparagraph 78(1)(b)(ii) deems the amount owing to be a loan from the non-resident to the Canadian taxpayer, any subsequent payments made by the Canadian taxpayer on account of that indebtedness are regarded as loan repayments and, therefore, are not subject to non-resident withholding tax.

Also, the provisions of section 78 apply to a deductible amount owing to a non-resident who does not deal at arm's length with the Canadian taxpayer even though the amount, such as a copyright royalty, is not subject to non-resident withholding tax.

#### (e) Unpaid Amounts vs. Reserve

Paragraph 18(1)(e) provides that a deduction is not allowed for an amount as, or on account of, a reserve, a sinking fund, or a contingent liability unless it is expressly permitted by the Act. In order for an expense that remains unpaid at the end of a taxation year to be deductible for tax purposes, it must constitute a genuine liability of the taxpayer. If such an unpaid amount does not constitute a genuine liability, no deduction is allowed. For a genuine liability to exist, there must be an enforceable claim by the creditor with a reasonable expectation that the debt will in fact be paid by the debtor. Therefore, if paragraph 18(1)(e) applies to a particular unpaid amount, section 78 does not apply.

#### (f) Identification of Payments with Amounts Unpaid

Where a particular expense remains unpaid and is made up of several unpaid amounts of the same nature, any payments received for these unpaid amounts are considered to apply first to the oldest amount outstanding unless the facts clearly indicate otherwise.

(g) **Winding-Up**

Where a deductible outlay or expense is owing by a subsidiary to a parent, or by a parent to a subsidiary, at the time a corporation is wound up pursuant to subsection 88(1), subsections 78(1) and (2) will only be applied if the debtor taxpayer is on the accrual basis of reporting income and the creditor is on the cash basis. Also, in such cases, these subsections will not be applied if the cash-basis taxpayer reports the receivable as income by the end of its taxation year in which the winding-up occurs. At the time of winding-up, if a deductible outlay or expense is owing by the subsidiary to a person other than the parent, section 78 will not be applied provided the Department is assured, to its

satisfaction, that the unpaid amounts will be paid by the parent before the dates on which subsections 78(1) or (4) would otherwise have become operative had the subsidiary not been wound up.

(h) **Sale of Property**

Where a taxpayer sells a property at a time when a deductible outlay or expense remains unpaid, and the purchaser assumes the obligation to pay the unpaid amount as full or partial consideration for the purchase, section 78 will not be applied to the taxpayer if the purchaser pays the unpaid amount before the date on which subsection 78(1) becomes operative.

---

<sup>1</sup> Modified by Correction Sheet CS 24 dated April 20, 2001.