TAX FOR THE Owner-Manager

The GST and Motor Vehicle Allowances

Section 174 of the Excise Tax Act (ETA) allows an employer to claim input tax credits (ITCs) for certain allowances paid to employees, including "mileage allowances" for motor vehicles, and broadly parallels the income tax rules providing for "employer deductibility" for similar allowances in paragraph 6(1)(b) of the Income Tax Act (ITA). Where section 174 applies, it deems the employer to have incurred the employee's expenses and to have paid the GST, which in effect allows the employer to recover the GST paid by the employee.

A recent GST case, *Melville Motors* (TCC 2003), clarifies the treatment of a mileage allowance based on kilometres travelled subject to a fixed ceiling. Previously, this issue had been somewhat uncertain: the CCRA had viewed these types of situations as involving allowances based on something other than kilometres and therefore as non-recoverable for GST purposes and non-deductible for income tax purposes.

This article summarizes the requirements that an employee must meet in order to obtain section 174 ITCs; it outlines the relevant parts of the *Melville Motors* case and provides commentary on the case's implications for owner-managers.

Section 174 ITCs: The Legislative Backdrop

In order to qualify for section 174 ITCs, an employer must ensure that the following requirements are met: (1) the automobile expenses must be incurred in Canada and GST must have been paid on the expenses; (2) the amount paid as the allowance must be deductible by the employer for income tax purposes; (3) the amount of the allowance must be "reasonable" (at the time it was paid); and (4) the employee must not receive a reimbursement from the employer in respect of the same vehicle.

With respect to requirement 2, paragraph 18(1)(r) of the ITA currently limits the deduction an employer may make for income tax purposes to a maximum of 36 cents per kilometre. If an employer chooses to reimburse in excess of this amount, the GST applicable to the excess amount is not recoverable. With respect to requirement 3, the word "reasonable" is subject to interpretation. Although the CCRA generally considers an allowance to be "reasonable" if it is based on the maximum deductible allowances set out above, other allowances may be reasonable, depending on the circumstances. Significantly, however, subparagraph 6(1)(b)(x) of the ITA provides that motor vehicle allowances are *not* reasonable if the allowance is "not based solely on the number of kilometres for which the vehicle is used in connection with or in the course of the office or employment."

The Melville Motors Case

In *Melville Motors*, the Tax Court was asked to determine whether motor vehicle allowances based on kilometres travelled, up to a fixed ceiling, could be considered to be "based solely on the number of kilometres" and thus reasonable under the rules described above.

The appellant operated an automobile dealership in Melville, Saskatchewan, and paid several employees an allowance for their motor vehicle expenses. The employees leased the vehicles from the appellant and used them in the course of their employment. Each employee submitted invoices setting out the overall kilometres travelled in the vehicles. Because the appellant's employees travelled extensively, there was a fixed ceiling on the number of kilometres for which the allowance would be paid. According to the appellant, without these fixed ceilings the mileage allowances claimed would have been greater than the amount the employees were paying the appellant to lease their automobiles. (It appears that the fixed ceilings were equal to the lease payments paid by the employees and that the allowances actually paid always reached the ceiling--that is, the allowances were always equal to the employee's lease payments.)

The CCRA seemed troubled by this arrangement, perhaps because the overall economic effect of the relationship was to allow the employees free use of the vehicles, except for the cost of the gas. The CCRA reassessed to disallow the ITCs on the allowances. It took the position that, as a matter of fact, the allowances were based on the lease payments and not solely on the number of kilometres travelled.

The Tax Court held--properly, in our view--that the allowances were in fact based on mileage and that the stipulation of a fixed ceiling did not change that. It held that the allowances (and the ceilings) were reasonable. It observed that the method of computing the allowances was a sensible one for the appellant to use, and that the appellant was entitled to exercise control over its employees and conduct its business in the manner it chose.

Commentary

Melville Motors is a helpful addition to the case law on the scope of section 174 and subparagraph 6(1)(b)(x). The Tax Court's willingness to recognize a ceiling arrangement is particularly welcome, given the practical difficulty that most employers face in policing the mileage travelled by their employees. In many, if not most, of the cases on allowances for business use of an automobile, an element of personal use is involved. Accordingly, it is not unreasonable for an employer to impose a limit on the amount of an allowance, provided that the limit is related to the expected business use of the automobile.

Melville consolidates and confirms previous jurisprudence. *Tri-Bec* (TCC 2002) also dealt with ceilings on motor vehicle allowances, but in less certain terms. In *Tri-Bec*, allowances of between $50 and $75 a week were paid to several employees; the Tax Court allowed ITCs to be claimed only on the allowance paid at a flat rate of $75 per week. With regard to the other allowances, the court found that the "details were too vague" to believe that they were based on actual kilometres travelled, and it denied the employer a deduction of them for income tax purposes.

Finally, the importance of tying allowances to kilometres travelled (even if at a capped amount) cannot be overstated. In *Melville* the court was satisfied, first and foremost, that the allowances were in fact based on actual kilometres travelled. Accordingly, owner-managers who rely on section 174 (and its income tax counterpart) should maintain sufficient documentary evidence to establish the business kilometres travelled by their employees. This process will usually start with an express requirement for the keeping of travel logs.

To the extent that a motor vehicle allowance meets the prescribed conditions, it can confer tax benefits on both the employer and the employee, because the allowance is not taxable in the hands of the employee and, unlike salaries paid to employees, entitles the employer to a full ITC.

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