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ALLOWABLE BUSINESS INVESTMENT LOSSES – PART 2

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on allowable business investment losses ("ABILs"). Alpert Law Firm is experienced in providing legal services to its clients in tax dispute resolution and tax litigation, tax and estate planning matters, corporate-commercial transactions and estate administration. Howard Alpert has been certified by the Law Society as a Specialist in Estates and Trusts Law, and also as a Specialist in Corporate and Commercial Law.

A. BUSINESS MUST QUALIFY AS A SMALL BUSINESS CORPORATION

Pursuant to subsection 38(c) of the Act, an ABIL is defined as one-half of a "business investment loss". Only a capital loss will qualify as a business investment loss. Therefore, if a transaction does not result in a capital loss or if the capital loss is deemed to be nil, no business investment loss arises.

A business investment loss may arise from the following dispositions by a taxpayer:

(a) a share of a corporation that is, or was at any time in the twelve months preceding the disposition, a small business corporation. A small business corporation is a Canadian controlled private corporation ("CCPC") that uses all or substantially all of the fair market value of its assets principally in an active business carried on primarily in Canada by the corporation or a related corporation; or

(b) a debt owing to the taxpayer by a small business corporation as defined above (other than, where the taxpayer is a corporation, a debt owed to it by a non-arm's length small business corporation). Therefore, a capital loss incurred by a corporation on a disposition of a debt owing to it by another corporation with which it does not deal at arm's length will not be regarded as a business investment loss.

***Gill v. M.N.R.*, 98 DTC 2048**

In this Tax Court of Canada decision, the taxpayers advanced funds to a corporation, which purchased land in 1988. The corporation then acted as the main contractor in the construction of a 17-unit strip plaza on the land. A receiver was

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appointed on October 22, 1993, for this plaza, and the taxpayers' advances were never repaid, having become bad debts during 1993. The Minister denied the taxpayers' ABIL deductions for 1993, claiming that the corporation was not a "small business corporation" carrying on an "active business", as defined in subsection 248(1), but was, in fact, a corporation carrying on a "specified investment business." Pursuant to paragraph 125(7)(e) of the Act, a "specified investment business" is carried on by a corporation: (i) who employs less than five full-time employees throughout the year; and (ii) whose principal purpose is to derive income from property.

The Tax Court of Canada dismissed the taxpayers' appeals since there was no evidence that the corporation had more than five full-time employees. In addition, the corporation's "principal purpose" was to earn income from property in the form of (i) rental income from this plaza, (ii) interest on the rental deposits, and (iii) a management fee. As a result, the Tax Court found that the corporation was involved in a "specified investment business," and did not qualify as a "small business corporation." Therefore, the losses sustained by the taxpayers were not ABILs, but were held to be net capital losses available for carryover to be applied against capital gains earned by the taxpayers in the carryover years.

B. BUSINESS LOSSES

***Giasson v. The Queen*, 2010 DTC 1115**

In this Tax Court of Canada case, the issue was whether the taxpayer's losses on his loan guarantees were considered to be ABIL or business losses. The taxpayer owned 99% of the shares of a corporation (HCI). HCI had bank loans owing, which were guaranteed by the taxpayer. The taxpayer sought to deduct as business expenses, losses he incurred in paying out the guarantees. However, the Minister took the position that the amounts paid under the guarantees were ABILs.

The Tax Court turned to *Easton v. The Queen* (97 DTC 464) for the general principle concerning personal guarantees of the shareholder that allow a corporation to obtain loans from financial institutions. The general principle was stated to be that guarantees by shareholders of corporate loans are generally presumed to be capital in nature. However, there are two exceptions to rebut that presumption: (i) guarantees given in normal course of the shareholder's business activities, and (ii) when corporate shares are held as a commercial asset rather than as an investment.

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The taxpayer argued that he fell within these exceptions (i.e. the guarantee was *not* capital in nature), and attempted to show that he granted the guarantees in the ordinary course of his business. Alternatively, the taxpayer noted that he did not seek to show that his shareholdings in HCI were a trading asset. If it were a trading asset, the gains or losses would be on account of income, and not capital.

The Tax Court held that the taxpayer did not meet the conditions for the exceptions set out in *Easton*. The Tax Court stated that the loans of HCI guaranteed by the taxpayer were incurred to provide HCI with operating funds, and that the taxpayer failed to show that he operated any business at all. Thus, there was no connection between the granting of the guarantees and the operation of a business by the taxpayer. Furthermore, the fact that the taxpayer held the shares for 10 years suggested that he held the shares as an investment. Thus, the Court concluded that the losses were correctly treated as ABILs by the Minister.

C. CURRENT STATUS OF DEBT

The Tax Court of Canada has ruled on two cases that interpret the effect that changes in the status of a debt can have on the ability of a taxpayer to deduct ABILs.

1. *Litowitz v. R,*, 2005 TCC 557

In this Tax Court of Canada case, the issue was whether the taxpayer's debt could be considered to have been bad at the time he declared a business investment loss. The taxpayer invested in a corporation the sole asset of which was shares in another company, whose sole asset was a co-tenancy project. When the co-tenancy ran into financial troubles, the financial prospects for the taxpayer's investment looked dim and he elected to declare the debt bad, pursuant to subsection 50(1) of the Act. The Minister disagreed with this assessment and disallowed the ABIL. The taxpayer appealed this decision to the Tax Court of Canada.

The Tax Court determined that the taxpayer was entitled to a degree of deference for their bona fide business decision making. This imports part of the business judgement rule of corporate law, and imparts a degree of deference for the business decision making of a taxpayer. The Tax Court also ruled on an interesting quirk that was specific to this particular situation. The corporation later recovered, and was able to pay the debt that it owed to the taxpayer, but the Tax Court determined that this did not affect the ability of the taxpayer to claim the ABIL.

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This decision indicates that the Tax court of Canada will focus on the decision making at play at the time of the election, and in doing so will give deference to the business decision making of the investor. This case also underscored that the Court will not take later situations into account in determining whether it was reasonable to consider that a debt had become bad.

2. *Delisle c. R.*, 2015 TCC 281

In this Tax Court of Canada case, the taxpayer was one of a number of creditors who possessed a debt from a company that had undergone financial troubles. The debtor company was forced into bankruptcy, and made a proposal to their creditors. This proposal was accepted by a majority of the creditors of the debtor company. The taxpayer declared the debt to have become bad in his next taxation year, and was reassessed by the Minister. The central issue was whether the acceptance of the bankruptcy proposal removed the debt underlying the ABIL claim.

The tax Court of Canada held that the acceptance of the bankruptcy proposal had discharged all of the remaining debts held by the debtor corporation. As a result, the Tax Court of Canada held that the taxpayer was not entitled to an ABIl deduction because the underlying debt no longer existed.

This holding indicates that the Tax Court will take subsequent events that affect the underlying debt into account, even where the loss is clear and unquestioned. This indicates that, while circumstances related to the ultimate satisfaction of a debt will not necessarily affect the ability of a taxpayer to claim an ABIL, but events that affect the existence of the debt will affect the ability of a taxpayer to claim an ABIL.

These two cases underscore the importance of timing with regards to events that affect the status of a debt. In *Litowitz,* the ABIL was claimed before the debt was ultimately satisfied, while in *Delisle,* the proposal in bankruptcy was agreed upon before the taxpayer made his ABIL claim. This shows the importance of considering the timing of events that take place after the creation of the underlying obligation.

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Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.