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ALLOWABLE BUSINESS INVESTMENT LOSSES – PART 1

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. ABILS CONTRASTED TO CAPITAL LOSSES

While a capital loss can only be deducted against taxable capital gains, an ABIL may be deducted against all other ordinary income including taxable capital gains, and therefore is a more favourable type of loss to the taxpayer.

In addition, where a taxpayer's ABIL in a year exceeds his income from all sources for that year, the excess may be carried back three years and forward ten years as a non-capital loss and applied against income from all sources in those years. After the expiry of this ten-year period, if the ABIL is not fully utilized, the remaining portion is converted into a net capital loss for further carry-forward indefinitely to be deducted against taxable capital gains only. However, if the ABIL arose prior to March 23, 2004, the carry-forward period will only be seven years. This can be contrasted to the loss carry-forward rules for ordinary allowable capital losses. In particular, ordinary allowable capital losses can be carried back three years and forward indefinitely. It should be noted that the provisions of the *Income Tax Act* (the "Act") which extend the carry-forward period of a non-capital loss from ten to twenty taxation years do not apply to an ABIL.

B. WHAT CONSTITUTES AN ABIL?

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:

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(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.

To qualify as a business investment loss, the disposition of shares or debt must: (i) be made to an arm's length purchaser; or (ii) be a disposition to which subsection 50(1) of the Act applies. Subsection 50(1) of the Act provides for a deemed disposition of a debt when the debt becomes a bad debt. In addition, subsection 50(1) of the Act provides for a deemed disposition of a share when the corporation which issued the share (i) becomes bankrupt; (ii) is insolvent and subject to a winding-up order under the *Winding-Up Act*; or (iii) meets certain conditions outlined in subparagraph 50(1)(b)(iii) of the Act. Namely, a deemed disposition of shares will occur if: (a) neither the corporation nor a corporation controlled by it carries on business during the year; (b) the fair market value of the shares is nil and it is reasonable to expect that the corporation will be dissolved or wound up and will not commence to carry on business; and (c) the taxpayer elects in his tax return for the year to have subsection 50(1)(b)(iii) of the Act affect that share.

Subsection 39(12) of the Act, in conjunction with subparagraph 39(1)(c) of the Act, allows a taxpayer to claim a business investment loss if the taxpayer has honoured a guarantee of the debt of a corporation. In order to be eligible for this treatment, the following conditions must be met:

(a) the amount paid under the guarantee must be paid to an arm's length party; and

(b) the corporation which owed the debt must be a small business corporation both at the time the debt incurred and at any time during the twelve months prior to the time that an amount first became payable under the guarantee.

If these criteria are satisfied, the part of the amount owing to the taxpayer as a result of the guarantee will be deemed to be a debt owing to the taxpayer by a small business corporation. As a result, the taxpayer may claim a business investment loss even where the corporation has ceased to carry on an active business. The case law in this area indicates that a loss incurred where a taxpayer honours a guarantee of a corporation's loans given solely to help out the principal of the corporation and not to produce income will not be deductible as a business investment loss.

The payment of employee wages and source deductions by a shareholder on behalf of a bankrupt corporation may result in a business investment loss, provided the criteria in Interpretation Bulletin IT-239R2 have been met.

However, this business investment loss treatment does not apply where a director of a corporation becomes liable for source deductions under section 227.1 of the Act. The amounts that the employer is required to withhold and remit under section 153(1) of the Act are viewed as debts of the employees. With respect to the amounts withheld, the employer is viewed to be an agent of the Minister and is deemed to hold these funds in trust pursuant to section 227(4) of the Act. Therefore, where section 227.1 of the Act applies to require a director to pay these amounts to the Minister, the payment is considered to have been made on behalf of the employees and not the corporation.

It is also the Canada Revenue Agency's ("CRA's") position that the liability that occurs as a result of a director's liability under section 227.1 of the Act is not acquired for the purpose of earning income. This is based on the Tax Court of Canada decision in ***Jackman v. M.N.R.*** **91 DTC 1275,** which stated that the payment of the corporate liability did not present in any way the prospect that either the director or the corporation could gain or produce any income therefrom. In this case, the taxpayer paid unremitted source deductions to the CRA before being assessed under section 227.1 of the Act and subsequently claimed the payment as an ABIL, which was disallowed by the Tax Court of Canada.

C. CALCULATION OF THE BUSINESS INVESTMENT LOSS

The amount of the business investment loss equals the amount of a capital loss otherwise determined less an adjustment relating to the capital gains exemption claimed by the taxpayer. With regards to the disposition of a share, the business investment loss is reduced further by:

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(a) the amount of the increase in the adjusted cost base to the taxpayer after 1977 as a result of the application of subsection 85(4) of the Act to that share or any share for which that share was received in substitution or exchange;

(b) where a share was issued prior to 1972 and the share was not acquired by the taxpayer in an arm's length transaction after 1971, taxable dividends received or receivable on such share after 1971 up to and including the date of disposition; and

(c) where the taxpayer is a spousal trust, the taxable dividends received or receivable on such share by the settlor of the trust or the spouse of the settlor.

The amount by which the business investment loss is reduced will still be a capital loss.

It should be noted that previously subsection 85(4) of the Act operated to prevent a taxpayer from recognizing a capital loss or taking a terminal deduction for capital property or eligible capital property where the property in respect of which the loss or deduction arose was transferred to a corporation controlled by the taxpayer, his spouse or a person or group which controlled the taxpayer. Instead, the taxpayer was required to add an offsetting amount in computing his adjusted cost base of any shares, which he held in the transferee corporation, thereby reducing the amount of a future capital gain arising on a subsequent disposition of such shares. Subsection 85(4) of the Act was repealed and effectively replaced by subsections 14(12) and 40(3.4) of the Act.

Normally, a taxpayer is entitled to a deduction when the taxpayer ceases to carry on business and no longer owns eligible capital property in respect of the business. The value of the deduction is equal to the taxpayer's cumulative eligible capital pool. Subsection 14(12) of the Act denies this deduction in circumstances where the taxpayer, or an individual affiliated with the taxpayer, retains ownership of the eligible capital property or an identical property.

Pursuant to subsection 40(3.4) of the Act, where a corporation disposes of non-depreciable capital property and the corporation or an affiliated person of the corporation acquires and continues to own the property or an identical property within 30 days of the date of disposition, any capital loss generated by the disposition is denied until the property is no longer owned by the corporation or affiliated person. The same rules apply to dispositions made by a trust or partnership. Unlike the former stop-loss rules, the denied loss is not added to the adjusted cost base of the property or the cost base of shares owned by the corporation in the transferee corporation.

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An individual's business investment loss is reduced further by four-thirds of the amount of any capital gains exemption claimed by the taxpayer in preceding taxation years ending after 1989. In addition, business investment losses in previous years or from other property dispositions in the same year also reduce a taxpayer's business investment loss. Therefore, where an individual realizes a capital gain and claims the capital gains exemption, he may not claim a deduction from income in respect of business investment losses in subsequent years until he has realized business investment losses equal to or greater than the capital gain in respect of which the capital gains exemption was claimed. Separate rules govern the calculation of the amount of the business investment loss for a trust.

D. REQUIRMENTS FOR AN ABIL CLAIM

In *Gamus v. The Queen*, [2001] 3 CTC 2342, the Court listed four essential factors for a successful ABIL claim. This test was re-worded in the form of four questions by Maureen Donnelly and Allister Young of the Faculty of Business, Brock University, in an article entitled "Substantiating an ABIL Deduction: An Analysis of the Key Elements":

(1) Did the taxpayer invest in shares or debt of a corporation?

(2) If the investment is debt, and not owed to a corporation with which the debtor corporation does not deal at arm's length, has the debt been established to be bad as required under paragraph 50(1)(a) of the Act? If the investment is a share, has the share become worthless in the circumstances referred to in paragraph 50(1)(b) of the Act, or has it been sold at a loss in an arm's length transaction?

(3) Was the property (share or debt) issued by a small business corporation as defined in part XVII of the Act?

(4) Was the property acquired by the taxpayer for the purpose of earning income as required under subparagraph 40(2)(g)(ii) of the Act?

E. DIRECT AND INDIRECT SHAREHOLDERS

Pursuant to subparagraph 40(2)(g)(ii) of the Act, the property (either shares or debt) must have been acquired for the taxpayer for the purpose of earning income. This

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will often occur through interest payments in the case of debt, or dividends in the case of shares. However, if the taxpayer owns the Small Business Corporation in question, interest is not required for a loan because the continued operation of the company is deemed to be an interest earning purpose.

***Alessandro v. The Queen*, 2007 DTC 1373**

In this Tax Court of Canada case, the taxpayer, who was represented by Alpert Law Firm, made interest free loans to a company called OPHL for several years. All of the shares of OPHL were wholly owned by two companies: (i) AHL, a company whose shares were all held by the taxpayer; and (ii) ABC, a company whose shares were held by the taxpayer's daughters. The loans to OPHL became bad and the taxpayer claimed an ABIL for the amount of the loans. The Minister disallowed the ABIL claimed on the basis that the taxpayer was not a shareholder of OPHL when the funds were advanced, and that the funds in question were not loans. The taxpayer appealed the decision.

The Tax Court of Canada allowed the taxpayer's appeal, holding that the taxpayer was entitled to claim an ABIL. The Tax Court found that the shares of ABC were actually being held in trust for the taxpayer by her daughters. As a result, the taxpayer was the sole shareholder of both ABC and AHL, which together owned all of the shares of OPHL. Therefore, the taxpayer indirectly controlled 100% of the shares of OPHL. A taxpayer who controls a company, directly or indirectly, is entitled to claim an ABIL in respect of a loss incurred on a non-interest bearing loan to that company because the continued operation of the company is considered to be an income earning purpose.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

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.