LEGAL BUSINESS REPORT | ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS
1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

# 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 and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.**

## 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:

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

(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.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

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:

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

(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.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

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

### 1. ***Gamus v. The Queen*, [2001] 3 CTC 2342**

In this Tax Court of Canada case, 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?

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

## E. DIRECT AND INDIRECT SHAREHOLDERS

### 1. *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.

### 2. *The Queen v. Byram*, 99 DTC 5117

In this Federal Court of Appeal case, the taxpayer made nine interest free loans to its US company ("USCO") to finance the USCO's operations. Some of the taxpayer's loans were advanced when he was a shareholder of USCO and others were advanced when the taxpayer was not a direct shareholder of USCO. When the taxpayer was not a direct shareholder of USCO, the taxpayer was a shareholder of ERL, which was the parent corporation and sole shareholder of USCO. In December 1984, USCO was unable to repay the loans and the taxpayer sold the loans to another person and claimed an allowable capital loss in respect to the disposition of the loans. The Minister disallowed the allowable capital loss deduction on the ground that the debt was not incurred by the taxpayer for the purposes of earning income from a business or property within the meaning of subparagraph 40(2)(g)(ii) of the Act. The taxpayer appealed to the Tax Court of Canada, which allowed the deduction of the allowable capital loss. The Crown appealed to the Federal Court of Appeal.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

The Federal Court of Appeal dismissed the Crown's appeal. The Federal Court held that while subparagraph 40(2)(g)(ii) of the Act requires a linkage between the taxpayer and the income from the loan to the corporation, there is no need for the income from the loan to flow directly to the taxpayer. The Tax Court found that when the taxpayer was a shareholder of USCO, he was directly linked to its income-generating stream. Any available dividends could have been declared in a simple and straightforward manner. Hence, he was entitled to a capital loss deduction in respect to the loans made by him during this period.

As for the period during which the taxpayer was not a direct shareholder of USCO but was a shareholder of ERL, admittedly the taxpayer would not have received dividend income directly from USCO. However, the Federal Court found that the connection between the loans made by the taxpayer during this period and the potential dividend income was still sufficient to invoke the exclusionary clause in subparagraph 40(2)(g)(ii) of the Act (i.e. USCO could declare a dividend to ERL, which in turn could declare a dividend to the taxpayer).

## F. TIMING OF BAD DEBTS

### 1. ***Beaudry v. The Queen*, 98 DTC 1898**

In this Tax Court of Canada decision, the taxpayer owned one-third of the issued shares of a corporation. By 1982, the corporation did not have adequate assets to pay the interest on its bank loan, and its shareholders advanced funds to the bank for this purpose and subsequently assumed personal liability for the corporation's bank loan. In return, the corporation transferred to them in equal shares its land at a loss, leaving the corporation with no realizable assets. The corporation then ceased all business activity, and its shareholders became subrogated to the position of the bank. In computing his income for 1982, the taxpayer attempted to deduct, as a business loss, his share of the amount owing by the corporation to its shareholders as at October 31, 1982. The Minister disallowed the deduction and claimed that the debt had not become bad in 1982 because the corporation had paid dividends during 1983.

The Tax Court of Canada allowed the taxpayer's appeal in part. The Tax Court held that the taxpayer had acquired his shares of the corporation as an investment and his guarantee of its debt as a shareholder was on capital account. Therefore, the loss could not be deducted in computing his income; rather the debt was a capital loss constituting a business investment loss under paragraph 39(1)(c) of the Act. Following the decision in ***Hogan v. M.N.R.*, 56 DTC 183**, which was approved by the Federal

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

Court of Appeal in ***Flexi-Coil Limited v. The Queen*, 96 DTC 6350**, the Tax Court held that it is for a taxpayer to objectively determine on reasonable grounds when a debt, whether on capital or income account, becomes a bad debt. A bad debt is the whole or portion of the debt that the creditor honestly and reasonably determines to be uncollectable at the end of the fiscal year. The Tax Court concluded that it was reasonable for the taxpayer to have determined the debt to have become bad in 1982. Therefore, the taxpayer was entitled to an ABIL deduction for 1982 (as opposed to 1983) in respect of his share of the outstanding shareholders' debt.

## 2. *Orlando v. The Queen*, 99 DTC 1201

In this Tax Court of Canada decision, the taxpayer loaned funds to a corporation, one-third of whose shares he owned. In 1993, the taxpayer agreed to delete from the corporation's records the amount of the loans owing to the taxpayer and to receive Class B shares from the corporation, seemingly as compensation. These Class B shares had no fair market value, and the taxpayer sold them to his wife for a nominal consideration. In computing his income for 1993, the taxpayer attempted to deduct an ABIL in respect of these transactions. The Minister disallowed the deduction for 1993 and also refused to permit the carryback to 1990 of any portion of the loss.

The taxpayer's appeal to the Tax Court of Canada was allowed. The taxpayer needed to prove that the debt owing to him by the corporation was still outstanding at the end of 1993. The Tax Court held that a debt remains outstanding even if, for business reasons, it has to be cancelled without receiving any payment. The Tax Court found that the taxpayer viewed the corporation's Class B shares issued to him to be worth nothing. Therefore, the taxpayer had merely deleted his loan from the corporation's books, since he considered the loan to be non-collectible in a practical and businesslike manner. As a result, the loan was not paid in 1993, and could not have been collected, so that it was still outstanding at that time. Therefore, the taxpayer was entitled to the ABIL deduction claimed.

## 3. *Adams v. The Queen*, 2000 DTC 2526

In this Tax Court of Canada case, the taxpayer advanced a loan to a corporation, which went bankrupt in 1995. The Minister disallowed an ABIL deduction and claimed that: (i) the corporation was not a small business corporation; (ii) the taxpayer had not invested in the corporation; and (iii) the taxpayer did not have a bad debt for 1995.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

The taxpayer's appeal was allowed by the Tax Court of Canada. The Tax Court found that the corporation had developed problems, which caused it to close its operations prior to March 25, 1995, when its bank seized its assets. In addition, the Tax Court found that the corporation was a CCPC, which carried on an active business, and the taxpayer's $60,000 loan to it was a bad and uncollectible debt on March 25, 1995. Therefore, the taxpayer was entitled to the ABIL deduction claimed.

## 4. ***Campbell v. The Queen*, 2000 DTC 2528**

In this Tax Court of Canada decision, the taxpayer was a builder-framer with only a grade 10 education. The taxpayer worked for a corporation and later became a shareholder, vice-president, and director of the corporation. On December 19, 1991, the taxpayer borrowed $33,000. The taxpayer advanced the $30,183.45 net proceeds of this loan (after deducting legal fees and other disbursements) to the corporation as a shareholder's loan on December 20, 1991. During 1994 and 1995, the taxpayer paid the corporation's source deductions in the amount of $5,296. In his 1994 income tax return, the taxpayer claimed an ABIL deduction in respect of three-quarters of both the $33,000 loan and the $5,296 source deductions. In reassessing the taxpayer, the Minister only partially allowed the taxpayer's ABIL claim.

The taxpayer's appeal was allowed by the Tax Court of Canada. The Tax Court concluded that the taxpayer was entitled to the ABIL deductions as a result of: (i) the taxpayer's lack of administrative business sophistication; and (ii) the taxpayer's credible and compelling testimony that established the existence of the loan without proper documentation. In addition, the Tax Court held that a debt is considered to have become a bad debt when the court is satisfied that a taxpayer, acting as a prudent and pragmatic business person, has exhausted all legal means of collection. The Tax Court concluded that the taxpayer had, in a prudent, expeditious and businesslike manner, found the debt to be bad and uncollectible in 1994.

## 5. ***Turner v. The Queen*, 2001 DTC 5581**

In this Federal Court of Appeal decision, a corporation owned by the taxpayer lost its commercial air service operating licence in 1984 and was wound up in 1994. In computing his income for 1994, the taxpayer sought to deduct, as an ABIL, his loss in respect of his investment in the shares of the corporation. The Minister disallowed such deduction. In dismissing the taxpayer's appeal, the Tax Court of Canada concluded: (a)

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

that the loss had occurred in 1984, and not in 1994; and (b) that the taxpayer had adduced inadequate evidence as to the quantum of the loss.

The taxpayer's appeal was allowed by the Federal Court of Appeal, which found that the Tax Court had erred in finding that the loss had occurred in 1984. The Federal Court of Appeal found that the Minister's assessment had been based on an erroneous finding that merely because the corporation had ceased to carry on business in 1984 after its operating licence had been revoked, that was the year in which the ABIL deduction should have been claimed by the taxpayer. The corporation's operating licence had, in fact, been reinstated in 1985, and the corporation was not wound up until 1994, after it had settled its lawsuit against the federal authorities for revoking its licence. Therefore, the taxpayer was entitled to claim the loss in 1994. The Federal Court of Appeal also held that the Tax Court also erred in finding that no evidence had been provided to determine the amount of the consideration paid by the taxpayer for the shares. The taxpayer's testimony, which substantiated the cost of the shares, was un-contradicted and was corroborated by an affidavit from his accountant.

## 6. ***Gurberg v. The Queen*, 2002 DTC 1363**

In this Tax Court of Canada case, the taxpayer was the sole shareholder of a corporation that manufactured women's clothing. By 1995, following economic difficulties encountered by the corporation, the taxpayer gave up control of the corporation to two new investors. In 1994, the taxpayer advanced a loan of $600,000 to the corporation, which he later agreed to forgive in mid-1996. The taxpayer claimed an ABIL deduction on his loss of $600,000 in the taxation year of 1996. The Minister disallowed the taxpayer's 1996 ABIL deduction claim, as there was no amount owing by the corporation to the taxpayer either at the end of 1995 or at the end of 1996 because the forgiveness agreement signed in 1996 was made retroactively effective on June 1995. The taxpayer appealed to the Tax Court of Canada.

The Tax Court of Canada allowed the taxpayer's appeal and held that the taxpayer could claim an ABIL deduction on his losses in 1996, since the debt was still in existence at the end of 1995. In finding that the debt was in existence in 1995, the Tax Court put considerable weight on the taxpayer's own testimony of when he actually realized that he was forgiving the loan. The taxpayer testified that the first time he realized that he was forgiving the loan was when he signed the forgiveness agreement in mid-1996. His testimony indicated that the debt was still in existence at the end of 1995 and only became bad debt in 1996.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

## 7. *Barrie v. The Queen,* 2004 DTC 2176

In this Tax Court of Canada case, the Minister disallowed the ABIL deductions claimed for several uncollectible loans the taxpayer had allegedly made to three corporations over a two year span. The taxpayer appealed. The Tax Court of Canada disallowed the ABIL on two grounds: (i) that the loans were not valid; and (ii) that the borrowing corporations did not qualify as small business corporations.

In regards to the validity of the loans, the Tax Court heavily weighed the documentary evidence and verbal testimony, which indicated that the taxpayer advanced the funds with the goal of advancing an ABIL claim and did not advance the funds with a view of earning income, as required by the paragraph 40(2)(g) of the Act. The Tax Court found that the loans were made without regard to the financial condition of the borrowers. The taxpayer claimed the debt was bad only one year after the loan was given and very soon after the borrowers informed him that they would not be able to meet their financial obligations. The taxpayer completely failed to query this statement or even investigate into whether the corporations had any assets available that could satisfy their debts, even partially. The Tax Court found that the taxpayer did not make the determination that the debts were bad debts in a reasonable and pragmatic business-like manner, and as such, the loans were not valid loans that could be used in the calculation of ABIL.

The Tax Court further stated that even if all the loans were valid loans, the evidence did not reveal whether the borrowing corporations qualified as small business corporations. The Tax Court was not satisfied that substantially all of the fair market value of the corporations' assets were used principally in an active business carried on primarily in Canada.

## 8. *Jodoin v. The Queen,* 2006 DTC 3627

In this Tax Court of Canada case, the taxpayer was found to be entitled to the ABIL deduction claimed for the year in which the taxpayer made the election for bad debt and the corporation was dissolved. The taxpayer was the sole shareholder of a corporation to which she made a loan. Between August 31 and December 31, 2003, the taxpayer disposed of the corporation's remaining assets, performed a final accounting for the corporation and submitted final HST returns to CRA. On the advice of an accountant, the taxpayer did not dissolve the corporation in that year. The corporation was eventually dissolved on February 10, 2004. In reassessing the taxpayer for 2004,

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

the Minister disallowed an ABIL deduction claimed for that year for the loans, but readjusted the taxpayer's 2003 income to permit the ABIL deduction for 2003.

The Minister's position was that at the end of 2003, it was reasonable to expect that the corporation would be wound up and would have no intention of carrying on business in the future. On her appeal to the Tax Court of Canada, the taxpayer argued that the debt owing to her by the corporation did not crystallize as a bad debt until February 10, 2004 and that she made a subsection 50(1) election in 2004, entitling her to the ABIL deduction claimed for 2004.

The Tax Court of Canada allowed the appeal. The Tax Court held that subsection 50(1)(a) of the Act: (i) does not require a taxpayer to establish a “reasonable expectation of dissolution or winding up” of the corporation that owes the debt; and (ii) does require the taxpayer to make a subsection 50(1) election prior to claiming an ABIL deduction. The Tax Court concluded that the taxpayer made the subsection 50(1) election in 2004 and was, therefore, entitled to the ABIL deduction claimed for 2004.

### 9. ***Martel v. The Queen*, 2008 DTC 5010**

In this Tax Court of Canada case, in 1996, the taxpayer sold: (i) 250 shares of E.G.Plus; and (ii) a right to be issued an additional 40,000 shares of Biagen in consideration, for $200,000. In 1998, the taxpayer claimed an ABIL alleging that $140,000 of the $200,000 was not paid and had become uncollectible. The Minister disallowed the ABIL claimed asserting that the debt had not become uncollectible since the taxpayer had not made adequate efforts to collect it. Further, the Minister claimed that any loss incurred from the debt was nil under paragraph 40(2)(g) of the Act.

The Tax Court of Canada allowed the taxpayer’s appeal. The Tax Court reiterated the test set out by the Federal Court of Appeal in ***Rich v. The Queen*, 2003 DTC 5115**, and held that a taxpayer is required to act honestly and reasonably to determine if a debt has become irrecoverable. However, there is no requirement to prove that *all* possible means of recovery have been attempted. The Tax Court found that the taxpayer met this standard by contacting his lawyer about the potential of recovering the amount and analyzing the financial situation of the purchaser. In addition, the transaction was arm's length and the funds were advanced to earn income, in accordance with paragraph 40(2)(g) of the Act. Therefore, the taxpayer was entitled to the ABIL claimed.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

**10. *Rich v. The Queen*, 2003 DTC 5115**

In this influential Federal Court of Appeal decision, the taxpayer was a 25% shareholder of a corporation operated by his son. The taxpayer claimed an ABIL deduction in respect of an interest-bearing debt owed by the corporation to the taxpayer. The Minister disallowed the deduction, and the taxpayer appealed to the Tax Court of Canada. The Tax Court dismissed the taxpayer's appeal on the grounds that: (i) the predominant purpose of the loan was the taxpayer helping his son, not the reaping of interest or dividends; and (ii) the taxpayer's assessment of the debt fell short of an honest and reasonable determination that the debt had become bad.

The Federal Court of Appeal reversed the Tax Court's decision and allowed the ABIL deduction. The Federal Court of Appeal followed the Supreme Court of Canada's decision in ***Ludco Enterprises Ltd. v. Canada*, 2001 DTC 5505**, holding that for a loan to meet the requirements of subparagraph 40(2)(g) of the Act, gaining or producing income need not be the exclusive or even the primary purpose of the loan, as long as it was one of its purposes. While the predominant purpose of the loan, in this case, was to help the taxpayer's son, another purpose was to reap interest and dividends (as a shareholder of the corporation), even though that was, in this situation, a "faint hope."

The Federal Court of Appeal found that the assessment of whether a debt is a bad debt is one based upon the facts at a particular point in time. After the creditor personally considers the relevant factors, the question is whether the creditor honestly and reasonably determined the debt to be bad. The Federal Court of Appeal also found that there was no evidence supporting the conclusion that the loan could be recovered through the taking of proactive steps. Moreover, it held that there is no obligation on the taxpayer to try to think of every conceivable proactive step and show that none would be productive; it is sufficient that the taxpayer provide evidence as to the condition of the debtor and its inability at the relevant time to repay the loan in whole or in part.

Note that the Court listed seven factors that should be taken into account when determining whether the debt has become bad:

(i) The history and age of the debt;

(ii) The financial position of the debtor, its revenues and expenses, whether it is earning income or incurring losses, its cash flow and its assets, liabilities and liquidity;

(iii) Changes in total sales as compared with prior years;

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

(iv) The debtor's cash, accounts receivable and other current assets at the relevant time and as compared with prior years;

(v) The debtor's accounts payable and other current liabilities at the relevant time and as compared with prior years;

(vi) The general business conditions in the country, the community of the debtor, and in the debtor's line of business; and

(vii) The past experience of the taxpayer with writing off bad debts.

**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.**

**No part of this publication may be reproduced by any means without the prior written permission of Alpert Law Firm.**

**© 2011 Alpert Law Firm. All rights reserved.**