

REPORT ON RECENT DEVELOPMENTS

I. Recent Success in ABIL Dispute

A recent decision of the Tax Court of Canada in an Allowable Business Investment Loss (“ABIL”) case highlights the need to carefully structure arrangements within a family unit.

Rules Governing ABIL Claims

Under the *Income Tax Act* (Canada) an ordinary capital loss (deductible as to 50% against taxable capital gains) can sometimes qualify as a business investment loss (deductible as to 50% against all sources of income). The more beneficial treatment as an ABIL will apply where various conditions are satisfied. One key condition in the case of debt is that the debt must have been acquired by the taxpayer for the purpose of gaining or producing income from a business or a property (other than exempt income) or as consideration for an arm’s length disposition of capital property. Where a creditor is also a shareholder of the borrowing corporation, the potential of dividend income can, in the appropriate circumstances, be considered adequate to establish an income producing purpose for the debt.¹

*Elliott v. The Queen*²

Konstantinos Voggas of our firm recently represented Aileen Elliott (the “Taxpayer”) before the Tax Court of Canada in an interesting ABIL case. The issue was whether the Taxpayer was entitled to ABIL treatment in respect of cash advances made to a corporation (the “Company”), as well as advances made on its behalf to another creditor. The Company was owned 50-50 by her husband and his brother, i.e. the Taxpayer was not a shareholder of the

Company. The sums advanced fell into two categories:

- amounts advanced to the Company directly over the period 1993 – 1997 on an interest – free basis.
- an amount paid to the National Bank of Canada in 1997 to discharge the Company’s line of credit under which the Taxpayer was guarantor.

Regarding the 1997 repayment of the line of credit, the Taxpayer borrowed \$40,000 at interest in order to discharge the line of credit and it was agreed that the Company would repay that advance together with any interest expense incurred by the Taxpayer.

The Company ceased operations in 1998, at which time all amounts owing to the Taxpayer became bad debts in her hands. The difficulty the Taxpayer faced was establishing that the advances she made were for the purpose of earning income.

In a decision rendered on January 7, 2005, the Court rejected the Taxpayer’s arguments that there was an overall income producing purpose insofar as the advances would enhance her husband’s revenue potential and that was an income producing purpose insofar as attribution rules might apply to impute property income earned on the loaned property to the Taxpayer, thereby rendering it taxable in her hands.

¹ *Byram v. R.*, 99 DTC 5117 (FCA) case.

² 2005 TCC 135.

However, in respect of the advance to repay the National Bank of Canada, the Court accepted Mtre Voggas' argument on behalf of the Taxpayer that an income earning purpose did exist by virtue of Quebec civil law. The Taxpayer essentially stepped into the shoes of the creditor bank and thereby became entitled to receive interest on the same terms as the bank. This provided the necessary income producing purpose. ABIL treatment was therefore allowed with respect to this portion of the advances.

Lessons Learned

In the *Elliott* case, the Taxpayer was able to obtain beneficial treatment for half of her losses as she had been subrogated in the rights of the original creditor.

As to the balance of the advances which could not qualify as either an ABIL or as a capital loss, Rip J. speaking for the Tax Court, sympathized with the Taxpayer's situation, noting that her case

is like that of many others, where well-intentioned individuals advance funds and offer to act as guarantors without stipulating any level of return or consideration, and therefore lacking the relevant "income producing purpose" when they are later in the unfortunate situation of trying to establish an ABIL.

The lessons learned:

- Ensure that any advance of funds has stipulated repayment terms and bears interest;
- Ensure that a reasonable guarantee fee is charged when accepting to act as a guarantor;
- Recall that advances from one corporation to a non-arm's length corporation will *never* qualify as an ABIL. The best one can hope for here is capital loss treatment, which itself requires an income earning purpose.

II. Legislative Developments

Budget 2005

On February 23, 2005, federal Finance Minister Ralph Goodale delivered the first budget of the Liberal minority Government. The tax measures include an increase (phased in over five years) in the basic personal amount to \$10,000, a reduction in the general corporate income tax rate beginning in 2008 (the rate going from the current 21% to 19% in 2010), and the elimination of the 4% corporate surtax after 2007. The budget also proposes other changes of importance to taxpayers, two of which will be of particular interest to our readers.

First, it seems the Government is going back to the drawing board in the interest deductibility area, given concerns expressed regarding the 2003 proposals which incorporated a "reasonable expectation of profit" test. The budget documents indicate that the Department of

Finance is developing a more modest proposal to be released at an "early opportunity".

Second, the budget proposes an extension of directors' liability in the GST context. The existing liability of corporate directors with respect to sales tax remittances will be extended to overpaid net GST refunds and interest. Directors will be jointly and severally liable where a corporation fails to return to the Receiver General any overpayment of a net tax refund or interest received. The new measure will apply to net tax refunds paid after Royal Assent is given to the enacting legislation.

The budget leaves outstanding a number of legislative proposals, including those concerning foreign investment entities and non-resident trusts which were tabled in October 2003. It says that legislation to implement these proposals will be introduced at a "suitable time".

III. Administrative Developments

Automobile Log

Get out your pen and paper if you use an employer-owned car. Effective 2005, Revenue Quebec requires such employees to maintain a logbook to record kilometrage and other relevant information. Failure to submit the logbook to employers by the prescribed deadline can result in a fine of \$200.00.

Non-Resident Clearance Certificates

A non-resident disposing of taxable Canadian property ("TCP") is required to notify the tax authorities and obtain a clearance certificate pursuant to section 116 of the *Income Tax Act* (Canada) (and the equivalent provisions of the *Quebec Taxation Act* where the property is in

Quebec). The provisions require that the seller notify the tax authorities prior to the sale or within 10 days of closing. A purchaser who acquires TCP from a non-resident without ensuring that a clearance certificate has been obtained may become liable for the non-resident seller's taxes.

None of this is new. What is new (since 2004) is the enforcement of penalties for late filing of the certificate request - \$25 per day, subject to a minimum of \$100 and a maximum of \$2,500. Now the seller, in addition to the buyer, must beware!

The material contained herein is necessarily of a general nature and cannot be regarded as legal advice. The members of our firm would be pleased to provide additional information. You may reach us at (514) 849-1188 or by e-mail as follows:

Sydney Sweibel ssweibel@sweibelnovek.com

Barbara L. Novek bnovek@sweibelnovek.com

Douglas Yip dyip@sweibelnovek.com

Jack Boidman jboidman@sweibelnovek.com

Denis A. Lapierre dlapierre@sweibelnovek.com

Brigitte Ramaseder bramaseder@sweibelnovek.com

Carol Rabbat crabbat@sweibelnovek.com

Konstantinos Voggas kvoggas@sweibelnovek.com

or visit our website at www.sweibelnovek.com