TAX ALERT

TAX ALERT is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new CRA administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information.

INVESTMENT WRITE-OFFS

Stock loss selling in December is a planned event to dispose of and repurchase securities that have dropped significantly in value. By selling them and buying them back more than 30 days later, realized capital losses can be offset against capital gains for the current year, previous three years and all future years. That's money in the pocket. What's not talked about as often are actual losses when shares or bonds become worthless.

Three Irishmen were talking about this in the pub on a Friday night recently and as it turned out all of them had 2008 losses that could give them tax refunds in April – but their situations were slightly different. Aidan's shares in a public company were worthless. Conor had purchased bonds a few years back and they too were a write off. Dermot did not own any publicly traded shares but his privately owned company was now worthless. The pub was a good place to be in this kind of a discussion.

Let's talk about each of their situations because the tax rules are a bit different for each.

In Aidan's case, the shares of Public Co had no value and it didn't look like there would be any recovery. The Income Tax Act allows deductions for a capital loss on shares that have become worthless if any one of the following conditions are met:

- The corporation became bankrupt during the year
- The corporation is insolvent within the meaning of the Winding-Up and Restructuring Act and a winding-up order has been made in the year
- At the end of the year the corporation is insolvent, the corporation (or corporation controlled by it) no longer carries on business, 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

A company is insolvent under the Winding-Up and Restructuring Act if it meets any one of several tests, some of which are as follows:

- It is unable to pay it's debts as they become due
- It calls a meeting of creditors
- It produces a statement showing inability to meet debts
- It has acknowledged its insolvency

Aiden will have some homework to do to prove that his shares qualify for a capital loss deduction. There is usually public information that can be obtained from investment advisors that will show that he meets the required tests. Taxpayers must elect in their tax returns for the year in order to get the capital loss tax deduction. The election is made by simply stating that an election is being made to claim the loss under Section 50(1) of the Income Tax Act.

It will be easier for Conor to claim a capital loss on his bonds than it was for Aidan to claim a loss on his stocks because the rules are a little easier for debt instruments. To claim a capital loss on bonds, a taxpayer must simply establish that the bond is a bad debt. CRA discusses this in the Interpretation Bulletin, IT-442R, available on the CRA website. Tax cases have shown that some of the relevant factors to claim a bad debt include the following:

- The history and age of the debt
- The financial position of the debtor
- The debtor's revenues or expenses and
- Whether the debtor is earning income or incurring losses.

Cash flow, assets, liabilities and liquidity of the debtor are also important. Simply because a debt has gone bad does not necessarily require the investor to petition the debtor into bankruptcy to prove the loan is bad. Conor must also make an election under Section 50(1) of the Income Tax Act on his tax return.

Dermot owns a private company, Tralee Inc., and invested in both shares and bonds of Tralee. Dermot must meet the same tests that Aidan had to meet for his stocks and Conor had to meet for his bonds.

Dermot will get a more liberal tax deduction than Aidan and Conor because his capital losses are what are known as allowable business investment losses (ABIL). Providing Dermot can show that his losses were on shares and debt of a small business corporation, he can claim them as tax deductions against all his sources of income and is not restricted to capital gains as are Aidan and Conor. Dermot had no capital gains in other years so he was pleased about the wider availability of applying the losses.

Fortunately, Aidan, Conor and Dermot were sitting across from a financial planner who was tending bar that night and he confirmed all of this for them. After several rounds of Guinness, they understood it perfectly and each knew they qualified. They set out the next day to see a tax advisor bloke (over another Guinness) to get all of this sorted out. The following Friday they came back to the pub with more step in their heel knowing they had locked up tax refunds.

Oh, there was another regular sitting at the bar sipping on a Guinness who was frantically making notes. His name was Ennis but not sure if he was Irish. The way he handled his Guinness – sure looked like he was. *This Tax Alert was first written as an article for the MoneySaver magazine.*

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