

THE **New** LOSS RULES

By Jamie Golombek

New tax laws coming in 2005 could affect clients who are borrowing to invest.

IN October, the Department of Finance introduced new draft legislation on the deductibility of losses, including losses created largely due to deductible interest expenses. The introduction of the new rules did not come as a surprise, since the February 2003 federal budget stated that two recent court decisions (specifically *Ludco* and *Stewart*, discussed below) had raised uncertainties that could lead to inappropriate tax results and were inconsistent with the appropriate tax policy. The new rules could affect clients who are borrowing to invest.

The Ludco Case

The *Ludco* decision in 2001 questioned whether the interest paid on a loan for purchasing shares was deductible. During the period in which the taxpayers held these shares, they deducted approximately \$6 million in interest expenses and received dividend income of only \$600,000. The Supreme Court of Canada (SCC) held that the taxpayers had a reasonable expectation of income from this investment notwithstanding that they only received \$600,000 in dividends. The court also reviewed in the Income Tax Act, which states that interest is deductible where the borrowing was made “for the purpose of earning income.” The SCC concluded that income does not necessarily mean “profit” or “net income.” In other words, the quantum of income that was actually received was not relevant and, therefore, did not need to exceed the amount of interest paid. As a result, the taxpayers were successful in having the interest be fully deductible.

The Stewart Case

In 2002, the SCC released its decision in the case of *Brian Stewart*. *Stewart* purchased condos that were highly leveraged and which would generate losses for a 10-year period before becoming profitable.

Stewart claimed losses of over \$58,000 which occurred primarily as a result of significant interest expense on the money borrowed to acquire the condos. CCRA disallowed these losses on the basis that *Stewart* had no “reasonable expectation of profit” (REOP) and therefore no business was being carried on. If no business existed, then business losses cannot have arisen to be claimed against other income.

The SCC found in favour of *Stewart*, allowing the deduction of the losses. According to the court, “the REOP test should not be accepted as the test to determine whether a taxpayer’s activities constitute a source of income” (i.e., a business). The SCC continued, “The motivation of capital gains accords with the ordinary businessperson’s understanding of ‘pursuit of profit’ and may be taken into account to determine whether the taxpayer’s activity is commercial in nature.”

As a result of *Stewart*, the denial of deductions by the CCRA of losses generated by many tax shelters because of “no REOP” was put on hold and the doctrine of REOP is dead—until 2005.

Under the new rules, a taxpayer will only be allowed to deduct a loss for a given year if, in that year, it is reasonable to assume that the taxpayer will realize a cumulative profit from

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Jay's Analysis

Year		Investment January 1	Share Increase 8%	Investment Dec. 31	Dividend Yield 3%	Interest		Cumulative Income A	Cumulative Expense B	Cumulative Profit A - B
						Rate on Loan 5%				
1	2005	\$10,000	\$800	\$10,800	-	(\$500)	-	(\$500)	(\$500)	
2	2006	\$10,800	\$864	\$11,664	-	(\$500)	-	(\$1,000)	(\$1,000)	
3	2007	\$11,664	\$933	\$12,597	-	(\$500)	-	(\$1,500)	(\$1,500)	
4	2008	\$12,597	\$1,008	\$13,605	\$408	(\$500)	\$408	(\$2,000)	(\$1,592)	
5	2009	\$13,605	\$1,088	\$14,693	\$441	(\$500)	\$849	(\$2,500)	(\$1,651)	
6	2010	\$14,693	\$1,175	\$15,869	\$476	(\$500)	\$1,325	(\$3,000)	(\$1,675)	
7	2011	\$15,869	\$1,269	\$17,138	\$514	(\$500)	\$1,839	(\$3,500)	(\$1,661)	
8	2012	\$17,138	\$1,371	\$18,509	\$555	(\$500)	\$2,394	(\$4,000)	(\$1,606)	
9	2013	\$18,509	\$1,481	\$19,990	\$600	(\$500)	\$2,994	(\$4,500)	(\$1,506)	
10	2014	\$19,990	\$1,599	\$21,589	\$648	(\$500)	\$3,642	(\$5,000)	(\$1,358)	
11	2015	\$21,589	\$1,727	\$23,316	\$699	(\$500)	\$4,341	(\$5,500)	(\$1,159)	
12	2016	\$23,316	\$1,865	\$25,182	\$755	(\$500)	\$5,097	(\$6,000)	(\$903)	
13	2017	\$25,182	\$2,015	\$27,196	\$816	(\$500)	\$5,913	(\$6,500)	(\$587)	
14	2018	\$27,196	\$2,176	\$29,372	\$881	(\$500)	\$6,794	(\$7,000)	(\$206)	
15	2019	\$29,372	\$2,350	\$31,722	\$952	(\$500)	\$7,745	(\$7,500)	\$245	

Assumptions:

- The share price will increase in value at 8% per year.
- Dividends will begin to be paid in 2008 at a dividend yield of 3%.
- Interest rate on the loan is fixed at 5%.

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the investment during the time the taxpayer holds (or can reasonably be expected to hold) the investment. The new rules also explicitly state that profit does not include capital gains, which essentially reverses the SCC's comments in Stewart.

Cumulative Profit Test

"Cumulative profit" means the aggregate profit over the entire profitability time period. It is not necessary that an investor demonstrate an actual profit in any particular year to be considered to have a reasonable expectation of cumulative profit.

Many business owners, for example, often realize a start-up loss from the business for one or more years before the business begins to generate a profit. The business owner would be able to claim the loss provided his expectations for a cumulative profit over the entire relevant time period were reasonable. But what is reasonable? It must be reasonable, given the facts of a particular situation, for an investor to expect to profit from the property or business. Consider this fictional case.

Jack's rental property purchase produces revenue in excess of related rental expenses and might be seen as an investment that should provide Jack with an REOP. However,

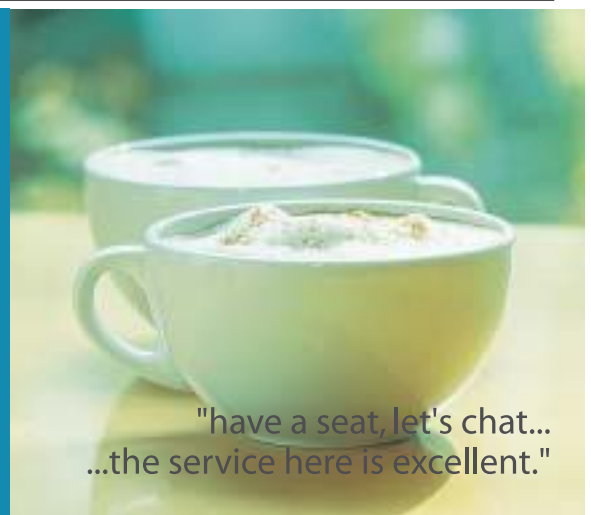
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this wouldn't be the case if Jack were to take on a large mortgage to finance the purchase of the property because the interest expense associated with the mortgage means Jack cannot profit from the rental activity. This was the issue in the Stewart case. The difference in Stewart was that the SCC found the opportunity for profit upon ultimate sale can be considered as part of the profit. Under the new rule, even if Jack intends to profit by reselling the rental property itself at a gain, this will not count toward cumulative profit, since income from a business does not include a capital gain.

Another "unreasonable" assumption might be an investor who borrows funds at a fixed rate of 8% and uses those funds to make an investment that has a fixed annual return of 5%. Assuming that the investment itself cannot increase in value, then there is no reasonable expectation of profit and the taxpayer will not be allowed to deduct the loss. On the other hand, given that the investor may have greater expenses than he has revenues generated by the investment, the Department of Finance also concedes that it would be "inappropriate" to tax any amount of that revenue. This would seem to permit the deduction of expenses up to the amount of revenue earned from the investment, but no more (i.e., a loss could not be created in this manner).

The jurisprudence before the draft legislation supported the view that as long as an investment has the potential to earn income, interest on such borrowings should be tax deductible. The draft legislation introduces a new test: whether or not it is reasonable to expect a cumulative profit from the investment, excluding any potential capital gain on ultimate disposition.

Interest on Money Borrowed to Purchase Common Shares

Interest on money borrowed to purchase common shares or mutual funds is generally tax deductible, but whether C CRA's position will be maintained in light of the proposed changes remains to be seen. The main problem concerns investors who borrow to purchase common shares that do not pay dividends or whose dividend yield is lower than the interest rate on the loan. In this case, a taxpayer would have to argue there is still a reasonable expectation of cumulative profit. This argument could be supported if the taxpayer plans to pay the debt down over time such that eventually the cumulative dividends received during the profitability time period exceed the amount of cumulative interest paid on the debt. Or an investor could argue that he plans to hold the shares for a long period of time so that as the shares appreciate the dividend yield will

ultimately exceed the interest paid. This would produce a cumulative profit by the end of the profitability period. This concept is best illustrated the following case study.

In 2005, Jay borrows \$10,000 at 5% to invest in shares that are not expected to pay dividends until at least 2008. Based on his analysis of the company's financial statements and economic operating environment, Jay predicts that the share price will increase, on average, by 8% compounded annually.

It is therefore quite likely that Jay will realize a significant capital gain when he sells his shares. Under the new draft legislation, however, this capital gain is irrelevant when determining whether or not he can deduct the \$500 of interest paid in 2005, 2006 and 2007. Instead, Jay would have to demonstrate that he has a reasonable expectation of cumulative profit over the time period he plans to hold the shares.

Jay prepares the analysis (see chart, page 40) which shows that if he plans to hold the shares for at least 15 years, he will indeed realize a cumulative profit. **AE**

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