Closing up shop? Don't forget about the ABIL!

Written by the Mackenzie Tax and Estate team

In a few weeks, we will be marking the one-year "anniversary" of a period marked by lockdown and disruption of our daily lives which appeared without warning.

An untold number of people have suffered the effects of COVID-19. Ultimately, all aspects of society as a whole will have been impacted by the pandemic. In this brief article, let's focus our attention on our businesses and more specifically, on our entrepreneurs.

At this stage of the pandemic, while we are forced to accept measures that restrict our usual routines for the welfare of all, some entrepreneurs have or will soon have played their last card and will be forced to shut down their businesses. In fact, many experts

are predicting that small, medium and large businesses in many sectors will be filing for bankruptcy and saying goodbye to assets that were built through the efforts of dedicated and committed entrepreneurs over the course of many years. Although some are doing what they need to – even performing miracles – to avoid bankruptcy, others will have to close their doors permanently in anticipation or as a preventive measure.

As harsh as the facts are, it is imperative to keep in mind the tax aspects related to the end of a business or its insolvency. Among these many tax considerations, one will qualify as a tax benefit: the allowable business investment loss (ABIL).

Basic Concepts

An understanding of two basic concepts is required where the ABIL is concerned:

1. The ABIL is, first and foremost, a capital loss. So why is it considered a business investment loss? This is what we will explain shortly.
2. The ABIL is applicable in two specific contexts related to a company:
   - During the disposition of eligible shares under an ABIL and/or
   - When a debt on an eligible business under an ABIL becomes uncollectible.

Before explaining the somewhat technical side of the ABIL, let's start with the key benefit it provides.

As mentioned above, an ABIL is essentially a capital loss. It is important to remember that a capital loss is deductible against a taxpayer's income at the rate of 50% of the amount of the loss, but only up to the taxable capital gain (i.e. 50% of a capital gain) included in the calculation of that taxpayer's income. Therefore, you can see that it will be possible for a taxpayer to claim a deductible capital loss for the year only if, for that year, a capital gain was realized and therefore included (taxable portion) in the calculation of the taxpayer's income.

To compensate for this restriction, a taxpayer is allowed to apply his or her so-called "net" capital loss to one of the three taxation years preceding the year in which the loss was realized or in a future year, always while observing the condition of having a taxable capital gain included in the calculation of income for a given year.

Once all the conditions are met, the ABIL, to some extent circumvents the restrictions related to the deductibility of a capital loss that we will term “ordinary.” In fact, for a predetermined period, an ABIL may be claimed as a deduction against income from all sources, and thus including, but not limited to, the taxable capital gains for a given year.

If a taxpayer is unable to claim an ABIL due to lack of income, the ABIL can be applied to one of the previous three taxation years or to one of the next 10 taxation years, while observing the same conditions and privileges. Following the tenth year after the year in which the ABIL was realized, it will go back to being an ordinary capital loss. From this point on, the deductible portion of the loss in question may be deducted only against a taxable capital gain, but for future years.

The ABIL may be of particular interest, from a tax standpoint, for a shareholder whose ABIL-eligible shares have lost their value. Unfortunately, that will prove to be the case for many entrepreneurs because of the pandemic.

Small business corporation

Shareholders who hold shares that have lost their value may, at the time of the actual or deemed sale of their shares, claim an ABIL only if those shares qualify as shares of a small business corporation (SBC). In summary, and to simplify things, a company that is a Canadian controlled private corporation (CCPC) may qualify as an SBC if it meets the following criteria:

1. 50% or more of the value of its assets are attributable to active business activities in Canada, or
2. 50% or more of the value of its assets arise from related SBC shares or debts, or
3. A combination of points 1 and 2.

For the purposes of this article, only point 1 will be considered.

Actual or deemed disposition of a share or debt

Having now defined what an SBC is, let’s go back to the circumstances that would allow an entrepreneur whose business is about to shut down to benefit from an ABIL.

Actual disposition

Although it seems unlikely that if his or her company is experiencing problems, an entrepreneur would find a buyer for his or her shares in an SBC or a debt on an SBC, this is truly possible, and when the disposition generates a capital loss, assuming all conditions are met to the letter, it will be possible for the entrepreneur to claim an ABIL. For the loss realized following the sale of the shares or the debt to qualify as an ABIL, the transaction must be made in favour of a buyer who deals at arm’s length with the seller. It is advisable to review the arm’s length rules in the Income Tax Act (ITA) to avoid any surprises that would cause the ABIL to be denied.

Deemed disposition

What happens when an entrepreneur, when unable to continue operating his or her business, cannot find a buyer for his or her SBC shares or SBC debt? Being unable to sell, were it not for an election in the ITA in this respect, the possibility of claiming an ABIL or even an ordinary capital loss arising from these shares and/or debt would be eliminated.

In fact, when certain conditions are met, it is possible for taxpayers (in this case, entrepreneurs) to make an election in their tax return for the year so that they are deemed to have disposed of the shares in question or the eligible debt for a sale price of $0, thus allowing an ABIL or ordinary capital loss to be realized.

It is important to mention that this election is not limited to SBC shares or debt owing by an SBC. In the event that all the criteria for this election are met, but the corporation involved is not an SBC, the end result would be an ordinary capital loss rather than an ABIL.

Without going into the minutiae of the election that allows a taxpayer to be deemed to have disposed of the shares or debt in a corporation, the following elements must be considered for the election to be valid:

- In the case of a debt, the taxpayer must have established that it has become a bad debt. The question of whether a debt has become uncollectible is a question of fact that must be proven by the creditor. For information purposes, the Canada Revenue Agency provides certain guidelines for determining whether a debt has become uncollectible, which can be found on its website.
- When a corporation's share capital is involved, the corporation would have to be bankrupt, wound up, or insolvent for the shares in question to be eligible.

There are other details that need to be considered, but these will not be covered here.

To provide greater clarity on all these concepts – which can certainly be complex – here are two brief examples:

1. Martin is the owner and sole shareholder of a hardware store which he has run for 15 years. His company is a business corporation and qualifies as an SBC. Because of the pandemic, Martin will have to shut down his business, which has become insolvent.

   The relevant data for Martin's shares are as follows:

   - Fair market value (FMV): $0
   - Adjusted cost base (ACB): $275,000

   Since Martin has no hope of selling his shares, he has decided to exercise the ITA election that allows him to be deemed to have disposed of his shares at a deemed sale price of $0. The difference between the sale price of $0 and the ACB of $275,000 will result in an ABIL of $275,000, 50% of which – $137,500 – will be deductible in the calculation of his income, against all sources of income.

2. Martin also has a debt of $45,000 owed by his company resulting from a cash advance to his company a few years ago. Once the valuation has been done and all recourses have been exhausted, Martin has determined that his debt has become uncollectible. By exercising the ITA election, Martin will be able, provided all the conditions are met, to claim an ABIL of $45,000 through the deemed disposition of his debt for a sale price of $0. Martin's ABIL will be 50% deductible, for a total of $22,500, against income from all sources.

As the previous examples show, thanks to the provisions in the ITA, although it's true that a business that is going under hardship would have a hard time attracting buyers, the deemed sale of eligible shares or debt can allow an entrepreneur to realize a capital loss. In addition, if all the conditions are met, as explained earlier, the capital loss could qualify as an ABIL.

It cannot be stressed enough that any entrepreneur facing the closure of a business they have invested in must consult a tax expert who will be able to cover all the rules relating to ABILs, capital losses and other tax considerations.

To those of you having to face this harsh reality, I wish you the best outcome possible!

The content of this article (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it. This should not be construed as legal, tax or accounting advice. This material has been prepared for information purposes only. The tax information provided in this document is general in nature and each client should consult with their own tax advisor, accountant and lawyer before pursuing any strategy described herein as each client's individual circumstances are unique. We have endeavored to ensure the accuracy of the information provided at the time that it was written, however, should the information in this document be incorrect or incomplete or should the law or its interpretation change after the date of this document, the advice provided may be incorrect or inappropriate. There should be no expectation that the information will be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise. We are not responsible for errors contained in this document or to anyone who relies on the information contained in this document. Please consult your own legal and tax advisor.

4484950 03/25