



Federal Court of Appeal Confirms Businesses Only Pursuing Losses, Cannot Claim Losses

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As a business owner, your goal is of for the business to generate profit and ideally, more profit with each year. Of course, from time to time, your business may see a loss and that loss may then be claimed on the annual tax return. All losses, though, are not eligible to be claimed. A business loss can only be claimed under the *Income Tax Act* if it was incurred further to a business endeavour, in pursuit of profit. If you are engaged in a personal activity, like buying the occasional lottery ticket, you cannot claim it as a business loss. You also cannot exclusively undertake to run up a loss, and then claim it as a business loss. Even if that loss is not a sham (i.e. it was an entirely legal undertaking), it still will not be a proper business loss under the *Act*.

The ability to claim a business loss, where that loss was actively sought, was recently considered by the Federal Court of Appeal in the matter of *Canada v. Paletta*. In that case, the taxpayer had developed a plan to avoid taxes, by engaging in foreign currency straddle transactions. In particular, he would buy and sell foreign currency in the same amount and then, as the currency fluctuated, he would crystalize a gain on one leg and crystallize a loss on the other leg. The taxpayer confirmed that the sole and expressed purpose of the plan was to avoid taxes. Further to this foreign exchange straddling tax avoidance plan, the taxpayer claimed approximately \$49 million in losses. In review, the Canada Revenue Agency disallowed all of the losses and assessed gross negligence penalties. The taxpayer appealed to the Tax

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Court of Canada, which agreed with the taxpayer that the losses were properly claimed. The Minister then appealed to the Federal Court of Appeal, which allowed the appeal and confirmed the reassessments.

In confirming the reassessments, the Federal Court of Appeal upheld that the taxpayer's plan was not a sham. The foreign exchange straddling tax avoidance plan was a real and legally effective plan. However, the Federal Court of Appeal noted that this does not mean that the losses are permitted under the *Income Tax Act*. For the taxpayer to be able to claim the losses, the taxpayer must establish that the losses were incurred in the pursuit of profit. The two-part test for whether it was incurred in pursuit of profit was established by the Supreme Court of Canada in the decision of *Stewart*. In particular, the Court must look at:

1. Is the activity of the taxpayer undertaken in the pursuit of profit, or is it a personal endeavour?
2. If it is not a personal endeavour, is the source of income a business or property?

The Federal Court of Appeal held that, under this test and other relevant tests, a business can exist where it is pursuing both a profit and has an intent to avoid taxes. However, under this test, a business does not exist where it is devoted exclusively to avoiding tax. In review of the facts before it, the Federal Court of Appeal held that, as the taxpayer was solely seeking to avoid taxes, and not to earn a profit, the taxpayer could not claim the loss.

Given the decision in *Paletta*, businesses that are engaged in proper tax reduction plans, must ensure that they are also still seeking to earn a profit, if they want to claim any losses. If the sole goal of the business is to achieve a loss, then the loss will be denied, even if it is a lawfully incurred loss. To that end, any written tax reduction plan should confirm that tax reduction is not the only goal. The business' goal of a profit should be expressly confirmed and should be clear from the endeavours engaged in by the business. Without such a proper tax plan and without a clear intention of pursuing profits, businesses run the risk of

losses being denied. Further, businesses run the risk of being assessed penalties, as occurred in *Paletta*.

For more information or to discuss any current tax disputes regarding the disallowance of business losses, please contact **our firm**.

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