



CESTNICK

TAX MATTERS

Tangling with the taxman over losses

My family and I went out for dinner last week. Whenever we go out to eat, the kids never finish their meals. So I end up eating their leftovers. That's right, I'm the dog with the credit card.

On this occasion the kids and Carolyn went off to do some shopping and left me to finish eating. I struck up a conversation with the gentleman alone at the table next to me. "Don't tell me," I said. "You're the dog with the credit card too?"

We started talking about our vocations, and then the conversation turned to a tax problem he had. Turns out he owned a couple of rental properties, had been claiming losses, and the taxman wasn't impressed. His losses were denied by the Canada Revenue Agency and he was wondering what to do. I shared with him the story of a couple who had a recent battle in the Tax Court of Canada over the same problem.

The story

On Feb. 5 of this year the Tax Court of Canada handed down a decision in the case Milan Opacic and Dragica Opacic v. The Queen (2010 DTC 1079). You see, in the years 2002 to 2007 Mr. and Mrs. Opacic had each reported rental losses on an apartment they owned in Bosnia, rental losses related to a store in Serbia, and business losses from a partnership carried on in Canada. They had each reported about \$21,000 in losses from the rental activities over those years, Mr. Opacic reported about \$59,000 in losses from the partnership over that time, and Mrs. Opacic reported about \$32,000 in losses from the partnership over those years.

The benefit to the couple, of course, is that business and rental losses can be applied against other income. So the tax savings added up over those years. The CRA didn't like this, and reassessed the couple for their 2004 and 2005 tax years, disallowing a portion of their rental expenses and all of their business losses.

The outcome

And so the court battle began. In the end, the court dismissed the appeal of Mr. and Mrs. Opacic. The couple lost this battle. You see, in 2002 the Supreme Court of Canada handed down a decision in the Stewart case (2002 SCC 46) which provides the criteria that must be considered when evaluating business or rental losses.

Where a "source of income" exists, then reasonable expenses incurred for the purpose of earning that income must be allowed, and if this results in a loss for the taxpayer, CRA is out of luck. There's no room in that case for CRA to disallow losses just because it's the view of CRA that there is no reasonable expectation of profit (REOP).

In the Stewart case, the court decided that if an endeavour is clearly commercial in nature, with no personal element to it, then a source of income does exist. This is not to say that the endeavour must produce a profit in any year. Where an endeavour is commercial in nature, there's no room to apply the REOP test to disallow losses.

Now, where an endeavour has some personal element to it (such as when you partly rent out and partly live in a property or run a business akin to a hobby), a source of income may still be considered to exist where your behaviour suggests that there is a "sufficient degree of commerciality." That is, when it's clear your intent is to generate a profit. In this case, the taxman can apply the REOP test as just one of many factors to determine whether or not the activity is sufficiently commercial in nature.

A primary motivation to avoid tax does not affect the validity of a transaction for tax purposes. As long as an endeavour is commercial in nature (in pursuit of profit), your deductible expenses should be allowed – even if they exceed your income.

As for Mr. and Mrs. Opacic, the court looked at the following factors to determine whether their activities were commercial in nature: (1) their profit and loss experience (they lost money five consecutive years), (2) the taxpayers' training, (3) their intended course of action (no steps were taken to make the ventures profitable after showing losses for five years), and (4)

the capability of the ventures to show profit (the judge felt there was none).

What about you? Build the case that you have a commercial activity by considering the above criteria and you'll likely be fine even if you have losses.

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