
INFORMATION BULLETIN

DEDUCTION OF BUSINESS LOSSES

Reasonable Expectation of Profit

For many years, Canada Customs & Revenue Agency (formerly Revenue Canada) used the "reasonable expectation of profit" test to determine whether or not losses incurred by a business were deductible against other income. Essentially, this rule disallowed the deduction of business losses unless the owner could prove that he or she would be earning taxable profits in the future. This interpretation of the Income Tax Act was challenged in court on more than one occasion with mixed results. However, recent cases heard by the Supreme Court of Canada have indicated that this reasonableness test is itself unreasonable. The Supreme Court has ruled that different tests must be applied to determine whether a venture is a commercial enterprise. If it is, then whether or not it has a reasonable expectation of profit is irrelevant in applying the other rules of the Act that determine deductibility. This of course is good news for taxpayers who establish a business, but for whatever reason, suffer substantial losses. The old rules of denying tax relief in such situations was adding insult to injury.

The New Rules

The new rules state that if a venture is clearly a commercial enterprise, then the regular provisions of the income tax act must be used to determine deductibility. The most important provision is that if an expense is incurred in order to earn income, then it is deductible. The method of deduction will vary depending on whether or not the expense is an operating cost or capital expenditure. Many other rules exist to determine the amount and timing of allowable deductions, but these do not involve the expectation of profit test.

If a venture is not clearly a commercial enterprise, in that it may have a personal or hobby component, then other rules must be applied. If it is clearly a

hobby then deduction of losses will be denied. If it is a hobby or contains a personal component, losses will still be allowable if the business is undertaken in a sufficiently commercial manner.

To demonstrate that their business has been undertaken in a sufficiently commercial manner, taxpayers will have to provide evidence such as realistic business plans, market studies, adequate capitalization, significant time devoted to the business and generally other evidence showing a business like approach to the endeavour. Reasonable expectation of profit may be considered as evidence of a realistic business endeavour.

When establishing a new business that may have a personal or hobby component, taxpayers should maintain documentary evidence of the activities they undertake to make it successful. These include, but are not limited to:

- § business plans
- § market studies
- § forecasts of income and expenses
- § sources of capital and financing
- § advertising and marketing plans
- § staffing levels
- § suppliers
- § any other evidence that indicates a true commercial purpose to the venture

For further information please contact Harvey & Lister Inc. at 250.492.8821 or email to info@harveylister.com.

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