



Reasonable Expectation of Profit

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I attended two tax updates in January this year sponsored by CGA BC and my local CGA chapter. Ed Kroft of McCarthy Tétrault LLP and David Christian of Thorsteinssons, Tax Lawyers, both had concerns about proposed legislation that became effective January 1, 2005, even though it isn't passed in to law yet.

It appears the Department of Finance has reinstated the "reasonable expectation of profit" test (REOP). The REOP test was shot down by the Supreme Court of Canada in 2002.

New REOP legislation may significantly affect your ability to claim losses from property or business in 2005 and future years. You will need to know about these changes, if for example, you have been claiming a loss on:

- Rental property,
- Self-employed business, either proprietorship or partnership,
- A corporation that has never made a profit, or
- Investments where the cost of borrowing exceeds the income from investments.

Here are some of the highlights of this punitive legislation:

- Each individual property or individual business is to be judged on its own merits.
- If you do not have a cumulative profit for each individual property or business over its lifetime, excluding capital gains or losses, you can not claim the loss in the year.
- If you have a profit later, you can not go back and claim the loss at a later date.
- What is meant by cumulative profit has yet to be defined clearly.
- There are no timing provisions, losses can not be carried forward or capitalized.
- There is no recognition of all properties held.
- The objective of holding property to realize a capital gain is not recognized.
- Income is "net income" each year after interest expense and possibly amortization (no one seems to be sure about this yet).

- It isn't clear exactly when you should test for REOP, at the beginning, the middle or the end of the year.
- Interest for the purchase of common shares appears to be an acceptable deduction, in most circumstances.

What can a business owner or investor do to protect themselves?

- Documentation will be critical on a business-by-business or property-by-property basis.
- Each situation is fact specific and objective driven.

Here are my suggestions:

- Prepare a history of each business or property since the date of purchase to prepare a cumulative profit test for each year starting with 2005.
- Prepare future-oriented financial information to prove your ability to claim a loss in the year with
 - Short-term forecasts (1 year), and
 - Longer-term projections with your assumptions about profit each year you plan to operate each business or hold each property.
- Evaluate your ownership in each asset or business in your portfolio in light of these property-by-property rules, giving consideration to whether ownership or operation is acceptable if there is no REOP.
- Consider your treatment of property as capital or income. If you hold property on account of income rather than capital, you may include the gain as part of cumulative profit. Ensure that your properties are indeed on account of capital rather than income.
- Contact your accountant or your tax lawyer if you have concerns about how this legislation will affect your taxable income in 2005.

Looking for more details?

Additional reference materials for more in-depth coverage of the subject are listed below.

 New Interpretation Bulletin IT533 - *Interest Deductibility and Related Issues* at

<http://www.cra-arc.gc.ca/E/pub/tp/it533/README.html>

 Interpretation Bulletin IT218R - *Profits, capital gains and losses from the sale of real estate, including farmland and inherited land and conversion of real estate from capital property to inventory and vice versa* at <http://www.cra-arc.gc.ca/E/pub/tp/it218r/it218r-e.html>

 Interpretation Bulletin IT102R2 - *Conversion of property other than real property, from or to inventory* at <http://www.cra-arc.gc.ca/E/pub/tp/it102r2/it102r2-e.html>

 *Capital Gains Guide for 2004* (T4037) at <http://www.cra-arc.gc.ca/E/pub/tg/t4037/README.html>

 Call 1-800-959-2221 to request these publications (reference numbers provided above).

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