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# Interpretation Bulletin IT-484R2

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## Business Investment Losses



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REFERENCE: Paragraph 39(1)(c) (also subsections 39(9), (10), and (12), 50(1), 84(9), and 164(6); paragraphs 3(b) and (d), 38(c), and 111(1)(a) and (b); and the definitions "capital dividend account" in subsection 89(1), "net capital loss" and "non-capital loss" in subsection 111(8), "Canadian-controlled private corporation" in subsection 125(7), "aggregate investment income" in subsection 129(4), and "small business corporation" in subsection 248(1))

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# Application

This bulletin cancels and replaces Interpretation Bulletin IT-484R dated May 5, 1989, and the Special Release to IT-484R dated August 26, 1994.

## Summary

A business investment loss is basically a capital loss from a disposition to which subsection 50(1) applies, or to an arm's length person, of shares or debt of a small business corporation. Three-quarters of this loss is an allowable business investment loss.

Unlike ordinary allowable capital losses, an allowable business investment loss for a taxation year may be deducted from all sources of income for that year. Generally, an allowable business investment loss that cannot be deducted in the year it arises is treated as a non-capital loss which may be carried back three years and forward seven years to be deducted in calculating taxable income of such other years. Any such loss that is not deducted by the end of the seven-year carry-forward period is then treated as a net capital loss so that

it can be carried forward indefinitely to be deducted against taxable capital gains.

Ordinary allowable capital losses for a taxation year may be deducted only from taxable capital gains realized in the year. If the allowable capital losses exceed the taxable capital gains, the difference is a net capital loss which may be carried back three years and forward indefinitely to be deducted only against taxable capital gains.

The purpose of the rules relating to the business investment loss is to encourage investment in small business corporations by giving such losses more generous tax treatment than that available for ordinary capital losses.

This bulletin discusses the various provisions of the Act relevant to determining what constitutes a taxpayer's allowable business investment loss for a taxation year and the deductibility of such a loss.

# Discussion and Interpretation

## General

¶ 1. An "allowable business investment loss" is defined in paragraph 38(c) as  $\frac{3}{4}$  of a "business investment loss" defined in paragraph 39(1)(c). To qualify as a business investment loss, an amount must first be a capital loss. Thus when a transaction does not give rise to a capital loss, or when a capital loss is deemed to be nil (e.g., under paragraph 40(2)(g)), no business investment loss can result.

Although a business investment loss for a year must first qualify as a capital loss, a taxpayer does not have the option of treating it as a capital loss for the year rather than a business investment loss.

The portion of a business investment loss included in calculating a taxpayer's allowable business investment loss has increased over the years. For example, in the case of an individual or a partnership, the above reference to " $\frac{3}{4}$ " should be read as a reference to " $\frac{2}{3}$ " if the taxation year or fiscal period in which the business investment loss

arose ended after 1987 and before 1990, and "1/2" if the taxation year or fiscal period ended before 1988.

¶ 2. In calculating income pursuant to section 3, an allowable business investment loss is not deducted from taxable capital gains under paragraph 3(b) but is deducted from income from all sources under paragraph 3(d).

Generally, any allowable business investment loss that cannot be deducted in the year it arises is treated as a "non-capital loss" as defined in subsection 111(8). Such a loss may, under paragraph 111(1)(a), be carried back three years and forward seven years and deducted in calculating taxable income of such other years.

The amount of the allowable business investment loss that is included as a non-capital loss is determined in the taxation year in which the business investment loss arises. No adjustment to the amount of the allowable business investment loss is required if the loss is carried forward or back to a taxation year in which the allowable portion of the business investment loss would be different had the loss occurred in that year. For example, a business investment loss arising in a taxation year in which the allowable portion of the business



investment loss is 2/3 will not be increased should that allowable business investment loss be deducted in a taxation year in which the allowable portion of business investment losses is 3/4.

Generally, an allowable business investment loss that is not deducted as a non-capital loss by the end of the seventh year of its carry-forward period becomes a "net capital loss," as defined in subsection 111(8), in that seventh year. This treatment allows the loss to be carried forward indefinitely to be deducted against taxable capital gains beginning in the eighth year. For example, if an individual incurred an allowable business investment loss in 1989, and the individual was unable to use the loss by the end of 1996, the loss will become a net capital loss in 1996. The individual can then carry the loss forward indefinitely and deduct it against taxable capital gains realized in 1997 and subsequent years.

Non-capital losses and net capital losses are discussed in the current version of IT-232, NON-CAPITAL LOSSES, NET CAPITAL LOSSES, RESTRICTED FARM LOSSES, FARM LOSSES AND LIMITED PARTNERSHIP LOSSES – THEIR COMPOSITION AND DEDUCTIBILITY IN COMPUTING TAXABLE INCOME.

¶ 3. A taxpayer's business investment loss may arise from the disposition of:

- (a) a share of a corporation that is a small business corporation, or
- (b) a debt owing to the taxpayer (except as discussed in ¶ 5 below) by a Canadian-controlled private corporation.

For a loss on the disposition of such property to qualify as a business investment loss, the disposition must be to an arm's length person or be deemed to have occurred under subsection 50(1) (see ¶ 6 below). For the meaning of "small business corporation" and more information regarding "Canadian-controlled private corporation" see ¶ 4 below.

¶ 4. The term "small business corporation" is defined in subsection 248(1). In general, a small business corporation is a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which is attributable to assets used principally in an active business carried on primarily in Canada or shares or debts of connected small business corporations or a combination of the two. For the purposes of determining a business investment loss, a corporation that was a small business corporation at any time in the 12 months before the disposition of the share or

debt, as the case may be, will be considered to be a small business corporation.

The Canadian-controlled private corporation referred to in ¶ 3(b) above and ¶ 6 below has to be:

- a small business corporation;
- a bankrupt (as defined by the BANKRUPTCY AND INSOLVENCY ACT) that was a small business corporation when it last became a bankrupt; or
- a corporation referred to in section 6 of the WINDING-UP ACT that was insolvent (within the meaning of that Act) and was a small business corporation at the time a winding-up order under that Act was made for that corporation.

The meaning of "Canadian-controlled private corporation" as defined in subsection 125(7) is discussed in the current version of IT-458, CANADIAN-CONTROLLED PRIVATE CORPORATION.

¶ 5. A debt owed to a corporation by a non-arm's length corporation is excluded from debts referred to in ¶ 3(b) above and therefore any

capital loss resulting from a disposition thereof will never qualify as a business investment loss.

¶ 6. Subsection 50(1) deems a taxpayer to have disposed of a debt or a share of a corporation at the end of a taxation year for nil proceeds and to have reacquired it immediately thereafter at a cost of nil if:

- in the case of a debt (other than a debt from the sale of personal use property), the debt is owing to the taxpayer at the end of the taxation year and it is established by the taxpayer to have become a bad debt in the year; and
- in the case of a share (other than a share received as consideration from the sale of personal use property), the taxpayer owns the share of the corporation at the end of the taxation year and the corporation:
  - has become a bankrupt (as defined by the BANKRUPTCY AND INSOLVENCY ACT) in the year;

- is a corporation referred to in section 6 of the WINDING-UP ACT that was insolvent (within the meaning of that Act) and for which a winding-up order under that Act was made in the year; or
- at the end of the year, is insolvent, and neither the corporation, nor a corporation it controls, carries on business. Also, at that time, the share has a fair market value of nil and it is reasonable to expect that the corporation will be dissolved or wound-up and will not commence to carry on business.

For taxation years ending after February 21, 1994, a taxpayer must elect to have subsection 50(1) apply in respect of a debt or a share. For taxation years ending before February 22, 1994, an election was not required in order to have subsection 50(1) apply in respect of a debt.

If subsection 50(1) applies, the taxpayer is deemed to have disposed of the property for nil proceeds and a capital loss will arise. If the debt is owed (except as discussed in ¶ 5 above) by a Canadian-controlled private corporation (see ¶ 4 above) or the share is a share of a small business corporation, the loss will be considered a business investment loss. Subsection 50(1), as it applies in respect

of a capital debt, is discussed in the current version of IT-159,  
CAPITAL DEBTS ESTABLISHED TO BE BAD DEBTS.

¶ 7. The business investment loss from a disposition described in ¶ 3 above is the amount by which the taxpayer's capital loss from the disposition exceeds the amount of any applicable reduction discussed in ¶s 8 to 11 below. The portion of the capital loss that does not qualify as a business investment loss (because of any reduction discussed in ¶s 8 to 11 below) remains a capital loss.

¶ 8. In determining a taxpayer's business investment loss, the capital loss resulting from the disposition of a share of a small business corporation in the circumstances described in ¶ 3 above is reduced:

- (a) under subparagraph 39(1)(c)(v), by the amount of any increase after 1977, from the application of subsection 85(4), in the adjusted cost base to the taxpayer of either that share or any "replaced share" (see ¶ 12 below);
- (b) under subparagraph 39(1)(c)(vi), by the amount of the taxable dividends received after 1971 and before or upon the disposition of the share (as well as such dividends receivable upon the disposition) by

- (i) the taxpayer,
- (ii) the taxpayer's spouse, or
- (iii) a trust of which the taxpayer or the taxpayer's spouse was a beneficiary

if the share was issued before 1972 or was a "substituted share" (see ¶ 12 below), other than a share or a substituted share that was acquired after 1971 from a person with whom the taxpayer was dealing at arm's length; and

- (c) under subparagraph 39(1)(c)(vii), if the taxpayer is a spouse trust referred to in paragraph 104(4)(a), by the amount of all taxable dividends received after 1971 or receivable at the time of the disposition by the settlor (as defined in subsection 108(1)) or by the settlor's spouse on the share if the share was issued before 1972 or was a substituted share, other than a share or a substituted share that was acquired after 1971 from a person with whom the spouse trust was dealing at arm's length.

**Note:** The Notice of Ways and Means Motion of June 20, 1996, proposes to repeal subsection 85(4). In general terms,

subsection 85(4) applies to deny a loss on a taxpayer's transfer of property to a corporation that is controlled by the taxpayer, the taxpayer's spouse or a person or group of persons by whom the taxpayer is controlled. Instead, the amount of the loss is added to the adjusted cost base of shares of the corporation owned by the taxpayer right after the transfer. As mentioned in ¶ 8(a) above, in determining a taxpayer's business investment loss, the capital loss resulting from the disposition of a share of a small business corporation is reduced under subparagraph 39(1)(c)(v) by the amount of any increase after 1977, from the application of subsection 85(4), in the adjusted cost base to the taxpayer of either that share or any "replaced share." If enacted as proposed, subsection 85(4) will not apply to dispositions of property occurring after April 26, 1995, subject to certain exceptions. Generally, the exceptions exclude transactions in progress before April 27, 1995.

¶ 9. In determining the business investment loss of an individual or a trust from a disposition of a share or debt described in ¶ 3 above, the capital loss resulting from such disposition is reduced under subparagraph 39(1)(c)(viii) by the amount determined in ¶ 10 below in the case of an individual or ¶ 11 below in the case of a trust.



¶ 10. An individual (other than a trust) is required under subsection 39(9) to reduce the amount of a business investment loss for a taxation year otherwise determined by the total of amounts each of which is  $\frac{4}{3}$  (except as noted below) of the amount, if any, deducted under section 110.6 as a capital gains deduction in a prior taxation year, to the extent that such an amount has not previously been applied in this manner in respect of other dispositions.

The above reference to " $\frac{4}{3}$  of the amount" should be read as a reference to:

- " $\frac{3}{2}$  of the amount" if the prior year ends after 1987 and before 1990 (except if the capital gains deduction was in respect of a deemed taxable capital gain included in income under subparagraph 14(1)(a)(v), in which case the reference to " $\frac{4}{3}$  of the amount" is applicable); and
- "twice the amount" if the prior year ends before 1988.

¶ 11. A trust is required under subsection 39(10) to reduce the amount of a business investment loss for a taxation year otherwise determined by the total of amounts each of which is  $\frac{4}{3}$  (except as noted below) of the amount, if any, designated under subsection

104(21.2) in respect of a beneficiary for a prior taxation year for the purpose of the capital gains deduction under section 110.6, to the extent that such an amount has not previously been applied in this manner in respect of other dispositions.

The above reference to "4/3 of the amount" should be read as a reference to:

- "3/2 of the amount" if the prior year ends after 1987 and before 1990 (except if the amount designated was in respect of a deemed taxable capital gain included in the trust's income under subparagraph 14(1)(a)(v), in which case the reference to "4/3 of the amount" is applicable); and
- "twice the amount" if the prior year ends before 1988.

¶ 12. The term "replaced share" in ¶ 8(a) above refers to any share, in a line of exchanges or substitutions, that was replaced by another share. For purposes of ¶ 8(a) above, only go back as far as any replaced share that existed on January 1, 1978. A "substituted share" for the purpose of ¶ 8(b) above, refers to any share acquired in a line of exchanges or substitutions which commences with a share issued before 1972 and ends with the share which is the subject of the

disposition. Replaced and substituted shares are those that are disposed of or acquired, as the case may be, as a result of corporate reorganizations and rollovers and would include those share exchanges or substitutions to which sections 51, 85, 85.1, 86, and 87 are applicable.

¶ 13. If a shareholder is dealing at arm's length with a small business corporation, a business investment loss may arise when the shares of that corporation are redeemed or purchased for cancellation. Subsection 84(9) provides that shares are disposed of by the shareholder to the corporation at the time they are redeemed, acquired or cancelled by the corporation. Any deemed dividend on a redemption, acquisition or cancellation of a share may reduce the business investment loss as indicated in ¶ 8(b) above.

¶ 14. In the case of a payment made by a taxpayer under a guarantee in respect of a corporation's liabilities, a debt does not arise between the corporation and the taxpayer until the payment is made. In some cases, this payment may be made subsequent to the time the corporation was a small business corporation and this may otherwise preclude any resulting capital loss from being a business investment loss. Under subsection 39(12), a payment made by a

taxpayer under a guarantee of the debts of a corporation is deemed to be a debt owing to the taxpayer by a small business corporation if:

- the payment was made to an arm's length person; and
- the corporation was a small business corporation both at the time the corporation's debt in respect of which the payment was made was incurred and at any time in the 12 months before the time any amount first became payable under the guarantee.

When these conditions are met, the taxpayer may be eligible to claim a business investment loss on any amounts owing to the taxpayer for payments made under the guarantee even if the corporation has ceased to carry on an active business.

A taxpayer may also be entitled to claim a capital loss if the taxpayer suffers a loss as a result of honouring a guarantee of the debts of certain corporations or from loaning money in the circumstances outlined in paragraph 6 of IT-239R2, DEDUCTIBILITY OF CAPITAL LOSSES FROM GUARANTEEING LOANS FOR INADEQUATE CONSIDERATION AND FROM LOANING FUNDS AT LESS THAN A REASONABLE RATE OF INTEREST IN NON-ARM'S LENGTH CIRCUMSTANCES. In such a case, if paragraph 50(1)(a) applies to the debt or the loan, and the other requirements outlined

in ¶ 3 above are met, the capital loss will be considered a business investment loss.

¶ 15. When calculating a corporation's "capital dividend account," as defined in subsection 89(1), a business investment loss remains a capital loss to be included in the total referred to in subparagraph (a)(ii) of that definition. Similarly, when calculating a corporation's aggregate investment income under subsection 129(4), any allowable business investment loss for the year must be considered in its original classification as an allowable capital loss under paragraph (a) in the definition of "aggregate investment income." The definition of "aggregate investment income" replaced the definition for "Canadian investment income" in subsection 129(4) for taxation years that end after June 1995. When calculating a corporation's Canadian investment income for taxation years that ended before July 1995, any allowable business investment loss for the year must be considered in its original classification as an allowable capital loss in determining the amount for A in the definition of "Canadian investment income."

## Deceased Taxpayers

¶ 16. If the estate of a deceased taxpayer realizes in its first taxation year a capital loss that qualifies as a business investment loss, an election under paragraph 164(6)(c) may be utilized to have all or part of such loss effectively treated as a business investment loss of the deceased in the year of death in the application of subsection 164(6). This treatment is effective only for the amount of the business investment loss less the excess of any capital gains over capital losses other than business investment losses in the estate. To the extent that a business investment loss is subject to such an election, it is not deductible from other income under paragraph 3(d) in calculating the income of the estate. In addition, no part of such a loss may be deducted for a taxation year preceding the year in which the taxpayer died. The subsection 164(6) election is discussed in the current version of IT-140, BUY-SELL AGREEMENTS.

# **Explanation of Changes**

## **Introduction**

The purpose of the EXPLANATION OF CHANGES is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

## **Reasons for the Revision**

The revision to Interpretation Bulletin IT-484R was undertaken to reflect amendments to the Income Tax Act enacted by the 5th Supplement to the Revised Statutes of Canada, 1985; S.C. 1994, c.7, Schedule V (1992 c.27 – formerly Bill C-22); S.C. 1994, c.21 (formerly Bill C-27); S.C. 1995, c.21 (formerly Bill C-70); and S.C. 1996, c.21 (formerly Bill C-36). The revision also contains a note regarding a proposed amendment to the INCOME TAX ACT included in the NOTICE OF WAYS AND MEANS MOTION of June 20, 1996. The comments in this bulletin are not affected by any other draft legislation released before September 23, 1996.

## Legislative and Other Changes

The Summary has been revised to provide the purpose, and a brief description, of the rules relating to business investment losses.

¶ 2 has been expanded to explain what happens to an allowable business investment loss that is not deducted as a non-capital loss by the end of its carry-forward period. An example has been added to illustrate the explanation.

New ¶ 4 contains information previously contained in ¶ 3. The information has been revised to include a general definition of "small business corporation." In addition, the reference to "BANKRUPTCY ACT" has been replaced with "BANKRUPTCY AND INSOLVENCY ACT," effective November 30, 1992.

New ¶ 5 contains information previously contained in ¶ 3.

New ¶ 6 has been added to explain when a disposition is deemed to have occurred under subsection 50(1).

New ¶ 7 contains information previously contained in ¶ 3.



¶ 8 (former ¶ 4) was expanded to provide a note regarding the proposed amendment to repeal subsection 85(4), applicable to dispositions of property occurring after April 26, 1995, subject to certain exceptions. Generally, the exceptions exclude transactions in progress before April 27, 1995.

¶s 10 and 11 (former ¶s 6 and 7) were expanded to reflect amendments made to subsections 39(9) and (10). When determining a business investment loss (BIL), a taxpayer is required to reduce the BIL by the lesser of the amount of the BIL and the taxpayer's net capital gains for which a deduction was claimed under section 110.6, to the extent that such gains have not been used to reduce other BILs. In calculating the net capital gains for which a deduction was claimed under section 110.6, deductions taken for taxable capital gains are grossed up by the applicable inclusion rate. Subsections 39(9) and (10) were amended, for the 1988 and subsequent years, to adjust the inclusion rate to  $\frac{4}{3}$  for deemed capital gains included in income under subparagraph 14(1)(a)(v) for a taxation year that ended after 1987 and before 1990.

¶ 15 (former ¶ 11) is expanded to reflect amendments to subsection 129(4). For taxation years that end after June 1995, the

definition of "Canadian investment income" in subsection 129(4) is replaced by the new definition for "aggregate investment income."

Former ¶ 12 has been deleted since the information it contained is not relevant for purposes of current taxation years. A general statement on this issue has been added to ¶ 1.

We have made a number of other changes to improve the overall clarity and readability of the bulletin.