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Tax

Tax planning strategies in a market downturn: Loss

By **Martin Sorensen, Marshall Haughey and Hennadiy Kutsenko**

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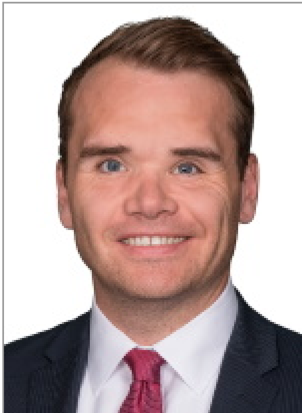

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(June 17, 2020, 2:41 PM EDT) -- In our last two articles, we discussed tax and estate planning and asset-protection strategies for taking advantage of lower business and asset valuations brought about by COVID-19 and reducing creditor and liability risk, respectively. This week, we will overview certain strategies that can minimize the immediate or eventual tax consequences of this downturn for businesses.

The discussion in this article is of a general nature only and we recommend that a professional tax adviser be consulted before implementing any of the strategies discussed.

Loss utilization

In Canada, losses are a valuable tax attribute. Non-capital losses are basically all losses other than losses realized on the disposition of capital property and, to the extent they are not wholly used up in the year they are realized, can be carried back and applied against income and capital gains in the three preceding taxation years or can be carried forward and applied against income and capital gains in the 20 subsequent taxation years.

Capital losses are losses realized on the disposition of capital property and, to the extent they are not wholly used up in the year, can be carried back and applied against capital gains in the three preceding taxation years or can be carried forward and applied against capital gains in any future taxation year.

As such, businesses that have operating losses or assets in a loss position should consider ways to utilize these losses to offset income and gains in the current year and to potentially recoup taxes paid in the three prior taxation years.

Loss consolidation

In Canada, each member of a corporate group is a separate taxpayer and must report its own income and losses on its tax return each year. The Canadian tax system does not permit members of a corporate group to "consolidate" the income and losses on their tax returns. As such, without planning, losses by one group member generally cannot be used to offset income of another group member to reduce the group's overall Canadian taxes.

However, there are strategies available that, when properly structured, can effectively consolidate losses within a corporate group. These strategies include:

- amalgamating or winding-up a wholly-owned "lossco" into a parent "profitco." Provided this is done in accordance with the detailed rules in the *Income Tax Act* (Act), the losses from lossco

can become available to amalco or profitco, as the case may be;
- profitco transferring income-producing assets to lossco on a tax-deferred basis so that lossco's losses can be used to offset the income from the assets;
- profitco transferring assets in a gain position to lossco on a tax-deferred basis and having lossco sell the assets to a third party so that lossco's losses can offset the resulting gains;
- creating intragroup indebtedness giving profitco an interest deduction and lossco an income inclusion (which is offset with lossco's losses); and
- creating other deductible expenses in profitco (such as management fees, lease payments, etc.) that are paid to lossco (which are offset with lossco's losses).

Accordingly, while the lemons of business or capital losses may be bitter and sour, the lemonade derived from them may sweeten other aspects of one's business in the corporate group and reduce the tax impact of earning profits elsewhere.

Debt forgiveness

Companies may seek to renegotiate certain debt obligations with their creditors when facing financial difficulties. When this renegotiation involves merely extending or deferring the payment schedule, or amending the ancillary terms of the debt to be more favourable, there should generally not be any adverse tax consequences to the debtor. However, when the renegotiation entails reducing or eliminating part or all of the principal or interest, the debt forgiveness rules in the Act may apply.

The debt forgiveness rules are intended to apply to a taxpayer that is wholly or partially relieved of their obligation to repay debt on which interest is, or could be, deductible (including the obligation to pay the interest itself, which is deemed to be a separate debt obligation for purposes of these rules).

When such a debt is extinguished without payment, the debt forgiveness rules can apply to reduce certain valuable tax attributes of a taxpayer in a set order, in the amount of the unpaid principal or interest, as the case may be. After these attributes have been exhausted, a taxable income inclusion may have to be realized.

The application of the debt forgiveness rules can therefore have considerable adverse tax consequences. Accordingly, pursuing the settlement of debt obligations with creditors should be approached with these rules in mind.

Concluding thoughts — making lemonade out of lemons

If you or your clients find yourself with an abundant supply of lemons, you might as well make use of them. The strategies outlined in this three-part series are intended to make the best of a bad situation, but may carry risks and should be implemented with the benefit of professional advice. Like your grandmother told you, there are opportunities to be found during times of adversity and misfortune. Take the lemons you have been handed and make some lemonade! For the right recipe, contact a tax adviser.

This is part three of a three-part series. Part one: Tax planning strategies in market downturn: Estate freezes, income splitting; part two: Tax planning strategies in a market downturn: Trusts.

Martin Sorensen's practice focuses on tax planning and tax litigation at Bennett Jones LLP*. He has particular experience in matters involving complex corporate, individual and international tax planning. Marshall Haughey practises tax law at Bennett Jones with a focus on corporate tax and transaction structuring. He also has a keen interest in estate planning transactions involving tax-effective restructuring of businesses and intergenerational transfers of wealth. Hennadiy Kutsenko is a tax associate in the Toronto office of Bennett Jones and practises in all aspects of income tax, GST/HST and provincial tax, with an emphasis on corporate reorganizations, cross-border transactions and public and private mergers and acquisitions.*

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