PRACTITIONERS' CORNER

Canadian Tax Incentives for an 'Active Business'

by Richard Eisenbraun

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On March 8, 2013, the Canadian Federal Court of Appeal (FCA) rendered its decision in *Ollenberger*,[1] which clarified the nature of the definition of the term ''active business'' for the purposes of the Income Tax Act (Canada). This definition is particularly relevant for private Canadian companies seeking to raise capital or to position themselves for a sale, since a variety of advantageous tax rules may apply where the corporation carries on sufficient active business.

Tax Benefits Available for an Active Business

The term ''active business'' is a critical part of the definition of the term ''small business corporation'' and various similar categories of corporations under the ITA (all of which are referred to here as an SBC), which are generally defined to include a Canadian-controlled private corporation (CCPC), all or substantially all of the fair market value of the assets of which are attributable to assets that are used principally in an active business carried on primarily in Canada by the corporation (or other specified entities).

Despite their name, SBCs do not necessarily have to be small and can be widely held. SBC status or a sufficiently active business can provide various tax benefits:

- *Lower Rates of Taxation*. CCPCs may be entitled to the small business deduction, which generally entitles them to a reduced rate of taxation on their first C $500,000 of income generated from active business in Canada. Also, income earned by a corporation from an active business that does not qualify for the small business deduction is generally taxed at a lower rate than income from more passive sources.
- *Capital Gains Deduction*. If other conditions are met, Canadian individuals can claim an exemption on up to C $750,000 of capital gains in their lifetime generated on the disposition of shares of SBCs. The Canadian government has proposed to increase this exemption to C $800,000 beginning in 2014 and to index this amount to inflation for subsequent tax years.
- *Business Investment Losses*. In most cases, a loss arising from the disposition of shares or debt of a corporation is a capital loss, which can only be used to offset capital gains, as opposed to other sources of income (for example, business, property, or employment income). Business investment losses provide more favorable tax treatment than capital losses, since half of a business investment loss is deductible from any source of income. A taxpayer must elect to claim the loss as a business investment loss, and business investment losses can only be claimed, in very general terms, on:
  - debts of an SBC that are established to be bad debts;
  - shares of an SBC that has gone bankrupt, is wound-up, or ceases to carry on business; or
  - shares or debt of an SBC sold to a person that deals at arm's length with the taxpayer.
- *Registered Retirement Savings Plan (RRSP)/Tax Free Savings Account (TFSA) Qualification*. Canada has

[1] *Ollenberger v. The Queen,* 2013 FCA 74, *rev'g* 2012 TCC 30.

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established several tax-advantageous plans to encourage Canadians to save for their retirement (registered plans). As a result, prospective investors in private companies often have a lot of capital tied up in registered plans, especially given Canada's aging population. However, registered plans can only make certain types of investments, and not all private company shares are qualified investments for registered plans. Shares of corporations that satisfy a modified version of the SBC definition and other criteria are qualified investments for the most common types of registered plans.

- *Replacement Property Rules*. An individual taxpayer can, in some cases, obtain tax deferral after the disposition of shares of an SBC on the portion of the taxpayer's proceeds of disposition that are reinvested in another SBC within 120 days after the end of the tax year in which the disposition occurred.
- *Attribution Rules*. Various rules in the ITA attribute income of one family member to another family member when the latter has, directly or indirectly, transferred or loaned property to the other. Typically, these rules attribute income to a higher-income family member. Some of these rules do not apply when the transfer involves shares of an SBC.

In addition to active business carried out within Canada, income from an active business earned by a controlled foreign affiliate of a Canadian resident is generally subject to more favorable tax treatment than foreign-source property income, on which the Canadian resident is generally subject to tax on an accrual basis rather than when funds are repatriated to Canada.

When Is a Business an 'Active Business'?

The ITA generally defines an ''active business'' to be ''any business'' *other than* a ''specified investment business'' and specific other exceptions.[2] A ''specified investment business'' can fairly be summarized as a business the principal purpose of which is to derive income (including interest, dividends, rents, and royalties) from property, unless certain indicia of business activity exists. The *Ollenberger* case clarified that the word ''active'' does not add anything to the meaning of ''active business,'' but rather that an ''active business'' is ''any business'' other than a business that falls within one of the specific exceptions in the ITA.

In *Ollenberger,* the taxpayer invested in a private oil and gas exploration company based in Calgary (AEF). AEF was in its early stages and had been actively pursuing ventures involving the acquisition of oil and gas properties. AEF had prepared a business plan and market analysis. AEF had also identified assets (the ''target assets'') to acquire and had negotiated an option to purchase those assets, with the intent of either operating or selling them, whichever was most profitable. AEF needed funds in order to pay for a 10 percent deposit on the target assets, which it raised in part through a loan from the taxpayer. Shortly thereafter, an alleged defect on the title to the target assets was identified, the deposit was forfeited, the loan was never repaid, and the taxpayer suffered a loss on his investment. The taxpayer claimed the loss as a ''business investment loss'' rather than an ordinary capital loss.

The Minister of National Revenue (MNR) denied the business investment loss on the basis that AEF was not carrying on an ''active business.'' The MNR took the narrow view that the business of AEF was not active enough in the circumstances, even though AEF had office space, paid rent, and had all of the paraphernalia associated with a business (such as a phone/fax number, business cards, and a website). The MNR believed that until AEF concluded its first major contract and was profitable, it was not active enough to qualify for favorable tax treatment.

The taxpayer appealed the MNR's decision and was successful at the FCA. The FCA concluded that the term ''active business'' simply means ''any business,'' other than two statutory exceptions that were not relevant in the *Ollenberger* case. The FCA elaborated as follows:

> The definition effectively recognizes that any business being carried on is an active business, but rather carves out of this definition particular businesses such as those which derive their income from property and do so without the need to employ a certain number of employees. . . . AEF must be held to qualify if it was carrying on business at the relevant time. In this regard, the admission by the respondent that AEF was actively pursuing ventures involving the acquisition of oil and gas properties necessarily leads to the conclusion that this condition was met. In my view, the Tax Court judge erred when she held that more was required in order to conclude that AEF was carrying on an ''active business''. As otherwise it is conceded that AEF had assets and that these assets were used exclusively in that pursuit — no other use is suggested — it follows that AEF was a ''small business corporation'' at the relevant time.[3]

As a result, the taxpayer was allowed to claim his loss as a business investment loss rather than a capital loss.

The FCA's decision is in line with the context in which the phrase ''active business'' is used in the ITA.

[2]Different definitions apply for controlled foreign affiliates.

[3]*Ollenberger*, at paras. 29-31.

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The definition of active business is often used in circumstances that give rise to favorable tax treatment, based on the policy rationale that the deployment of capital to fund business ventures is something to be encouraged. The FCA's comments in *Ollenberger* provide some welcome certainty in the analysis of what constitutes active business for the purposes of the ITA, especially for business ventures that incur considerable start-up costs before becoming profitable. Had the MNR succeeded in *Ollenberger*, considerable uncertainty would have surrounded the availability of such tax benefits in the context of business start-ups and other private corporations. Taxpayers seeking to attain the tax benefits described above should nevertheless seek specific tax advice as early as possible in order to avoid some of the common pitfalls that could deny the availability of those benefits.

Conclusion

The FCA's clarification of the definition of the term ''active business'' for the purposes of the ITA is valuable, in that it clarifies that any business can qualify as an active business as long as it has commenced and does not fall within one of the relevant statutory exceptions. This may be of assistance to private Canadian companies seeking to raise capital or to position themselves for a sale. ◆

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