THE GLOBE AND MAIL

TAX MATTERS

Claiming a loss? Tax ruling offers important lesson

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Special to The Globe and Mail
Published Wednesday, Jan. 14 2015, 7:30 PM EST
Last updated Thursday, Jan. 15 2015, 10:18 AM EST

I've often told my kids: If you want to have a million dollars one day, start with $10-million then invest in a hot tip. More than a few Canadians have lost thousands this way. We can learn a lot from those who have made mistakes before us. The story of Allan Prochuk, an engineer-turned-investor from British Columbia, is a good reminder of what can happen when a hot tip turns bad. His story also sheds some light on a tax issue that many Canadians should be aware of.

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The story

Until 1985, Allan Prochuk worked for B.C. Hydro when he was laid off due to the postponing of a major development project. He was given severance pay at that time that was paid into his registered retirement savings plan (RRSP). Mr. Prochuk always had an interest in the financial field, and so began working in the financial services industry after leaving B.C. Hydro. After working for a few years in the financial world he decided to leave to focus on investing his own RRSP money because he was having some success at it. According to Mr. Prochuk, he actively traded in his RRSP and managed to increase the value of his RRSP eightfold between 1987 and 1999.

It was in 2003 that Mr. Prochuk met a couple of gentlemen who introduced him to some tax reduction strategies (which were very aggressive and led to reassessments by CRA – but I digress). These same men advised Mr. Prochuk, in 2005, to invest money in a foreign currency fund with an organization called Sabourin and Sun Group of Companies (SSGC). He withdrew $250,000 from his RRSP and invested it with SSGC, which, as it turns out, was a fraudulent investment scheme. It was Feb. 10, 2011, when Mr. Prochuk received a letter from the anti-racket division of the Ontario Provincial Police informing him that one of the SSGC principals was under investigation regarding his investment practices. Mr. Prochuk only recovered some of his money. He lost $186,250.

The tax issue

So, what's the tax issue here? Surely Mr. Prochuk should have been entitled to claim a loss for his misfortune. Yes, he was entitled to claim a loss. But there are different types of losses. Mr. Prochuk had to decide whether to claim a capital loss, or a business loss (called a non-capital loss). You see, capital losses can be applied to reduce capital gains – but not other types of income. Business losses offer greater flexibility because they can be applied against capital gains or any other type of income. Mr. Prochuk tried to argue that his losses were business losses, not capital losses.

Over time, the courts have established principles that the Canada Revenue Agency (CRA) is obligated to consider when looking at your investment transactions and determining whether your losses should be capital losses (on "capital account") or business losses (on "income account"). The factors to be considered are: (1) the number of transactions; (2) the intention of the purchaser when buying the securities (did you intend to buy and hold them to earn income, or simply flip them for a profit?); (3) the length of time that the securities are held; (4) the quality of the securities; (5) the time devoted to stock market transactions (is this your full-time job or a hobby?); (6) the extent of borrowing; and (7) the taxpayer's expertise or special knowledge in the securities market.

In the case of Mr. Prochuk, he argued that he was in the business of trading in securities because he did this full time to earn a living for himself. He also argued that he was carrying on an "adventure in the nature of trade" (essentially, carrying on a business). He pointed to the management of his RRSP (many of the factors listed above would point to business loss treatment if you look at how he manages his own RRSP) as evidence that this particular SSGC investment outside of his RRSP should be given business loss treatment.

He lost his case. Notwithstanding how Mr. Prochuk managed his RRSP, the court concluded that he acquired the SSGC investment for the long term and was a passive investor. So, he was provided capital loss treatment, not business loss treatment. A key moral of the story is this: When considering capital versus income treatment for a particular investment transaction, the treatment can be different from one investment account to the next – even if owned by the same investor. It makes sense, then, to segregate any day trading activity (sometimes considered on income account) into a separate account from your buy-and-hold securities.

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