

Claiming Losses on Worthless Shares

Investors sometimes hold shares which have become worthless as a result of the company becoming insolvent or bankrupt. If sold, the shares would likely have generated a capital loss, but generally shares of insolvent or bankrupt companies cannot be traded. Fortunately, a provision under subsection 50(1) of the *Income Tax Act (ITA)* can be applied to provide some tax relief.

Conditions for Subsection 50(1) *ITA* to apply

Subsection 50(1) of the *ITA* stipulates that a taxpayer who owns shares at the end of the year can elect to deem a disposition of such shares under one of the following circumstances:

- The corporation issuing the shares has become bankrupt;
- The corporation issuing the shares is insolvent and a winding-up order has been made under the Winding-up and Restructuring Act; or
- The corporation issuing the shares is insolvent, does not carry on business and the fair market value of the share is nil and it is reasonable to expect that the corporation will be dissolved or wound up.

A situation where this election cannot be made is where the shares were received by the taxpayer as consideration in respect of the disposition of personal use property.

It should be noted that the issue of a cease trading order (CTO) does not automatically suggest that the above conditions for ss. 50(1) to apply are satisfied. A CTO is issued by a provincial or territorial securities commission against a company for failing to meet disclosure requirements and prohibits trading in that company's shares; nevertheless, the company may continue to carry on business.



Application of Subsection 50(1)

Where subsection 50(1) applies, the shares will be deemed to have been disposed of for proceeds of nil at the end of the year, and to have been reacquired for adjusted cost base (ACB) of nil immediately after the end of the year. As a result, the taxpayer will be able to realize the capital loss on the property. The superficial loss rule does not apply in this situation. The capital loss is applied first against capital gains in the current year. If there are any excess capital losses, they can be carried back to any of the three preceding taxation years, or forward indefinitely and applied against capital gains in those years.

Business investment loss

The loss under subsection 50(1) from the shares of a “small business corporation” may result in a business investment loss, 50% of which is

referred to as the “allowable business investment loss”, or ABIL. Unlike capital losses, an ABIL is deductible against all sources of income, not just capital gains. While an ABIL may be carried back up to three years it can only be carried forward 10 years and deducted in calculating the taxable income of such other years. An ABIL that is not deducted as a non-capital loss by the end of the carryforward period becomes a net capital loss at the end of the tenth year. This treatment allows the loss to be carried forward indefinitely to be deducted against taxable capital gains beginning in the eleventh year.

A “small business corporation” as defined in the ITA refers specifically to a Canadian-controlled private corporation of which substantially all (i.e. 90% or more) of the fair market value of the assets are used in an active business carried on primarily in Canada.

Election Procedure

There is no prescribed form for making a subsection 50(1) election. Canada Revenue Agency (CRA) has however provided the following guidelines:

- The election should take the form of a signed letter attached to the tax return stating that the taxpayer wants subsection 50(1) of the ITA to apply to the shares in question.
- For returns that are electronically filed, all elections and supporting documentation must be submitted in writing. The taxpayer's full name, address, and social insurance number should be clearly identified on all election forms and letters, and the cover letter should indicate that the documents are submitted in support of the taxpayer's electronically filed return and state the intention to apply subsection 50(1) of the ITA.
- Where the business investment loss is in respect of shares of a small business corporation, information such as the name of the small business corporation, the number and class of the particular share(s) and the adjusted cost base of the share(s) should be provided. Where applicable, the date the corporation became bankrupt

or the date of the winding-up order should also be provided.

Subsequent recovery

Since an investor who makes a subsection 50(1) election is deemed to have disposed of and reacquired the property at an ACB of nil, if at some point in the future the shares are no longer worthless, the investor will realize a capital gain upon disposition. It is to be noted however that where the election is made in respect of an insolvent corporation and the corporation begins to carry on business again within 2 years, the capital loss previously reported will be eliminated.

Other possible ways to realize a loss on worthless securities

- Gift the shares to a family member (other than a spouse) and claim the loss.
- Check with your financial institution to see if there is a procedure for clients to remove delisted and near worthless investments. Many financial institutions will purchase the security from the client for a nominal price (e.g. \$0.01) and charge a nominal fee with a view to having the sale net the client a zero balance proceeds. This allows the client to use the transaction slip from the sale for tax purposes.

It is important to understand the potential downside of utilizing this procedure: If the “worthless security” ever revives itself and becomes re-listed and tradeable, you would have given up all ownership rights by selling the shares to the financial institution.

Summary

If you hold shares in a company that has become worthless at the end of the year, you may wish to talk to your tax advisor about utilizing one of the methods mentioned to realize a capital loss to apply against capital gains in the current or other years



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