Docket: 2001-2751(IT)G

BETWEEN:

AILEEN ELLIOTT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on November 2, 2004 at Montreal, Quebec

Before: The Honourable Justice Gerald J. Rip

Appearances

Counsel for the Appellant:	Konstantinos Voggas
Counsel for the Respondent:	Alain Gareau

JUDGMENT

The appeal from the assessment made under the *Income Tax Act* for the 1998 taxation year is allowed, with costs, and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the appellant in computing her income for 1998 is entitled to deduct an allowable business investment loss equal to three-quarters of the amount she paid to the National Bank.

Signed at Ottawa, Canada, this 7th day of January 2005.

"Gerald J. Rip"

Gerald J. Rip

Citation: 2005TCC35
Date: 20050107
Docket: 2001-2751(IT)G

BETWEEN:

AILEEN ELLIOTT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

[1] Aileen Elliott appeals an income tax assessment for 1998 in which the Minister of National Revenue denied her an allowable business investment loss ("ABIL") within the meaning of section 38 and subsection 248(1) of the *Income Tax Act* ("*Act*").

[2] Ms. Elliott, a dental surgeon, is married to Donald Elliott. Donald Elliott and his brother Michael Elliott were the sole shareholders and directors of Michael & Donald Elliott Construction Limited ("Construction"). Construction was a small business corporation within the meaning of subsection 248(1) of the *Act* and carried on the business of general construction, mainly carpentry. As most small businesses, the corporation had good and not so good years. In January 1993 the brothers were working on a roof of a building. The scaffolding broke and both brothers were seriously injured and could not work. Donald Elliott recalled that Construction "burned up a lot of money that year".

[3] At the end of 1993, the corporation's credit was "maxed out", according to Donald Elliott, and the company was in bad shape. In 1993 Construction borrowed $20,000 from Ms. Elliott to pay bills and "keep things running".

[4] Construction obtained some contracts in 1994 but the profits were negligible. After the accident the bank ceased to be friendly, said Donald Elliott.

[5] In 1996 Ms. Elliott made two loans to Construction, one for $2,000 and another for $5,000. The company had a profit of $10,869 in 1996 but Donald Elliott commented that the company hired a "large crew" that year and, in retrospect, the company should have shut down in 1993.

[6] Ms. Elliott made six more loans to Construction in 1997, in May of $2,000, in June of $5,000, in November of $5,000 and $1,000, in December of $10,000. Construction repaid her $2,000 in July.

[7] Construction had a line of credit with the National Bank of Canada which was personally guaranteed by Ms. Elliott. An interest rate of approximately 12 per cent was being charged to Construction for the monies obtained on the line of credit. In order to reduce the interest rate Ms. Elliott paid off Construction's debt of $40,245.61 to the National Bank. This took place in November, 1997. Construction was not in default to the bank and the bank had not demanded that Ms. Elliott made good on her guarantee. Ms. Elliott obtained the funds to pay the bank by personally borrowing $40,000 from the Bank of Nova Scotia at an interest rate of between 5 to 6 per cent; the loan was secured by a hypothec on the family home owned by Ms. Elliott. Ms. Elliott paid the interest on the loan. Construction was to reimburse her for any interest she paid on the loan and to repay her the $40,000. Unfortunately, at the end of 1997 the company was "running out of money". By the end of 1997 the company was "cash poor", stated Mr. Elliott.

[8] Ms. Elliott agreed that she advanced money to Construction for it to stay in business. She corroborated her husband's evidences that Construction agreed to repay her for the money she advanced and to repay her for the money she borrowed from the Bank of Nova Scotia, plus the interest she paid on the loan. She paid the money so that her husband could make a living. She described her husband and brother-in-law as hard working people and she thought that they would get through the difficulty and pay her back.

[9] Mr. Elliott said that Construction paid no interest to Ms. Elliott and that she was not entitled to any interest on the money she advanced. There was, he declared, an understanding with his wife that if she had to borrow money to pay interest on money borrowed to advance to Construction, Construction would pay, or reimburse, her the interest she paid.

[10] Some of the funds advanced by Ms. Elliott to Construction came out of a joint bank account she had with her sister-in-law, Michael Elliott's wife. Donald and Michael also advanced money to Construction.

[11] In early 1998, the brothers met with Construction's accountant, Michel Roussin, and decided to close down the company. At the time the company owed $94,000 to Ms. Elliott. Ms. Elliott was not paid; the debt was bad.

[12] Mr. Roussin had prepared Construction's financial statements since 1978. The company's minute books were maintained, Mr. Elliott stated, until 1995 by D. Kisilenko, a lawyer in Pointe Claire, Quebec. Mr. Kisilenko sent the minute books to Construction for signature sometime in 1995 and then "disappeared".

[13] A note to Construction's unaudited balance sheet as at December 31, 1997 advises that "During the year ended December 31, 1997, 5,000 common shares were issued and fully paid in the amount of $50,000". Mr. Réjean Gauthier, Mr. Roussin's former partner, testified $25,000 was converted from loans to shares in each of 1996 and 1997. Apparently, according to Mr. Elliott, Mr. Roussin advised him that Ms. Elliott should be a shareholder. While Mr. Elliott could not speak to the truth of the financial statements, he did acknowledge that his wife was not a shareholder of Construction; the paperwork (i.e. the directors' resolution) was not completed until 2001 and no share certificate had been issued to her. Mr. Gauthier stated that he thought that he saw a subscription for shares by Ms. Elliott. Ms. Elliott testified that she never received a share certificate and did not consider herself a shareholder of Construction.

[14] According to Construction's balance sheet as at December 31, 1997, the corporation had a deficit of $165,036.

[15] I accept every word of the testimony of the Elliotts. They are good and honest people. Their evidence was a breath of fresh air in a dry, warm courtroom. Their answers to questions posed to them were clear and unambiguous. They told the truth even when the truth may have been contrary to Ms. Elliott’s interests in her appeal.

[16] Appellant's counsel submitted that his client advanced money to Construction, a small business corporation, over the years for the purpose of earning income and incurred a loss when Construction was unable to repay the loans; she was deemed to dispose of the debt in 1998 when it became a bad debt: paragraph 39(1)(*c*), subparagraph 40(2)(*g*)(ii) and paragraph 50(1)(*a*) of the *Act.*

[17] Counsel for the appellant agreed that between 1993 and 1998 Ms. Elliott financed activities of a family business operated through Construction of which her husband was a shareholder. She should be entitled to an ABIL arising from the deemed disposition of her loans to Construction regardless of whether she was technically a shareholder of the company. She had a beneficial interest in her spouse's shares of Construction and an indirect expectation to earn income. The only distinction between claiming an ABIL, he submitted, on the disposition of loans rather than on disposition of shares is that subparagraph 40(2)(*g*)(ii) of the *Act* must be satisfied in the case of an ABIL arising from a loan. He declared that the loans to Construction were made for the purpose of earning income and therefore satisfy the requirements of subparagraph 40(2)(*g*)(ii) of the *Act*.

[18] The lending of money by Ms. Elliott to Construction even without interest, counsel stated, resulted in the creation of a potential source of income for her in light of the attribution rules provided in the *Act* with respect to loans made directly or indirectly to, or for, the benefit of a spouse. The payment by the appellant to the National Bank to satisfy Construction's line of credit gave rise to an indebtedness bearing interest in favour of the appellant, by the operation of legal subrogation of rights.

[19] I cannot agree with appellant's counsel that the appellant had a beneficial interest in her husband's shares of Construction and an indirect expectation to earn income so that one could find that she advanced money to Construction so as to earn income. I have no doubt that Ms. Elliott did advance the funds to Construction

and paid the National Bank for the reason she said she did, for her husband to continue to make a living from Construction, that is, for the family to earn income. If Construction were successful it could pay salary and dividends to Mr. Elliott, not the appellant.

[20] Paragraph 39(1)(*c*) of the *Act* refers to a "taxpayer's business investment loss" and to a "debt owing to a taxpayer". Subsection 248(1) defines the word "taxpayer" to include "any person whether or not liable to pay tax". A family is not a taxpayer, although an individual member of a family is a taxpayer.

[21] Ms. Elliott's problem is not unusual, unfortunately. There are many people who lend money and guarantee loans to small businesses to corporations in which their spouses own shares but they do not. Many of these people are not sophisticated in tax matters. They do what they feel is important for the economic well-being of the family. They do not do consult lawyers or accountants who may advise how to structure the loan or guarantee so, if something goes wrong, then, for tax purposes, they could deduct at least a portion of the money they may lose. Many of these people and their spouses are hard-working people of modest means. They do what they think is right; they are optimistic. They do not foresee possible failure. When failure does come, they lose everything. On the other hand, a more sophisticated person may impose a rate of interest on the loan to the spouse's corporation or acquire shares in that company and in the case of a loan guarantee, charge the corporation for the guarantee. In the latter cases, if the loan goes bad or the person must honour the guarantee, because income was a consideration for the loan or guarantee, the person would be eligible to deduct a portion of the amount lost as an ABIL. Our senior courts have told us there is no equity in a taxing statute and as the *Act* is written, there is not much I can do to help Ms. Elliott. Parliament may well wish to consider the unique situation of family controlled small business corporations and the possibility of permitting family members to deduct a portion of the amount of loans and guarantees made by a shareholder's spouse for the benefit of such a corporation when the loans go bad or guarantees are exercised. As the law now stands, such taxpayers are not even entitled to claim a capital loss on such misadventure.

[22] The loans made by Ms. Elliott to Construction were not made by her for purpose of earning income for herself as a taxpayer. Her counsel's submission that

she was the beneficial owner of her husband's shares of Construction is not tenable on the evidence. The facts in *Buhler v. The Queen*[1] bear no resemblance to those at bar and are of no assistance to the appellant.

[23] On the other hand, when Ms. Elliott voluntarily paid $40,000 to the National Bank to satisfy Construction's debt from its line of credit, Ms. Elliott became legally subrogated in the rights of the bank. As such, Ms. Elliott obtained recourse against Construction of the amount she paid to the bank, plus interest. Article 2346 of the Civil Code of Québec reads as follows:

2356. A surety who has bound himself with the consent of the debtor may claim from him what he has paid in capital, interest and costs, in addition to damages for any injury he has suffered by reason of the suretyship; he may also charge interest on any sum he has had to pay to the creditor, even if the principal debt was not producing interest.

A surety who has bound himself without the consent of the debtor may only recover from him what the debtor would have been bound to pay, including damages, if there had been no suretyship; however, costs subsequent to indication of the payment are payable by the debtor.

2356. La caution qui s'est obligée avec le consentement du débiteur peut lui réclamer ce qu'elle a payé en capital, intérêts et frais, outre les dommages-intérêts pour la réparation de tout préjudice qu'elle a subi en raison du cautionnement; elle peut aussi exiger des intérêts sur toute somme qu'elle a dû verser au créancier, même si la dette principale ne produisait pas d'intérêts.

Celle qui s'est obligée sans le consentement du débiteur ne peut recouvrer de ce dernier que ce qu'il aurait été tenu de payer, y compris les dommages-intérêts, si le cautionnement n'avait pas eu lieu, sauf les frais subséquents à la dénonciation du paiement, lesquels sont à la charge du débiteur.

[24] In the case at bar, while there is no evidence one way or the other, because Ms. Elliott and Construction do not deal at arm's length, I infer that Construction had consented to the guarantee. Indeed, without the guarantee, it is doubtful that the bank would have given Construction a line of credit.

[25] Respondent does not dispute that Ms. Elliott was subrogated in the rights of the bank. Respondent's counsel simply submits that in order to give rise to an ABIL the guarantee given or the payment made under the guarantee must have been made for the purpose of gaining income.

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1 2003 TCC 234.

[26] The evidence is clear: the guarantee itself was not made for the purpose of gaining income. However, when Ms. Elliott paid the money to the National Bank, she stood in the shoes of the bank who did advance the money for the purpose of earning income and she was entitled to interest from Construction on the same terms as the bank.

[27] In income tax, persons often become liable for tax as a result of a transaction or legal result that they did not intend. For example, what a person intends to be a capital transaction may turn out to be a transaction on income account, or what a person intends to be a tax free event is held to be a taxable event. While Ms. Elliott's purpose in paying off the bank was not to earn income - she may not have even been aware of her rights to be subrogated in the rights of the bank - the result of paying the bank entitled her to claim interest from the bank's debtor, Construction. The purpose of the loan she inherited from the bank was for an income earning purpose. When Ms. Elliott took over the bank's loan to Construction, she was entitled to claim interest; she became a creditor of a potential income-producing loan. Had Construction paid her interest on the subrogated loan amount, the interest would be included in her income; once the loan became bad in 1998, she incurred a capital loss that is a business investment loss, and she ought to be entitled to claim an ABIL on the amount she paid to the National Bank.

[28] The appeal is therefore allowed to permit the appellant to deduct in computing income for 1998 an allowable business investment loss equal to three-quarters of the amount she paid to the National Bank. The appellant is entitled to costs.

Signed at Ottawa, Canada, this 7th day of January 2005.

"Gerald J. Rip"

Gerald J. Rip

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APPEARANCES:

Counsel for the Appellant:	Konstantinos Voggas
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