Repayment of a Bad Debt

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Barrington Lane Developments Limited (2010 TCC 388) involved the recovery of a previously written-off debt. The issue was whether the recovery gave rise to a capital gain or an income inclusion pursuant to paragraph 12(1)(i).

The taxpayer was in the real estate development business. Between 1996 and 1998, it advanced funds to a related corporation to assist in the construction of a mall. In 1998, the taxpayer, on the advice of its accountants and lawyers, determined that the borrower would not be able to repay the loan. The loan was written off, and a capital loss was claimed on the relevant schedule to the tax return. Presumably an election pursuant to subsection 50(1) was made, so that the taxpayer was deemed to dispose of the debt for proceeds equal to nil and to have reacquired it at the same cost. However, the loss had also been recorded as a bad debt expense on the financial statements. There was no form T2S1 adjustment to add back the bad debt in the computation of income for tax purposes. As a result, the taxpayer claimed both a capital loss and a bad debt expense (or income loss) for the same debt in its 1998 tax return. Notwithstanding the double deduction, the CRA assessed the 1998 return as filed.

In 2004, the loan was repaid, and the taxpayer reported the repayment as a capital gain pursuant to subsection 40(1). The CRA reassessed to include the full amount of the repayment in income on the basis of paragraph 12(1)(i) as a recovery of a debt for which a bad debt deduction had previously been claimed.

The Tax Court accepted that the double deduction in the taxpayer's 1998 tax return was an unintentional error. The CRA apparently agreed, because there was no suggestion of any penalty assessment. There was also no suggestion that the CRA thought that the normal reassessment period for the taxpayer's 1998 taxation year might be extended pursuant to subparagraph 152(4)(a)(i) or, specifically, that the double deduction was a misrepresentation attributable to neglect or carelessness. Rather, the case proceeded on the basis that the taxpayer's 1998 taxation year was statute-barred.

The taxpayer argued that because it was not in the business of lending money, the loan in question was on capital account. It argued that its 1998 loss was properly a capital loss and the subsequent recovery should also be on capital account. Curiously, the CRA acknowledged that the 1998 loss should have been a capital loss. However, the CRA took the position that paragraph 12(1)(i) applied in 2004 to treat the repayment as a recovery on income account because the taxpayer had claimed the loss as a bad debt expense in its 1998 return. This position seems to derive from a strict reading of paragraph 12(1)(i), which provides that an amount received in the year on account of a debt "in respect of which a deduction for bad debts . . . was made in computing the taxpayer's income for a preceding taxation year" is to be included in computing the taxpayer's income from a business or property. At first blush, it might appear that because a deduction for a bad debt was made in a preceding taxation year, the amount received by Barrington Lane in its 2004 taxation year should be fully included in computing its income from a business or property. However, the court did not adopt this approach.

The court noted that the minister was obliged to assess the taxpayer's 2004 taxation year--and each year--on the basis of the law. The proper starting point was to determine the character of the loan: was it capital or was it income from business or property? An error in assessment made in a previous year could not, in and of itself, change the character of the property or its tax treatment in a subsequent taxation year. Accordingly, the fact that a bad debt expense had been erroneously claimed and assessed as such in the taxpayer's 1998 taxation year did not recharacterize the income as income from business when the taxpayer was not in the business of moneylending. The court found that the loan in question was capital in nature, as the CRA had acknowledged. As a result, subsection 40(1) applied on the repayment, and the taxpayer realized a capital gain.

Barrington Lane shows that the tax consequences of a particular action in a particular taxation year are to be assessed on the basis of the application of the Act in that year, notwithstanding that the action might be

consequential on an event in a previous statute-barred taxation year. While this might be considered trite law, the case is a reminder that a past year's assessment should not guarantee the assessment's carryforward to a subsequent year. This means that a past year's error in assessment should not be perpetuated by the CRA on the basis of consistency (see *Trom Electric Co.*, 2004 TCC 727, and *170635 Canada Ltée.*, 93 DTC 1120 (TCC), both of which were cited in *Barrington Lane*). Therefore, the assessment of the bad debt deduction in Barrington Lane's 1998 taxation year, although an error on the CRA's part, did not mean that the recovery of the debt should automatically be treated as income from business. This point is conceptually similar to the utilization of tax accounts from prior years where the validity of such accounts is assessed in the taxation year in which the taxpayer seeks to benefit from them. Examples include loss carryforwards (*New St. James*, [1966] Ex. CR 977); investment tax credit carryforwards (*Papiers Cascades Cabanco Inc.*, 2006 FCA 419); capital dividend accounts (CRA document no. 9600625, January 19, 1996); and refundable dividend tax on hand (CRA document no. 2002-0157005, October 11, 2002).