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Marmer Penner Newsletter

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CAPITAL LOSSES AND THE CHILD SUPPORT GUIDELINES

Canada's income tax system has limited equity built into its loss carry forward and loss carry back mechanism. If a taxpayer realizes a capital gain in 1999, the taxable portion is included in the taxpayer's income and income tax is paid on this amount. If the same taxpayer realizes a capital loss of the same magnitude in 2000, the taxpayer has the option to apply the 2000 loss against the 1999 gain. As a result, the taxpayer is permitted to re-file the 1999 return and recover the income taxes paid on the capital gain. This makes economic sense since overall the taxpayer has just broken even. Accordingly, no income tax should have been paid.

The limitation in the carry forward-carry back mechanism is that losses may be carried back only three years. So if the same situation occurs with a gain in 1997 and an equal but offsetting loss in 2001, no carry back would be allowed and the taxpayer is left hoping that there will arise one day sufficient capital gains against which to apply the unused 2001 losses. While this apparent inequity exists in the *Income Tax Act*, we can only hope that the *Child Support Guidelines* ("the *Guidelines*") do not exacerbate this situation.

Let's consider the plight of Pat, the non-custodial parent. Pat earns $100,000 in employment income each year from 1997 to 2001. In addition, Pat realized a capital gain of $25,000 in 1997. Pat held on to these investment proceeds until the decision was made in 2000 to buy $25,000 in Nortel call options. Not surprisingly, the options expired unused in 2001 and Pat realized a $25,000 capital loss. Pat was upset to learn that the $25,000 loss could not be applied against the gain in 1997. Pat was further upset to learn that the Guidelines do not specifically state that capital losses are deducted from line 150 income to determine a payer's income.

Both the non-taxable and the taxable portion of Pat's 1997 capital gain was included in

Pat's income and *Guidelines* support was determined on that amount. Would it be equitable not to give Pat a break on support payments when a capital loss is realized?

According to Schedule III of the *Guidelines*, line 150 income is adjusted for items including "replace taxable capital gains . . . by the actual amount of capital gains . . . in excess of . . . actual capital losses". Some have interpreted this to mean that net taxable capital gains are adjusted upward but in the year of net capital losses, the amount is left at nil as the schedule only refers to adjusting gains. As this appears inequitable, there are two possible approaches which would allow the actual losses to reduce income:

(a) a capital loss is a negative capital gain – following the formula but insert a negative number thereby adding negative income to lower *Guidelines* income;

(b) refer to paragraph 17(2) of the *Guidelines* – non-recurring losses including capital losses may be ignored if the courts determine it would be appropriate to do so. This appears to imply that in the absence of any "appropriateness" actual capital losses may be considered in the calculation of *Guidelines* income.

With reference to (b) it may be that the intention of 17(2) was to allow the courts to ignore discretionary capital and non-capital losses created by the purchase of tax shelters or the use of hedging or straddle transactions.

We will look to the courts or our readers for guidance.