MINDEN GROSS LLP
BARRISTERS & SOLICITORS
145 KING STREET WEST, SUITE 2200
TORONTO, ON, CANADA M5H 4G2
Tel 416.362.3711 Fax 416.864.9223
www.mindengross.com

Effect of a BIA Proposal on ABIL Claim

Joan Jung
Partner, Minden Gross LLP
Tel. 416.369.4306
jjung@mindengross.com

July 2015

Two recent Tax Court of Canada cases dealt with ABIL timing issues where a proposal is made under the *Bankruptcy and Insolvency Act*. Both *Gaumond v. The Queen* (2014 TCC 339) and *St.-Hilaire v. The Queen* (2014 TCC 336) were decisions under the informal procedure. While such cases technically have limited precedential value, they are informative and raise ABIL planning issues.

In *Gaumond*, the taxpayer was the principal shareholder of a CCPC who had advanced over $300,000 to the corporation over a number of years. In May 2011, the corporation made a proposal under the BIA and at the time of the proposal, the taxpayer's aggregate advances represented 40% of the total unsecured claims of the corporation. The taxpayer forgave his debt at the request of other creditors who then voted in favour of the proposal in August 2011. The taxpayer claimed an ABIL in his 2011 return on the basis that his forgiveness of the debt in the proposal process was a disposition. While other commentators have noted the court's reasoning that the forgiveness was not a disposition "to" the corporation (in the absence of a rule analogous to subsection 84(9)), little note has been made of the fact that the court also held that subsection 50(1) could not apply because the debt was no longer owing to the taxpayer at year end. The taxpayer had waived his debt prior to year end. Paragraph 50(1)(a) clearly refers to a debt owing to a taxpayer at the end of the year which is established to have become a bad debt in the year.

In *St.-Hilaire*, the taxpayer was the sole shareholder of a CCPC who had made advances in excess of $250,000 over a number a years. In August 2008, the corporation made a proposal under the BIA that was accepted by the required majority of creditors. However, the taxpayer waived any dividends as an unsecured creditor with regard to his advances and the debt was written off under the terms of the proposal. The court held that there was no debt owing to the taxpayer at year end. Thus, section 50 could not apply and the taxpayer was not entitled to an ABIL.

It is instructive to review the proposal process and consequences of same from the owner-manager's perspective.

Under the BIA, a proposal is defined to include a proposal for a "composition". For this purpose, "composition" has been held to mean an agreement between debtor and creditor(s) whereby the creditor(s) agree to accept a lesser sum than is owing to him in full satisfaction of their claims while the debtor keeps control of his assets (see Houlden and Morawetz, *Bankruptcy and Insolvency Law of Canada* (4th ed.) at paragraph E.1). It has been said that "a proposal is in reality only a contract between the parties" ([*Mutual Trust Co. v. Scott, Pichelli & Graci Ltd.*, 1999 CarswellOnt 2190 at paragraph 18). The proposal amends the terms of the agreement between the debtor and affected creditors. As a proposal will typically provide that the amount paid shall constitute full, final and absolute settlement of the rights of the claims affected, it is clear that payment of less than the full amount owing to an affected creditor results in the extinguishment of such portion. Presumably the owner-manager of an insolvent business hopes that given the compromise of debts as a result of the proposal, the business will become viable.

The BIA imposes strict voting requirements for creditor acceptance. All unsecured creditors with proven claims are entitled to vote on the proposal. Those secured creditors in respect of whose secured claims the proposal was made may vote. The proposal is deemed to be accepted by the creditors if all classes of unsecured creditors vote for the acceptance by a majority in number and two-thirds in value of the unsecured creditors present in person or by proxy and voting on the resolution. The statute expressly prohibits a creditor who is related to the debtor from voting in favour of the proposal. Following creditor acceptance of the proposal, approval of the court is required. The court has discretion to approve or refuse to approve a proposal but once the proposal is approved by the court, the BIA declares it to be binding on all affected creditors. In the above cases, the particular taxpayer (as the sole or principal shareholder) could not vote for the proposal; rather, acceptance by other creditors (in the necessary majority) was required. But once the proposal was approved by the court, the proposal was also binding on the taxpayer.

As the owner-manager may well be a large unsecured creditor, the proportionate dividend which would be paid to him/her as unsecured creditor if a proposal is accepted would make the terms of the proposal unattractive to other unsecured creditors whose vote is required. This was likely the concern in the above cases. Rather than participating in the proposal as in *Gaumond* and *St.-Hilaire*, the owner-manager or other related unsecured creditors could postpone or subordinate their claims. This means that the owner-manager or such other creditors will not share in the dividend and therefore, the amount available to other creditors under the proposal is not affected by what may be a large debt to the owner-manager. Subordination or postponement is distinct from a forgiveness or waiver.

From a timing perspective, this means that the approval and completion of the proposal would not, in and of itself, constitute a triggering event with respect to the owner-manager's possible ABIL. Rather, as the debt would continue, the possibility of such a claim would be deferred until a later year. In such later year, the taxpayer would have to establish that a debt owing to him at the end of the year became a bad debt in the year or dispose of the debt and otherwise satisfy the statutory criteria for an ABIL

* First published by the Canadian Tax Foundation in 2015 Vol. 15, no. 3 *Tax for the Owner-Manager.*