

**PERSONAL GUARANTEES**  
- and -  
**DEDUCTIBILITY OF**  
**CAPITAL LOSSES**

**Overview**

Taxpayers who are shareholders in a Canadian corporation may be unaware of the opportunity of deducting a capital loss arising from personally guaranteeing loans of a corporation. Have you properly structured your affairs so as to effectively use pretax money versus after-tax money to pay a personal guarantee? The answer depends on whether or not the payment under your personal guarantee will be considered a capital loss for income tax purposes.

***Revenue Canada's Position***

Revenue Canada's general position regarding the deductibility of a capital loss is that if a taxpayer who, as a shareholder of a Canadian corporation, guarantees a debt of the corporation, is subsequently required to make payment under the guarantee, the payment will be considered a deductible capital loss under the Income Tax Act (Canada) (the "Act") so long as the guarantee was given for adequate consideration. The key issue in determining whether or not a deductible capital loss is available to the taxpayer is the adequacy of the consideration for the guarantee. For instance, a taxpayer who has received an option to acquire shares of the corporation at a price below fair market value as compensation for a loan he has guaranteed has received adequate consideration for his guarantee. If the corporation of which the taxpayer is a shareholder pays the taxpayer a sufficient sum of money as consideration for a loan he has guaranteed, then the taxpayer has received adequate consideration for the guarantee.

Each circumstance must be analyzed on its own facts to determine what amount of payment/consideration should be sufficient.

***Exception to Revenue's Canada Position***

Notwithstanding the requirement for adequate consideration in the scenario described above, a deductible capital loss may also be available in the circumstance where the taxpayer can show certain criteria as having been met. Despite the absence of adequate consideration, Revenue Canada will allow a deductible capital loss if all of the conditions described below are satisfied:

1. The corporation whose debts are guaranteed used the borrowed funds in order to produce income from a business or property;
2. The corporation made every effort to borrow the necessary funds through the usual commercial money markets but could not obtain financing without the guarantee of the shareholder at interest rates at which the shareholder could borrow; and

3. The corporation has since the date of the guarantee ceased to permanently carry on its business.

Revenue Canada's position regarding the third condition, whether or not the corporation has ceased permanently to carry on its business, requires the taxpayer to establish that for all intents and purposes there is no possibility that any business operations will be revived by the corporation. For example, this would be the case where the corporation was without assets capable of being used in an income-generating process, was in receivership, in bankruptcy or subject to similar judicial proceedings.

### ***Conclusion***

Traditional means of financing often require the giving of personal guarantees. The ultimate cost of such guarantees may depend upon how the transaction is structured. Please speak with us if you have any concerns as to the deductibility of any capital losses that you may have incurred in the past as a guarantor of a company's loans or if you have questions or concerns regarding how to structure an existing or contemplated personal guarantee.

**For more information, please contact:**

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