INTEREST DEDUCTIBILITY

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GENERAL PRINCIPLES

Corporations can be financed through both debt or equity share capital. The return to an equity investor is dividends. The return on debt is interest.

For tax purposes, the general principle is that dividends are not deductible by the payer and are received "tax free" by a Canadian corporate shareholder. Canadian shareholders who are individuals also receive beneficial treatment of dividends through the "gross up and credit" mechanism in the *Income Tax Act*. In the case of interest, the general principle is that interest is deductible by the payer and included in income of the recipient.

Needless to say, there are exceptions to these rules. There are complex provisions in the Act dealing with the taxation of dividends, including provisions limiting the tax-free nature of dividends and special taxes on either the payer or the recipient of a dividend. The issues relating to the deductibility of interest are not due to the complexity of the provisions of the Act, but arise out of the peculiar language of paragraph 20(1)(c) and the case law that has interpreted it.

The basic provision for the deductibility of interest has not changed for 50 years. Paragraph 20(1)(c) provides that the following amounts of interest are deductible:

> an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on
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> (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),
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> (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),
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> (iii) …
>
> (iv) …
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> or a reasonable amount in respect thereof, whichever is the lesser.

On October 31, 2003, the Department of Finance released draft legislation to deal with interest deductibility issues arising as a result of recent decisions of the Supreme Court of Canada. This proposed amendment will not affect paragraph 20(1)(c) itself, but would add a new rule which would deny the deductibility of losses from the deduction of interest and other expenses in some cases, where there is no reasonable expectation of profit.

WHY IS PARAGRAPH 20(1)(c) NECESSARY?

The reason why paragraph 20(1)(c) is necessary is because, according to the Supreme Court of Canada,[1] interest is usually a payment "on account of capital" deductibility of which is denied under paragraph 18(1)(b) of the Act, which provides that, except as otherwise provided in the Act, no deduction is permitted in respect of "a payment on account of capital." In *Gifford v. The Queen*, 2004 DTC, the Supreme Court of Canada said that the test for determining whether interest is on account of capital is based on what the proceeds of the loan are to the borrower, not what the borrowed money is spent on. If the proceeds of a loan are inventory to the borrower, such as in the case of a money lender (i.e., where the borrowing is part of the day to day business) then interest expense would be deductible.[2] In other cases where borrowed money is not inventory to the borrower, it will usually be a capital expense.[3]

In *The Queen v. Phyllis Barbara Bronfman Trust*, 87 DTC 5059, Chief Justice Dickson said that the purpose of subparagraph 20(1)(c)(i) is "to encourage the accumulation of capital which would produce taxable income." This statement has been referred to without question in numerous later decisions of the Federal Court of Appeal and the Supreme Court of Canada. It is questionable whether this is the purpose of the provision. Subparagraph 20(1)(c)(i) provides that interest is deductible only if the borrowed money is used for the purpose of earning income. Thus interest is not deductible if the borrowed money is used for the purpose of making a capital gain. In this respect, subparagraph 20(1)(c)(i) does no encourage the accumulation of capital gains. It would seem that, in fact, the provision encourages the accumulation of income.

The treatment of interest is different from similar business expenses, such as rent. In *Ikea Limited v. The Queen*, 98 DTC 6092, the Supreme Court of Canada said that "the payment of rent is most obviously an expense on revenue account, as it is incurred for the purpose of producing income and does not result in the acquisition of any capital asset." This was notwithstanding that, earlier in the reasons, the same Court acknowledged that the lease of premises was a capital asset to the lessee. One could argue that interest should be deductible on the same basis as rent. The difference, however, seems to be that, in the cases on interest deductibility, the courts seem to have interpreted the word "capital" to mean "borrowed capital" – similar to the meaning of "share capital"[4] – whereas the other cases on paragraph 18(1)(b) distinguish between a "current" and "capital" expenditure and an expense on "capital" or "revenue" account.[5]

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[1] See, for example, *Canada Safeway Ltd. v. M.N.R.*, 57 D.T.C. 1239

[2] The *Gifford* case is of limited utility to a regular taxpayer who is not in the money lending business and is consistent with the administrative practice of the CRA.

[3] In CCLI (1994) Inc. v. The Queen, 2007 DTC 5372, the Federal Court of Appeal said that the exception for moneylenders did not apply to a leasing company.

[4] It is perhaps worth noting that the earlier version of the Act referred to interest on "borrowed capital" – see Minister of *National Revenue v. T.E. McCool Ltd.*, 49 DTC 700

[5] See, for example, *Johns-Manville Canada Inc. v. The Queen*, 85 DTC 5673 (Supreme Court of Canada)

THE CURRENT STATUS OF INTEREST DEDUCTIBILITY[6]

On October 31, 2003, CRA[7] issued Interpretation Bulletin IT-533 ("Interest Deductibility and Related Issues) to provide a comprehensive restatement of its views. A number of these matters are discussed below.[8]

Meaning of "Interest"

Paragraph 20(1)(c) refers to "interest". This term is not defined in the Act, but has been dealt with in numerous non-tax cases. IT-533 states that, in CRA's view, in order for a payment to qualify as "interest", it must have three characteristics:

1. calculated on a day to day basis
2. calculated on a principal sum or a right to a principal sum, and
3. compensation for the use of the principal sum or the right to the principal sum.

There are two main areas where this definition raises concerns. One is participating interest. The other is discounts.

Participating Interest

In the case of participating interest, CRA has taken the position that, where payments of "interest" are determined solely by reference to cashflow, or revenue or profit, the payments are not deductible as interest because they are not "referable to a principal amount."

In *The Queen v. Sherway Centre Limited*, 98 D.T.C. 6121, however, the Federal Court of Appeal held that it was not an essential characteristic of interest that it be calculated as a percentage of a principal sum. CRA did not appeal the *Sherway Centre* case. IT-533 states that the principle in that case applies only in the limited circumstances where the interest is limited to a stated percentage of principal which reflects prevailing arm's length rates or the facts show that the payments are intended to increase the rate to prevailing market rates. As well, the facts cannot indicate the presence of an equity investment. The legal basis for these requirements is questionable.

Debt Issued at a Discount

Another area of controversy is the taxation of discounts on the issuance of debt. An example of this is commercial paper. This is a common form of short term borrowing whereby a corporation

[6] This paper does not deal with the various provisions of the Act which limit interest deductibility in specific circumstances. See s. 20(1)(c) – exempt income and life insurance; 18(2) – debt relating to the acquisition of land; 18(3.1) – costs relating to the construction of a building or ownership of land; 18(4) – thin capitalization; 18(9) – prepaid expenses; 18(11) – contributions to statutory plans; 18.2 – double dip income [to be repealed]; 20.3 – weak currency debt.
[7] In this paper, "CRA" refers to the Canada Revenue Agency and its predecessors, including the Canada Customs and Revenue Agency, and Revenue Canada.
[8] See also, Paul Tamaki: "Interest Deductibility", *Proceedings of the 5th Annual Conference of the Canadian Tax Foundation* (Toronto: Canadian Tax Foundation, 2004).

raises money on the capital markets by issuing $100 face amount of debt for, say, $99 – i.e., at a discount of $1.00. Often the debt does not have a stated rate of interest, so that the return to the investor is the $1.00 profit on maturity of the debt.

In the past, CRA regarded the discount as interest for the purposes of paragraph 20(1)(c), but the legal basis for this conclusion was not clear because a discount does not accrue from day to day.[9] In IT-533, CRA reversed its administrative position and said that a discount is not legally interest, but they also pointed out that subsection 16(1) of the Act may apply. Subsection 16(1) provides as follows:

> 16. (1) Income and capital combined — Where, under a contract or other arrangement, an amount can reasonably be regarded as being in part interest or other amount of an income nature and in part an amount of a capital nature, the following rules apply:
> (a) the part of the amount that can reasonably be regarded as interest shall, irrespective of when the contract or arrangement was made or the form or legal effect thereof, be deemed to be interest on a debt obligation held by the person to whom the amount is paid or payable; and
> (b) the part of the amount that can reasonably be regarded as an amount of an income nature, other than interest, shall, irrespective of when the contract or arrangement was made or the form or legal effect thereof, be included in the income of the taxpayer to whom the amount is paid or payable for the taxation year in which the amount was received or became due to the extent it has not otherwise been included in the taxpayer's income.

In the bulletin, CRA stated that, where a corporation raises capital by issuing commercial paper at a discount with no interest stipulated to be payable, the discount will be deemed to be interest by virtue of this provision.

"Legal Obligation"

Paragraph 20(1)(c) refers to a *legal obligation* to pay interest. This has created issues when the taxpayer borrows under non-recourse debt.

IT-533 confirms that the limited recourse nature of a debt does not, in and of itself, negate a legal obligation to pay. In *Collins v. The Queen*, 2010 DTC 5028 the Federal Court of Appeal said: "Even if it is absolutely certain that the value of the property will not cover the mortgage debt, the full amount of the debt remains a legal obligation of the borrower unless and until the mortgaged property is sold."

However, in *Barbican Property Inc. v. The Queen*, 97 D.T.C. 5008, the taxpayer borrowed money under a loan which provided that, if net operating revenue from properties purchased with the borrowed money was not enough to cover interest payable in a year, payment of interest would be deferred by the taxpayer. This was interpreted by the Tax Court as meaning that there was no legal obligation to pay interest unless or until net cash flow exceeded interest payable or there was sufficient capital appreciation in the underlying property. For that reason, the Tax Court said

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[9] See Edgar, "The Concept of Interest Under the Income Tax Act," 96 *Canadian Tax Journal* (Toronto: Canadian Tax Foundation, 1996) pp. 321 – 3.

deferred interest was not deductible because the lender could not enforce payment (97 D.T.C. 122). This view was confirmed by the Federal Court of Appeal.[10]

CRA has recently issued a technical interpretation that interest on borrowed money is not deductible where a corporation is under the protection of a stay of proceedings under the federal *Corporation's Creditors Arrangement Act*, because there is no legal obligation to pay interest during the stay order period.[11]

Payable "In Respect of the Year"

Paragraph 20(1)(c) refers to interest paid in the year or payable in respect of the year, depending on the method regularly followed by the taxpayer in computing the taxpayer's income.

In *Crown Forest Industries Limited v. The Queen*[12] it was held that any taxpayer could choose to deduct interest on either a cash or accrual (payable) basis, so long as the method is consistently followed. This is notwithstanding that generally accepted accounting principles would require the taxpayer to account for the expense on an accrual basis.[13]

The reference to interest payable "in respect of" the year creates difficulties for accrual-basis taxpayers where interest becomes payable in a year, but in respect of the use of the money in a previous year.

In *M.N.R. v. Mid-West Abrasive Company of Canada Limited*, 73 D.T.C. 5429 (Federal Court – Trial Division), the taxpayer borrowed money from its US parent. The promissory note for the debt provided: "Interest will be paid if requested, but not in excess of 6%." In 1967, the taxpayer was requested to pay (and paid) interest for the current and prior years. It was held the interest in respect of the prior years was not deductible in 1967 because the words "payable in respect of the year" refer to the years during which the borrowed money was used and accrued. Accordingly, the interest could only be deductible in those years – not the year in which the request was made.

In *Redclay Holdings Limited v. The Queen*, 96 D.T.C. 1207 (Tax Court of Canada), the terms of the taxpayer's debt provided that the lenders were entitled to payment to the extent of 50% of available cash flow. It was held that interest was not deductible in the years during which there was insufficient cash flow to support it because the amount of interest was unascertained and therefore not "payable" in those years.[14]

[10] The taxpayer was denied leave to appeal this case to the Supreme Court of Canada. In *Barbican*, it was also held that deductibility of interest was also denied by paragraph 18(1)(e). See also *Hill*, 2002 DTC 1749.
[11] CRA document 2008-0304841I7
[12] 2006 DTC 2321 (Tax Court of Canada)
[13] Overruling *The Queen v. Terra Mining & Exploration Limited (NPL)*, 84 D.T.C. 6185 (Federal Court-Trial Division).
[14] See also *Barbican Properties Inc.*, discussed above. See CRA Document 9729670 (December 9, 1997).

"Borrowed Money"
"Amount Payable for Property"

Subparagraph 20(1)(c)(i) refers to interest on borrowed money. Subparagraph 20(1)(c)(ii) refers to interest on amounts payable for property. In other circumstances, interest is seemingly not deductible under paragraph 20(1)(c).[15]

For example, in *Parthenon Investments Limited v. M.N.R.*, 97 D.T.C. 5343 (FCA), a subsidiary corporation declared a dividend payable to its parent. The subsidiary then paid the dividend by delivering an interest-bearing promissory note to the parent. It was held that interest on this note was not deductible, since, although the note represented a debtor-creditor relationship, there was no borrower-lender relationship and no "borrowed money".

Another situation where this issue arises is in respect of the assumption of debt. Where a taxpayer purchases a property and assumes an interest-bearing debt as part of the consideration, IT-533 confirms that interest is deductible, on the basis that the interest is on an amount payable for property acquired. This is not the case, however, in the following situation:

1. Aco borrows money from a third party and reloans it to Bco.

2. Bco assumes the third party debt in satisfaction of Bco's indebtedness to Aco.

In this case, interest on the assumed third party debt is not deductible by Bco, since, from Bco's point of view, the third party debt is neither "borrowed money" nor "an amount payable for property acquired."[16]

It appears that CRA does not always strictly apply this requirement. In 2007 CRA issued a ruling which confirmed that interest was deductible where a corporation subscribed for units of a trust and paid the subscription price by assuming the trust's third party debt. In that case, there was no borrowed money although the assumed debt was arguably an amount payable for the fund units.[17]

Lender/Borrower Relationship

Another aspect of the requirement for the existence of borrowed money is that, in CRA's view, this requires a "lender–borrower" relationship. The implication seems to be that there must be an obligation to repay. In this connection, the CRA considered a debt instrument which the borrower could mandatorily convert into preferred shares of the borrower. In their view, this requires that the lender must be able, at some given time, to enforce payment of the amount advanced, either by receiving cash or property having an equal value. The mandatory conversion feature negated

[15] The *Gifford* case supports the deductibility of interest charges on unpaid deductible expenses, such as service fees (see para. 36 of IT-533) or certain fines of penalties (see CRA document 2005-011972 (May 10, 2005)). S. 20(1)(d) deals with deductibility of compound interest (interest on unpaid interest). This suggests that compound interest would not otherwise be deductible.
[16] See CRA documents 2000-0000205 (February 23, 2000), 2004-0098141I7 (January 14, 2005).
[17] CRA Document No. 2007-0245281R3.

the existence of "borrowed money" because the instrument could be repaid with shares, cash or other property having a fair market value less than the amounts advanced under the instrument.[18]

"Use"

Paragraph 20(1)(c) refers to interest on borrowed money *used* for the purpose of earning income from a business or property. In *Bronfman Trust*, the Supreme Court of Canada held that, in order for interest to be deductible, the taxpayer has the onus of tracing the borrowed money to an income producing use. For this purpose, "use" means current use. When borrowed money is used to acquire property or for use in a business and the property or business is sold, the proceeds of sale must be spent on a new income-producing use in order to preserve interest deductibility on the borrowed money. In other words, the current use of the borrowed money must be traced to an eligible income producing use.

Cash Damming

IT-533 confirms that one way to satisfy the tracing requirement is through the technique of cash damming. The basic idea of cash damming is to establish two bank accounts so that cash derived from borrowed money can be applied to an eligible income producing use and "clean" or non-borrowed money can be accumulated (or cash dammed) to be used for ineligible purposes which do not support interest deductibility.

Tracing vs Linking

In *Ludco Enterprises v. The Queen*, 2001 DTC 5505 (Supreme Court of Canada), the principal issue was the meaning of "purpose" in paragraph 20(1)(c), but there was a subsidiary issue related to tracing. In *Ludco*, the taxpayer used borrowed money to purchase shares of offshore corporations. Subsequently, it transferred the shares to a wholly-owned subsidiary, in consideration of both interest-earning and non-interest earning assets. The amount of the income-earning assets exceeded the outstanding amount of the taxpayer's borrowed money, but it was apparently no longer possible to trace the borrowed money directly to the income-earning assets.

On this issue, Iacobucci, J. referred to the following quotation from *Tennant*:

> As long as the taxpayer establishes a link between the current shares, the proceeds of disposition of the original shares, and the money that was borrowed to acquire the original eligible use property, it is in keeping with the interest-deduction provision to permit the taxpayer to continue to deduct the interest payments for the full amount of the original loan, regardless of the value or costs of the newly acquired shares.

Based on the above, Iacobucci, J. concluded that the taxpayer in *Ludco* had to establish a "link" between the current eligible use property, the proceeds of the old eligible use property and the borrowed money. He then said:

> However, nowhere in *Tennant*, *supra*, did the Court require a strict interpretation of tracing for the continuing entitlement to deduct interest after a roll-over transaction. Instead, as noted above, the

[18] CRA Document No. 9924775 (October 5, 1999). But see, CRA document 2006-017143R3 (2006) and 2005-0152441R3 (2005).

> Court spoke in broader terms, referring to the need to "establish a link" between the original and current eligible use property. Based on this more flexible approach, I conclude that, although the shares in the companies were commingled with other assets and disposed of as part of a group of assets, for the purpose of the interest deductibility provision, the shares in the Companies can be traced to any specific assets received by *Ludco* as a result of the roll-over. In this case, the taxpayer can trace the shares in the Companies to income-producing assets. Therefore, the appellant has established the required link.

In Iacobucci, J.'s view, therefore, the concept of "linking" is more flexible than "tracing". Illustrations of the application of the principle are set out in IT-533.

In *Palmer-McLellan (United) Ltd. v. M.N.R.*, 68 D.T.C. 5304, the Exchequer Court of Canada held that, where a corporation borrowed money to acquire shares of an acquired corporation and subsequently amalgamated with it, interest on the borrowed money was not deductible after the amalgamation because the amalgamated company did not hold shares of the acquired corporation after the amalgamation. Although the borrower did have the assets of the acquired corporation, those assets were not what the borrowed money was used to purchase. This case arguably stands for the principle that no property is acquired by an amalgamating corporation as a result of an amalgamation. If so, interest on borrowed money to acquire shares of the amalgamated corporation would not be deductible after the amalgamation. A similar issue exists on a winding-up. Nevertheless, IT-533 confirms that, in this case, it is permissible to link the current use of the borrowed money between the shares that were initially acquired (and which disappeared on the amalgamation or winding-up) and the assets formerly held by the acquired corporation that has been wound up or amalgamation (and which become held by the continuing corporation).

There have recently been a number of CRA technical interpretations which adopt a narrow interpretation of the applicability of "linking" in applying paragraph 20(1)(c). Where a taxpayer uses borrowed money in part for an eligible income-producing use and in part for a personal use, CRA has said that any repayment of the loan must be proportionately. For example, assume that a taxpayer borrowed $300 of which $200 was used for investment and $100 was used for personal purposes. If the taxpayer repays $100, CRA has said that the repayment must be applied to both uses of the borrowed money, so that interest on only $133 of the remaining balance of the loan is deductible.[19] This is contrary to the "flexible approach" contemplated by Iacobucci, J. in *Ludco*. Under a flexible approach, the taxpayer should be able to allocate the $100 repayment to the portion of the borrowed money that was used for personal purposes, so that interest on all of the remaining loan is deductible.

If a taxpayer uses borrowed money to acquire shares of a corporation or units of a trust and receives a return of capital on the shares or units, it is arguable that interest on all of the borrowed money should continue to be deductible so long as the borrowed money can continue to be linked to the remaining investment as a source of income. CRA disagrees. In their view, the amounts received as a return of capital must be used for eligible income producing purposes.[20]

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[19] See CRA Document 2007-0252211E5 (June 5, 2008), 2007-0243181C6 (Oct. 5, 2007), 2007-0221071E5 (Sept. 7, 2007), 2007-0230431E5 (Aug. 23, 2007).

[20] See, Thomas E. McDonnell, "Borrowing to Return Paid-Up Capital" (2008) vol. 8, no 1 *Tax for the Owner-Manager*, 7 (Canadian Tax Foundation) and CRA Document 2007-0236351E5 (Aug. 21, 2007).

CRA has said that, where a taxpayer borrows money to purchase units of a mutual fund and receives a distribution of capital on the trust units, a portion of the interest on the borrowed money will no longer be deductible if the taxpayer uses the capital distribution to pay interest on the borrowed money. This is a questionable conclusion. If a taxpayer borrows money to acquire units of a mutual fund trust and receives a return of capital on the units, interest on the borrowed money should be deductible if the money is used for an income earning purpose. Such a purpose should include the payment of interest on the borrowed money. CRA has confirmed several times that, if a taxpayer borrows additional money to pay deductible interest on an existing loan, the interest on the additional borrowed money is deductible.[21]

Disappearing Source

One of the implications of the current use test is that, where borrowed money can no longer be traced to an income-producing source (i.e., a business or property), interest is no longer deductible. This result is illustrated in *Emerson v. The Queen*, 86 D.T.C. 6184 (FCA).[22] In that case, the taxpayer borrowed money to purchase shares. The taxpayer subsequently disposed of the shares at a loss and borrowed a second loan in order to repay the balance of the previous loan. It was held that interest on the second loan was not deductible. An essential requirement under paragraph 20(1)(c) was the continued existence of the source to which the interest expense related.

The problem of loss of source is now dealt with in section 20.1 of the *Income Tax Act* which deems the original use of borrowed money to be continued under certain circumstances after a taxpayer ceases to use borrowed money for the purpose of earning income from a capital property or from a business.

Another aspect of the "loss of source" issue was dealt with by the Supreme Court of Canada in *Tennant v. The Queen*, 96 D.T.C. 6121. In that case, the taxpayer borrowed $1,000,000 which he used to invest in shares of a corporation. The value of these shares subsequently declined to $1,000. At that time, the taxpayer rolled the $1,000 investment into a holding company under section 85 of the *Income Tax Act*, taking back shares of the holding company. It was argued that interest on only $1,000 of the original loan was deductible after this transaction, on the basis that, following the transfer of the shares to the holding company, only $1,000 of the original loan continued to be used for the purpose of earning income from property. This argument succeeded in the Tax Court and the Federal Court of Appeal, but was rejected in the Supreme Court of Canada. In the Supreme Court of Canada, it was held that the money was borrowed and used by the taxpayer in order to produce investment income and continued to be used for this purpose even though the investment vehicle had changed. In their view, the ability to deduct interest was not lost simply because the taxpayer sold income-producing property, so long as the proceeds were reinvested in eligible-use property.

[21] See CRA documents 2005-0116661C6 (May 3, 2005) and 2007-0254941E5 (November 15, 2007)
[22] See also, *The Queen v. Moufarrège*, 2005 DTC 5605 (Supreme Court of Canada).

Indirect "Use"

Subsection 20(3) of the Act declares for greater certainty that, where a taxpayer has used borrowed money to repay money previously borrowed, the borrowed money is deemed to have been used for the same purpose as original borrowing.

In *Trans-Prairie PipeLines Ltd. v. M.N.R.*, 70 D.T.C. 6351, the taxpayer was incorporated to construct and operate a pipeline. It was initially capitalized with common shares and redeemable preferred shares. Subsequently, it issued first mortgage bonds and used a portion of the proceeds to redeem the preferred shares. The issue was whether the taxpayer was entitled to deduct interest on the first mortgage bonds. The Minister took the position that the borrowed money under the first mortgage bonds was used for the purpose of redeeming the preferred shares and therefore was not used for the purpose of earning income. In the Exchequer Court of Canada, Jackett, P. held that the interest was deductible. He said that the words "money used in a business to earn income" refer to the mass of capital dedicated to that business through different forms while it remains in the business and, as a practical matter of business common sense, the borrowed money was used to "fill the hole" left by the redemption of the taxpayer's preferred shares.

The *Trans-Prairie* case was accepted by CRA and extended to other similar circumstances:

- In Interpretation Bulletin IT-80 (November 27, 1972), CRA confirmed that interest was also deductible on money borrowed to pay a dividend, unless a substantial portion of the "accumulated profits" of the corporation was not used for an eligible purpose under paragraph 20(1)(c). This policy was stated to put a taxpayer that used profits for expansion and then is required to borrow money to pay dividends in the same position as one that paid dividends out of profits and then is required to borrow to finance the expansion.

- Interpretation Bulletin IT-445 (February 23, 1981) dealt with the deduction of interest on funds borrowed either to be loaned at less than a reasonable rate of interest or to honour a guarantee given for inadequate consideration in non-arm's-length circumstances.

- Interpretation Bulletin IT-498 (October 6, 1983) dealt with the deductibility of interest on money borrowed to reloan to employees or shareholders.

The correctness of *Trans-Prairie* was called into question in *Bronfman Trust*. In *Bronfman Trust*, the taxpayer was a trust all of the assets of which were held for investment purposes. The Trust's investment strategy focused primarily on capital appreciation rather than income. The trustees determined to make a capital distribution to the beneficiary of the Trust and, rather than liquidate investments in order to fund the capital allocation, the Trust used borrowed money to make the distribution. The issue was whether the Trust was entitled to deduct interest on this borrowed money.

The Trust's argument was that, although the borrowed money was used to pay the distribution, it was also used for the purpose of earning income from the Trust's property, since it permitted the Trust to retain income-producing investments. In the Supreme Court of Canada, it was held that the interest was not deductible, on the basis that the direct use of the borrowed money was not for an eligible income-producing purpose.

The majority judgment was written by Chief Justice Dickson. He wrote that it was the "current use" rather than the original use of borrowed money that is relevant in determining interest deductibility. If the taxpayer borrows money and uses the proceeds to purchase income-producing assets, the interest is deductible. If the taxpayer sells the property and puts the proceeds to an ineligible use, interest ceases to be deductible. Where a taxpayer uses borrowed money for an ineligible use which does not involve the purchase of an asset, the borrowed money cannot be available to the taxpayer for a subsequent use, whether eligible or ineligible. In *Bronfman Trust*, the borrowed money was originally used to make capital allocations. Since the Trust did not receive any property or consideration for the borrowed money, the use of this borrowing was not of an income-earning nature.

The Trust's argument was that the borrowed money permitted the Trust to retain income-producing assets which it otherwise would have had to sell in order to obtain the funds to make the capital distributions to the Trust beneficiary. This argument failed. In Chief Justice Dickson's view, the *Income Tax Act* did not permit the courts to ignore the direct use of the borrowed money. He pointed out that, with the exception of *Trans-Prairie*, the case law did not permit claims based on indirect, eligible uses for borrowed money when there was a direct, but ineligible use. He referred to *Trans-Prairie* as an "exceptional circumstance".

The immediate reaction of CRA to the *Bronfman Trust* case was to cancel Interpretation Bulletin IT-80. This created considerable concern in the tax community. In response to CRA's action, on June 2, 1987, the Minister of Finance issued a press release and attached a Notice of Ways and Means Motion To Amend the *Income Tax Act*. The stated purpose of the June 2, 1987, Notice of Ways and Means Motion was to confirm the previous administrative practice of CRA with respect to the deductibility of interest. As a result, CRA said that it would continue its former administrative practice on interest deductibility.[23] The Motion was extended a number of times pending review of the rules on interest deductibility by the Department of Finance.

It was not until December 20, 1991, that the Minister of Finance released draft legislation on interest deductibility. The draft legislation was intended to provide legislative support for the manner in which the *Income Tax Act* was being administered by CRA prior to the *Bronfman Trust* case. However, the provisions were criticized for their complexity and in some instances they also apparently did not reflect the administrative practice of CRA. Perhaps because of the complexity of the issues, none of these proposals have been enacted.

As a result, following *Bronfman*, there were many areas where taxpayers were in the position of having to rely on CRA's administrative practices on interest deductibility without any caselaw or statutory provisions to back them up.

Eventually, however, the pendulum began to swing back in favour of the taxpayer. In particular, *Shell Canada (infra)*, *Ludco Enterprises*, and *Singleton (infra)* each eroded the effect of the *Bronfman Trust* case. So much so that the Trans-Prairie "fill the hole" principle was accepted by CRA when IT-533 was issued on October 31, 2003.

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[23] See Couzin, Daman, Hiltz and Lawlor: "Tax Treatment of Interest: *Bronfman Trust* and the June 2, 1987 Release" in *Current Developments in Measuring Business Income for Tax Purposes*, 1987 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1987), 10:1-25.

IT-533 confirms that the use test will be met where borrowed money replaces contributed capital or accumulated profits that were used for eligible income-producing purposes.[24]

A case which illustrates a potential pitfall in this area is *Chase Manhattan Bank of Canada v. The Queen*, 2000 D.T.C. 6018. In that case, the taxpayer was a leasing subsidiary of a bank. The subsidiary was initially funded by way of interest-bearing loans from the parent bank. Subsequently, the decision was made to "capitalize" the loan and this was done by having the parent bank subscribe for share capital of the subsidiary, and the subsidiary used the funds to repay the inter-company loan. A year later, it was decided to reverse the effect of this transaction. Accordingly, the subsidiary obtained an interest-bearing loan from the parent and used the proceeds to pay a cash dividend to the parent. The cash dividend in effect set up an accounting deficit in the subsidiary's books, to the extent that the amount of the dividend exceeded the subsidiary's retained earnings at the time. In reviewing this arrangement, the Minister disallowed the deduction of interest on the borrowed money used to pay the dividend, to the extent that the amount of the loan exceeded the subsidiary's retained earnings at the time of the dividend. The taxpayer appealed, arguing that *Trans-Prairie* should apply. The Tax Court of Canada denied the appeal. Contrary to the situation in *Trans-Prairie*, it was not shown that the loan had been used to fill a "real hole" in the capital requirements of the subsidiary. The taxpayer appealed to the Federal Court of Appeal and lost there as well. In their view, the direct use of the borrowed funds was to pay the dividend. The share capital was not redeemed or cancelled at the time of the borrowing. None of the share capital was converted to debt. Therefore, except to the extent of the retained earnings, the borrowed money was not a replacement of monies that had been withdrawn from the business. The direct use of the balance of the funds was to pay a dividend, which was an ineligible purpose.

This case highlights the danger of not complying precisely with the CRA's view of the "fill the hole" test. If the taxpayer had borrowed money to pay a return of capital on its common shares, it seems that CRA would have allowed the deduction. Furthermore, it also seems that the taxpayer would have been allowed interest deductibility under the language of the December 20, 1991 draft amendments to the *Income Tax Act*. However, draft legislation obviously did not reflect CRA's administrative practice.

Other Exceptional Circumstances

The scope of the "exceptional circumstances" exception was also canvassed in *Canadian Helicopters Ltd. v. The Queen* 2002 D.T.C. 6805 (Federal Court of Appeal). In that case, the taxpayer borrowed money and loaned it to its parent corporation on an interest-free basis. The parent corporation, in turn, loaned the money to its parent, which used the proceeds of the loan to purchase the shares of an operating corporation. In the Tax Court of Canada, Judge McArthur concluded that the direct use of the borrowed money was an interest free loan to its parent, which was a direct ineligible use.

Having found that there was a direct ineligible use, Judge McArthur considered whether the facts were within the scope of the "exceptional circumstances" referred to by Dickson C.J.C. in

[24] For the application of the "fill the hole" and "linking" principles to amounts payable for property referred to in s. 20(1)(c)(ii), see CRA Document 2007-0256671R3 (Jan. 21, 2008).

Bronfman Trust. He referred to the two-pronged test discussed by Robertson, J. A. in *74712 Alberta Ltd*, 97 D.T.C. 5126 that the taxpayer establish (i) a *bona fide* purpose (intention) to use the funds to earn income, and (2) that there was a reasonable expectation of earning income in excess of the interest expense.

Judge McArthur found that there was conclusive evidence that the group's purpose in acquiring the shares was to increase the taxpayer's income by charging management fees to the acquired corporation for valuable services rendered. Accordingly, the first requirement was met because the reality was that the taxpayer borrowed the money and in return received management fees far in excess of the interest paid. Secondly, the taxpayer had a reasonable expectation that the transaction would yield income in excess of the interest expense.

In his view, the taxpayer reasonably expected to earn management fees and that the target corporation's non-Quebec operations would be transferred to it, as a result of which it anticipated significant gross annual revenue. He concluded that the indirect use was for an eligible use, to earn income. Accordingly, the interest was deductible because it was on borrowed money used for the purpose of earning income from a business or property.

In the Federal Court of Appeal, it was held that McArthur, J. correctly followed the analysis established in *74712 Alberta Ltd.* where he held that the taxpayer had proven exceptional circumstances warranting the interest deduction.

In *Penn Ventilator Canada Ltd. v. The Queen*, 2002 D.T.C. 1498 (Tax Court of Canada), a corporation redeemed its shares held by two shareholders and paid part of the redemption price with an interest-bearing promissory note. Since there was no borrowed money, interest was not deductible under subparagraph 20(1)(c)(i). Judge Lamarre Proulx held, however, that the interest was deductible under subparagraph 20(1)(c)(ii) of the Act – i.e., interest on an amount payable for property acquired for the purpose of gaining a producing income. She said:

> Considering that the promissory note issued for the redemption of the shares replaced the paid-up capital and the retained earnings that were used in the business and considering that there was an acquisition of property in such a manner, I therefore conclude that there was an acquisition of property that had for purpose, the gaining or producing income from a business within the meaning of 20(1)(c)(ii) of the Act, and that the interest expense on the promissory note may accordingly be deducted.

This reasoning is reminiscent of the reasoning in the *Trans-Prairie* case. In *Trans-Prairie*, however, it was decided that interest was deductible under subparagraph 20(1)(c)(i), dealing with interest on borrowed money. *Penn Ventilator* extends the reasoning to subparagraph 20(1)(c)(ii). This case has been accepted by CRA in IT-533, para. 29.

Direct "Use" – *Shell Canada, Singleton, Lipson*

One of the ongoing issues in the area of interest deductibility is whether a taxpayer can structure his or her affairs in order to obtain interest deductibility by causing the direct use of borrowed money to be for an eligible use where there is also an indirect ineligible use.

In *The Queen v. Singleton*, 2001 DTC 5533 (Supreme Court of Canada), the taxpayer was a partner in a law firm. The taxpayer required funds to purchase a home and, in order to do so, he structured the following transaction:

1. The taxpayer was repaid $300,000 from his capital account in the law partnership. These funds were used to purchase the home.
2. Later the same day, the taxpayer borrowed approximately $300,000 from a bank and paid the total back to the partnership as a contribution of capital.

In the Tax Court of Canada, Bowman, T.C.C.J. (as he then was) had no difficulty in concluding that interest on the loan was not deductible (see 96 D.T.C. 1850).[25] In his view, the reality of the situation was that money came from the bank, went through the firm and immediately went out to the taxpayer and was used in the purchase of the house.

> On any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purpose cannot be altered by the shuffle of cheques that took place on October 27, 1988.
>
> …
>
> The true purpose of the use of the borrowed funds subsumed the subordinate and incidental links in the chain. Theoretically one might, in a connected series of events leading to a predetermined conclusion, postulate as the purpose of each event in the sequence the achievement of the result that immediately follows but in determining the "purpose" of the use of borrowed funds within the meaning of paragraph 20(1)(c) the court is faced with practical considerations with which the pure theorist is not concerned.
>
> …
>
> What the appellant purported to do, he did. I am basing my decision on the fact that, even if one accepts the legal validity of the steps that were taken and also treats the obvious tax motivation as irrelevant, one is still left with the inescapable factual determination that the true economic purpose for which the borrowed money was used was the purchase of a house, not the enhancement of the firm's income earning potential by a contribution of capital.

The taxpayer appealed to the Federal Court of Appeal and succeeded. The decision was appealed further to the Supreme Court of Canada. By the time that the Supreme Court of Canada considered *Singleton*, it had decided *Shell Canada Limited v. The Queen*, 99 D.T.C. 5669.

In *Shell Canada*, the taxpayer required U.S. funds but borrowed New Zealand dollars under a hedging arrangement which limited its economic exposure to the equivalent of a U.S. dollar loan. As a result, the taxpayer paid (and deducted) interest on the NZ loan at 15.4% and realized an offsetting gain of $21 million (U.S.) when the hedging transactions were closed at the end of the term of the loan. In essence, the taxpayer's objective was to get fully deductible interest expense during the term of the loan which was offset by a capital gain at the end of the term.

In *Shell Canada*, the taxpayer won at the Tax Court of Canada, but lost in the Federal Court of Appeal. In the Federal Court of Appeal, Linden J.A. said that Parliament intended to restrict the

[25] See also, *Mark Resources v. The Queen*, 93 D.T.C. 1004

deduction of interest “to those amounts that were reasonable and which reflected the economic realities of the situation”. In his view, “looking realistically at the substance of the situation, there was no use and purpose other than the avoidance of taxation for borrowing NZ$.” This was not an eligible use. In the Supreme Court of Canada, McLachlin, J. (as she then was) said that, in order to support interest deductibility, it is necessary to establish a “direct link” between the borrowed money and the eligible use. She said that it has never been held that the “economic realities” of a situation could be used to recharacterize a taxpayer’s legal relationships and “absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer’s legal relationships must be respected in tax cases.” The taxpayer’s reason for a particular method of borrowing is irrelevant under paragraph 20(1)(*c*). “The issue is the <u>use</u> to which the borrowed funds are put. It is irrelevant why the borrowing arrangement was structured the way that it was or, indeed, why the funds were borrowed at all.”

In the Supreme Court of Canada decision in *Singleton*, Major, J. referred to and applied the above principles from *Shell Canada*. Giving effect to the legal relationships of the taxpayer’s transactions, it was clear that the taxpayer used the borrowed money to finance his capital account in the partnership. The fact that the money was borrowed in order to allow the taxpayer to use his own money to purchase a personal residence was irrelevant.

The *Singleton* case was accepted by CRA in paragraph 15 of IT-533, which states: “A taxpayer may restructure borrowings and the ownership of assets to meet the direct use test.”

The *Lipson* case (2009 DTC 5015), raises the question whether the general anti-avoidance rule could be applied in this type of tax planning. In *Lipson*, the following steps were carried out:

1. The taxpayer and his wife entered into an agreement of purchase and sale for a personal residence.

2. The taxpayer’s wife borrowed $562,000 from a bank under a temporary loan and used the money to purchase shares of a family company from the taxpayer.

3. The next day, taxpayer used the $562,000 to purchase the personal residence in joint tenancy with his wife.

4. On the same day, the wife used borrowed money under a mortgage of the personal residence to repay the temporary bank loan.

As a result of the operation of the attribution rules under the Act:

1. the shares of the family company were transferred to the wife at the taxpayer’s adjusted cost base under subsection 73(1) of the Act,

2. interest on the temporary bank loan was deductible under paragraph 20(1)(c) because the borrowed money was used to acquire shares,

3. interest on the mortgage loan was deductible because it was used to repay the temporary bank loan and, by virtue of subsection 20(3) of the Act, the borrowed money was deemed to have been used for the same purpose as the temporary loan,

4. the wife's loss from deducting her interest expense (net of dividends received on the acquired shares) was attributed back to the taxpayer by virtue of subsection 74.1(1) of the Act.

In the Tax Court of Canada (2006 DTC 2687), Chief Justice Bowman held that GAAR applied to deny the deductibility of the loss to the taxpayer. In his view, the above provisions were used by the taxpayer to achieve a purpose for which they were not intended – i.e., to make interest deductible that would not be deductible if the money had simply been used to buy the personal residence. This decision was upheld by the Federal Court of Appeal (2007 DTC 5172) on the basis that Chief Justice Bowman was entitled to consider the transactions as a whole and their overall purpose in deciding whether there had been a misuse or abuse and, on that basis, there was no reason to interfere with his decision. In the Supreme Court of Canada, the majority held that the tax benefit of the interest deduction resulting from the wife's borrowing was not abusive when viewed in isolation, but the ensuing tax benefit of the attribution of the wife's interest deduction to the taxpayer was. Thus the latter tax benefit was denied under GAAR because the object, spirit and purpose of subsection 74.1(1) had been frustrated. In so deciding, the majority did not revisit *Singleton*. This suggests that, as stated by Rothstein, J. in his dissenting judgement, "There is no reason why taxpayers may not arrange their affairs so as to finance personal assets out of equity and income earning assets out of debt."

"Purpose" – *Ludco*

In order for interest to be deductible, the borrowed money must be used for the "purpose" of earning income. The meaning of "purpose" was considered in the *Ludco Enterprises* case. In *Ludco*, the taxpayer borrowed money to invest in shares of two foreign corporations. These corporations invested mainly in Canadian debt securities. Although the foreign corporations paid nominal dividends on an annual basis, the investment policy of the corporation was that its earnings would be reinvested and accumulated in the foreign corporations, and eventually returned to the investors as a capital gain on the redemption of their shares. In the promotional material that accompanied the investment, it was pointed out that this strategy enabled income to be accumulated offshore without payment of Canadian tax and ultimately returned to the investors by way of a redemption of shares giving rise to a capital gain.

In the Supreme Court of Canada, three different tests were considered for determining whether the requisite income-earning purpose is present: *bona fide* purpose, dominant purpose and reasonable expectation of income.

In previous decisions, including in the lower courts in the *Ludco* case, the courts have referred to a *bona fide* purpose test enunciated by Dickson C.J. in his discussion of "exceptional circumstances" in *Bronfman Trust*. In *Ludco*, Iacobucci, J. held that an ancillary purpose to earn income was sufficient and the test was whether, considering all the circumstances, the taxpayer had a "reasonable expectation of income" at the time the investment was made.

"Income" – Gross or Net?

The next issue addressed by the Supreme Court of Canada in *Ludco* was whether the word "income" in paragraph 20(1)(c) referred to gross income or net income. In the view of Iacobucci, J., the term "income" in subparagraph 20(1)(c)(i) did not refer to net income, but income subject to tax – i.e., an amount that is included in gross income for taxation purposes.

Applying these principles, Iacobucci J. held that the evidence indicated that the taxpayers did have a reasonable expectation of income. Although earning income was not the principal factor that motivated the taxpayer to invest, the taxpayer did anticipate the receipt of dividend income. In Iacobucci, J's view, the expectation of dividend income was reasonable and accordingly the requisite purpose was present.

This comment – that income means gross income – in paragraph 20(1)(c) has given rise to a considerable amount of controversy and resulted in the proposed amendment to the Income Tax Act discussed below.

"Reasonable Amount"

Another issue dealt with in the *Shell Canada* case is the effect of the closing words in paragraph 20(1)(c) which limits the interest deductibility to "a reasonable amount in respect thereof". In this connection, it was held that, where an interest rate is established in an arm's length market, it is generally a reasonable rate.

OCTOBER 31, 2003 DRAFT PROPOSALS

Finance is concerned about the deductibility of interest where the taxpayer has no reasonable expectation of profit. There are two concerns.

One is the *Ludco* case, where it was held that, for the purposes of paragraph 20(1)(c), "income" means gross income.

The second concern stems from the decisions of the Supreme Court of Canada in *Stewart v. The Queen*, 2002 D.T.C. 6969 and *The Queen v. Walls and Buvyer*, 2002 D.T.C. 6960. In *Stewart*, the taxpayer was an individual who used borrowed money to purchase four rental condominiums. Since the rental income from the properties was less than the carrying costs, the taxpayer had a loss which he sought to deduct against his income from other sources. Under section 3 of the Act, a loss is deductible only if it is from a source of income, such as a business or property. In this context, the Crown argued that, for the purposes of section 3, a taxpayer does not have a source unless there is a "reasonable expectation of profit" (REOP) from the activity. It was argued that Mr Stewart did not have a REOP because he was projected to realize rental losses from the properties and his real purpose in acquiring the properties was to realize a capital gain on the ultimate sale of the properties. The Supreme Court of Canada rejected this argument. In the Court's view, the existence of a source of income is to be determined by looking at the commerciality of the activity. Where there is no personal element, the activity is clearly commercial and REOP has no relevance. With respect to the taxpayer's purpose of realizing a capital gain, the Court said that, in its view, the motivation of capital gain accords with the ordinary business person's understanding of "pursuit of profit" and may be taken into account in determining whether the activity is commercial in nature.

In *Walls and Buvyer*, the issue was the deductibility of losses of a limited partnership formed to operate a mini-warehouse. It was argued that the loss was not deductible because the partnership did not have a REOP and therefore there was no loss from a source. Again, the Court rejected the REOP test. Since the activities of the partnership were clearly commercial, the taxpayer was engaged in the pursuit of profit and therefore had a source of income.

In response to these cases, the Department of Finance released for public comment draft proposals which would introduce a new provision into the Income Tax Act to impose a statutory REOP test for the deductibility of losses. The proposed section reads as follows:

> 3.1 (1) Limit on loss — A taxpayer has a loss for a taxation year from a source that is a business or property only if, in the year, it is reasonable to expect that the taxpayer will realize a cumulative profit from that business or property for the period in which the taxpayer has carried on, and can reasonably be expected to carry on, that business or has held, and can reasonably be expected to hold, that property.
> (2) Determination of profit — For the purpose of subsection (1), profit is determined without reference to capital gains or capital losses.

The draft proposals have come under a considerable amount of criticism. In the February 23, 2005 federal budget papers, Finance acknowledged that concerns had been raised and they said they would respond by developing a "more modest" legislative initiative that would respond to the concerns while still achieving the Government's objectives. There have been no official government statements since then.

One of the proposals which Finance is considering is whether to substitute the words "net profit" or "net income" wherever the word "income" is used in the Act.[26]

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[26] Some of the implications are discussed in: Paul K. Tamaki, "Policy Forum: Thoughts on the Deductibility of Interest and Other Expenses" (2004) vol. 52, no. 4, *Canadian Tax Journal* 1121 -89.