

**THE DEDUCTION OF FINANCING EXPENSES  
OTHER THAN INTEREST**

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June 3, 2010

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## THE DEDUCTION OF FINANCING EXPENSES OTHER THAN INTEREST

### 20(1)(e) - Financing Expenses

The purpose of paragraph 20(1)(e) is to permit the amortization over a five year period of certain financing expenses relating to:

- (1) an issue or sale of shares, units of unit trusts, or partnership or syndicate interests,
- (2) a borrowing of money used for the purpose of earning income that is not exempt,
- (3) the incurring of indebtedness for property that is acquired for the purpose of earning income that is not exempt, or
- (4) a rescheduling, restructuring or assumption of a debt obligation that is described in (2) or (3).

All of these expenses would otherwise be regarded as non-deductible capital expenditures. Generally, the financing expenses contemplated by this paragraph include legal, accounting and other expenses relating to the financing, including, printing fees, registration fees, filing fees, commitment or standby fees, guarantee fees, promoter's service fees, loan arrangement fees, certification fees and certain other "soft costs". These expenses are deductible under paragraph 20(1)(e) at the rate of 20% for a full fiscal period of 365 days over a five year period.

Payments on account of principal or interest are specifically excluded from a deduction under paragraph 20(1)(e), as are amounts that are contingent on the use or production from property or computed by reference to revenue, profit, cash flow, commodity price or any other similar criteria. Interest is specifically dealt with under paragraph 20(1)(c). Paragraph 20(1)(e) contains a purpose test similar to that for interest deductibility under paragraph 20(1)(c). In order for borrowing costs to be deductible, the borrowed money must be used by the taxpayer for the purpose of earning income from a business or property, the income from which is not exempt. For expenses incurred after 1987, subsection 20(3) applies to paragraphs 20(1)(e) and (e.1), and provides that, in general, borrowings used to repay existing debt will be considered to have been used for the same purpose as that debt so that financing fees incurred in connection with the new debt will be deductible in accordance with those paragraphs.

It is unclear what is meant by the phrase "a borrowing of money". The proceeds from the sale of bankers' acceptances are specifically included in the definition of "borrowed money" under subsection 248(1). However, it is the Canada

Revenue Agency's (the "CRA") administrative position that an assumption of a debt obligation does not constitute the "borrowing of money". Subparagraph 20(1)(e)(ii.2) was added to explicitly include the assumption of a debt obligation. There was also a concern that "a borrowing of money" was not broad enough to include the purchase of assets through the use of instalment payments or promissory notes issued to the vendor. Subparagraph 20(1)(e)(ii.1) was added to specifically include this type of indebtedness.

"Rescheduling or restructuring ... of a debt obligation" is considered by the Department to generally describe changes to the rights and obligations of the parties to the debt obligation. They may include, *inter alia*, alteration of payment schedules, extension of maturity dates, alteration of interest rates and conversion or substitution of the original debt obligation to or with a share for another debt obligation. Specifically excluded are those payments to which subsection 18(9.1), as discussed below, would otherwise apply.

Example 1: A taxpayer has paid commitment fees to a financial institution with respect to a proposed loan to be used to acquire an income-producing investment. The taxpayer subsequently borrows the money from a different financial institution. The commitment fee paid to the first financial institution would be considered to be an expense incurred in the course of borrowing money within the meaning of subparagraph 20(1)(e)(ii) if the taxpayer used the borrowed money to acquire the income-producing investment. The actual financing must be a substitute for the loan originally sought.

To be deductible under paragraph 20(1)(e), expenses must be applicable to the source of income. The preamble to subsection 20(1) provides that, in computing income from a business or property, there may only be deducted such amounts as are "wholly applicable to that source" or such part of those amounts as "may reasonably be regarded as applicable thereto". For the purposes of subparagraph 20(1)(e)(i), with respect to expenses incurred in the course of an issuance or sale of securities, the CRA has interpreted this language to mean that the expenses must be wholly applicable to the sale or issuance, and not merely a consequence or result of the sale or issuance. On this basis, the CRA takes the view that subparagraph 20(1)(e)(i) would generally not apply to investment banker fees paid for advice in connection with issuing shares on a merger or for a fairness opinion as to whether the terms of a share issuance are fair to existing shareholders.

Fees paid to an investment banker are usually incurred in the course of acquiring a business involving the acquisition of share capital. Such costs should be added to the cost of the shares acquired by the purchaser. Consequently, this type of expense is usually not deductible pursuant to subparagraph 20(1)(e)(i).

Generally, the rules in paragraph 20(1)(e) are applicable only where the expenses would not otherwise be deductible because of paragraphs 18(1)(a), (b) or (h). Expenses that do not meet the terms of paragraph 20(1)(e) may qualify as eligible capital expenditures, provided, of course, that the requirements of the definition of "eligible capital expenditures" in subsection 14(5) are met.

Example 2: A corporation attempts to raise money through the issuance of debt. The debt proceeds are to be used by the corporation to finance its business activities. The corporation incurs various legal and accounting costs with respect to the attempt to raise money through the issuance of debt; however, ultimately, the loan transaction is not carried out. As such, the expenses incurred do not meet the requirements for a deduction under paragraph 20(1)(e). Assuming the borrowed money would not have been the taxpayer's stock-in-trade (as would be the case if the taxpayer is not a money lender), the borrowing would have been on account of capital and a deduction thereof would be denied pursuant to paragraph 18(1)(b). However, expenses on account of capital and incurred for the purposes of gaining or producing income from a business may qualify as an "eligible capital expenditure" under that definition in subsection 14(5).

Other rules may also apply to the treatment of certain financing expenses which may take precedence over the treatment in paragraph 20(1)(e). Paragraph 20(1)(e.1) is discussed below. Paragraph 20(1)(g) may apply in connection with share transfer fees and other similar fees deductible by a corporation. Expenses incurred to meet obligations imposed under a *Securities Act* or a *Business Corporations Act* may be deductible under subsection 9(1). Certain outlays or expenses relating to the construction, renovation or alteration of a building shall be included in computing the cost or capital cost of the building according to the rules in subsections 18(3.1) to (3.7). Where a taxpayer borrows money for the purpose of acquiring depreciable property, expenses incurred in the course of borrowing that money, that are otherwise deductible under paragraph 20(1)(e), may be capitalized along with the interest paid or payable thereon as part of the cost of the depreciable property, provided an election to do so is made under section 21. Where such costs are so capitalized, they form part of the capital cost of the depreciable property subject to capital cost allowance.

Subsection 18(11) prohibits the deduction of interest and financing expenses on funds borrowed for the purpose of purchasing certain deferred annuities, paying premiums or contributions under RRSPs, registered pension plans, and deferred profit sharing plans after November 12, 1981, or making contributions to retirement compensation arrangements, net income stabilization accounts, accounts under prescribed provincial pension plans or registered education savings plans.

It should, however, be noted that the CRA has expressed the view that an annual standby charge to maintain a line of credit with a financial institution is

generally deductible under paragraph 20(1)(e.1) in the year it is incurred provided that the taxpayer intends to use the line of credit.

### *Timing of the Expense*

Previous versions of paragraph 20(1)(e) referred to expenses incurred “in the course of borrowing money” or “in the course of issuing” securities. These expressions were changed respectively to “in the course of a borrowing of money” and “an issuance” of securities. This use of wording may have been intended to ensure that the securities must actually be issued or sold, or the money borrowed, before subparagraph 20(1)(e) can apply, so that no amount would be deductible where the issuance, sale or borrowing was contemplated but not completed for any reason. This is the interpretation given by the CRA (paragraph 12 of IT-341R4). It has also been suggested that the revised wording may be more restrictive in that it may refer only to the time in which the borrowing occurred and thus would effectively prevent the deduction of finance expenses incurred at a subsequent time. However, this restrictive interpretation of the provision does not appear to have been the apparent policy adopted by the CRA (paragraph 14 of IT-341R4). The amendment may not be sufficiently clear to override the broad interpretation put forward by the Federal Court of Appeal in the Yonge-Eglinton case, and more recently by the Federal Court of Appeal in Sherway Centre, with respect to the timing of the expense.

In MNR v. Yonge-Eglinton Building Ltd., [1974] C.T.C. 209 (F.C.A.), the taxpayer’s cost of obtaining interim financing for the construction of a building included not only interest at 9% on the amount borrowed, but also an undertaking to pay 1% of gross rental revenue for a period of 25 years. In a divided judgment of the Federal Court of Appeal, the latter payments were held to be deductible as an expense incurred in the course of borrowing money within paragraph 11(1)(cb) of the former Act (now paragraph 20(1)(e)). In reaching this conclusion, Mr. Justice Thurlow stated (at p.214):

“What appears to me to be the test is whether the expense, in whatever taxation year it occurs, arose from the issuing or selling or borrowing. It may not always be easy to decide whether an expense has so arisen but it seems to me that the words “in the course of” in paragraph 11(1)(cb) [now paragraph 20(1)(e)] are not a reference to the time when the expenses are incurred but are used in the sense of “in connection with” or “incidental to” or “arising from” and refer to the process of carrying out or the things which must be undertaken

to carry out the issuing or selling or borrowing for or in connection with which the expenses are incurred.”

Similarly, in *Sherway Centre Ltd. v. The Queen*, [1998] 2 C.T.C. 343 (F.C.A.), the taxpayer obtained long-term financing for construction of a shopping centre through the issuance of certain bonds, that in addition to containing a conventional interest feature of 9 3/4%, included a Participating Interest equal to 15% of Operating Surplus in excess of \$2,900,000. The Court concluded that even if participating interest payments were not deductible under paragraph 20(1)(c), they were deductible under paragraph 20(1)(e), which was not limited to expenses incurred at the time the borrowing took place. Financing expenses incurred both before and after the borrowing may be eligible for amortization under paragraph 20(1)(e).

However, see below under the heading “Participation Payments” and the discussion of “excluded amounts” under subparagraph 20(1)(e)(iv.1).

### *Timing of the Deduction*

Those expenses incurred before 1988 in respect of issuances or sales before 1988 of shares, trust units and partnership and syndicate interests, or in respect of borrowings occurring before 1988 were deductible under former paragraph 20(1)(e) as and when they were incurred. The amortization rules in paragraph 20(1)(e) are applicable to expenses incurred after 1988 in respect of issuances or sales of shares and other property, or in respect of borrowing occurring after 1987.

The deduction under paragraph 20(1)(e) of 20% of the qualifying financing expenses in a taxation year is limited to the amount by which the expense exceeds the amounts deductible in respect thereof in a preceding taxation year (subparagraph 20(1)(e)(iv)). Thus, 20% of the financing expenses may be deducted in the year incurred and in each following taxation year until fully deducted, but if such expenses could have been deducted in a preceding taxation year and were not, the taxpayer may not carry forward the unused deduction. Subparagraph 20(1)(e)(iii) provides for a proration of the 20% deduction in taxation years of less than 365 days.

### *Who may Deduct*

The deduction permitted by paragraph 20(1)(e) or (e.1) in respect of borrowing money, is restricted to the taxpayer who issues or sells its shares, units or interests or borrows the money or incurs the indebtedness. Consequently, expenses incurred by a parent company in connection with the issuance of shares by a subsidiary company are not generally deductible by the parent company under

paragraph 20(1)(e). However, the deduction of such expenses by the parent is not prohibited by paragraph 18(1)(a) where the value of the services rendered is billed by the parent to the subsidiary, the amount so billed being income to the parent. The amount billed by the parent and paid by the subsidiary would be deductible by the latter under paragraph 20(1)(e), provided the amount is reasonable in the circumstances.

In International Colin Energy Corp. v. R., [2003] 1 C.T.C. 2406 (T.C.C.), Bowman A.C.J.T.C. commented that if certain fees paid to professional financial advisors in the course of considering possible merger candidates had not been deductible under ordinary principles, they may have fallen within paragraph 20(1)(e). Although Bowman A.C.J.T.C. expressed “no concluded view on the point”, his logic was that “sale” in subparagraph 20(1)(e)(i) must imply something other than the issuance of a share, and the only other thing to which it can refer is a sale by the shareholders in the course of corporate transaction where the interests of the corporation are affected. The CRA does not agree with this interpretation and takes the position that the reference to “sale” in subparagraph 20(1)(e)(i) does not contemplate a sale of shares by the shareholders of a corporation. Instead, the CRA suggests that the reference to “sale” includes, for example, a sale of shares to an underwriter for the purposes of distributing the shares to the public in return for a commission.

### *Repayment*

While qualifying financing expenses must normally be amortized over a five year period, the deduction of an expense incurred in the course of a borrowing of money need not be deferred once all of the debt obligations in respect of the borrowing or indebtedness are repaid or otherwise settled or extinguished, except on a refinancing. Deductibility in full in the year of qualifying repayment or other settlement results from the requirement that paragraph 20(1)(e) be read without reference to the 20% restriction and without reference to the phrase “the lesser of”. Partial settlement of the debt obligation in respect of a borrowing or indebtedness will not enable the taxpayer to obtain current deductibility.

By subparagraph 20(1)(e)(v), the unamortized balance of such costs may be deducted in full in a taxation year if all of the debt obligations in respect of the borrowing are settled or extinguished for consideration that does not include certain specified things. The write-off is not available where the consideration includes any unit, interest, share or debt obligation of the taxpayer or person with whom the taxpayer does not deal at arm’s length, or of a partnership or trust of which the taxpayer (or person with whom the taxpayer does not deal at arm’s length) is a member or beneficiary. Without the provision restricting the type of consideration recognized for the settlement or extinguishment of the debt obligation, a taxpayer

could presumably have avoided deferral of their deduction by converting an original debt into another debt or equity instrument issued by the taxpayer or a person with whom the taxpayer did not deal at arm's length. The balance of the unamortized financial expenses also cannot be deducted if the settlement or extinguishment of a debt obligation took place in a transaction made as part of a series of borrowings or other transactions and repayments.

### ***Dissolution of Partnership***

Subparagraph 20(1)(e)(vi) provides a special rule concerning the unamortized costs of a partnership under paragraph 20(1)(e) where the partnership has ceased to exist at any time in its fiscal period. In such event, the members of the partnership immediately before its cessation may deduct their appropriate shares of the unamortized costs in their taxation years which would have contained the year-end of the partnership had it not been terminated. The costs will continue to be amortized over the remainder of the five years in the hands of the partners. The share of costs is pro-rated on the basis of the fair market value of the partnership interests immediately before the termination. By subparagraph 53(2)(c)(x), the adjusted cost base of a partner's interest in the partnership which has ceased to exist must be reduced by the amount of financial expenses deductible by that partner under subparagraph 20(1)(e)(vi) in respect of the partnership for a taxation year.

### ***Amalgamation and Wind-up***

Paragraph 87(2)(j.6) was amended in 1988 to ensure that when a corporation with unamortized paragraph 20(1)(e) costs is amalgamated after 1988 with another corporation, such costs may be carried forward and deducted by the amalgamated corporation over the remainder of the five year period. This rule in paragraph 87(2)(j.6) is incorporated by reference in paragraph 88(1)(e.2), so that where a subsidiary corporation with an unamortized balance of financing costs is wound-up, the parent corporation may continue to deduct expenses over the balance of the five year period.

### ***Discount or Fee for Underwriting***

Expressly included as qualifying financing expenses are commissions, fees or other amounts for services rendered by a person as a salesman, agent, or dealer in securities in the course of an issuance or sale. Paragraph 20 of Interpretation Bulletin IT-341R4 sets forth the CRA's view with respect to what constitutes a "commission".

Amounts paid or payable to a person to whom the shares, units or interests were issued or sold or from whom the money was borrowed are normally considered to be discounts and are not deductible under paragraph 20(1)(e) or (e.1), nor do they qualify as eligible capital expenditures. However, where a person acting as a principal in such a transaction is an underwriter in the transaction and there is clear evidence that the acquisition of shares, units, interests or debt obligations by the underwriter was for the purpose of making a public distribution thereof, any underwriting fees paid or payable for the services to be performed by the underwriter which are a clear cost associated with the issuance, sale or borrowing are deductible under paragraph 20(1)(e), or in respect of borrowing money or incurring indebtedness under paragraph 20(1)(e.1), to the extent that they are reasonable in the circumstances. Any additional payment which is, in substance, a discount will not be deductible. Where an underwriting fee or commission is a fixed amount or is computed with reference to the number of sales or sales value of completed transactions, they will be regarded as commissions, fees or any other amounts. An amount paid or payable to the underwriter or dealer in their capacity as a financial advisor does not bar deduction of that amount in respect of a borrowing for purposes of paragraph 20(1)(e) or (e.1), although as noted above, the CRA appears to regard certain advisory fees as not “wholly applicable” to the issuance, sale or borrowing in certain circumstances.

### *Participation Payments*

A participation payment, for purposes of this discussion, will be limited to additional compensation established as a percentage of sales, profits, revenues, or cash flow of the borrower, or dependent on external factors such as stock performance or commodity value, which is provided to a lender over and above a fixed rate of interest. In order to be deductible, such a payment must fall within a specific provision of the Act allowing a deduction. Formerly, participation payments could be characterized as either interest or as a financing expense to be deductible under either paragraphs 20(1)(c) or (e), where appropriate. However, paragraph 20(1)(e) now denies a deduction for an “excluded amount”, which includes a typical participation payment. An excluded amount is defined in subparagraph 20(1)(e)(iv.1) to include amounts that are contingent or dependent on the use of or production from property, and amounts that are computed by reference to revenue, profit, cash flow, commodity price or any other similar criteria or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

In an apparent reversal of the Yonge-Eglington and the Sherway Centre decisions of the Federal Court of Appeal, the CRA continued to hold the position that participation payments are consideration for the on-going use of money, rather than expenses incurred in the course of a borrowing and are therefore not generally

deductible under paragraph 20(1)(e). In Income Tax Technical News No. 16 dated March 8, 1999 (subsequent to the Sherway Centre decision), the CRA confirmed its analysis that paragraph 20(1)(e) was not intended to permit the deduction of interest-like expenses and stated that it had recommended to the Department of Finance that amendments be made to that paragraph to clarify its tax policy intent. The Department of Finance acted on the recommendation by introducing the amendments to paragraph 20(1)(e) that are discussed above.

While it would appear that the amendments have effectively eliminated the deductibility of participation payments under paragraph 20(1)(e), the Sherway Centre decision may still allow some scope for deductibility as interest under paragraph 20(1)(c) in certain circumstances. Please refer to the paper on interest deductibility for a more detailed discussion of this topic.

### *Currency Hedge*

In MacMillan Bloedel Limited v. The Queen, [1990] 1 C.T.C. 468 (F.C.T.D.), the Federal Court - Trial Division held that losses incurred under certain foreign exchange hedging transactions were deductible under subparagraph 20(1)(e)(ii) as expenses incurred in the course of borrowing money. In this case, the taxpayer arranged to borrow U.S. dollars and, to ensure that specific amounts of Canadian dollars would be available on closing, entered into forward hedging contracts with certain banks for delivery of U.S. dollars in the future for the Canadian dollars based upon specified exchange rates. When the borrowing was completed, the Canadian dollar had weakened as against the U.S. dollar. As a result, the Canadian dollar equivalent of the amount borrowed in U.S. dollars exceeded the Canadian dollars actually realized under the hedging contracts. The loss was claimed as an expense incurred in the course of borrowing money under subparagraph 20(1)(e)(ii) and accepted by the Court as being a loss under the hedging contracts, which were to be regarded as transactions separate from the loan transaction.

It should be borne in mind that the MacMillan-Bloedel case was decided on the basis of paragraph 20(1)(e) as applicable to the 1974 taxation year. It is not clear whether a court would reach the same conclusion on the basis of the current wording of paragraph 20(1)(e), which seems to require that the expense be incurred in connection with a particular borrowing and not as part of a separate, but related transaction.

The Department considers that the decision reached by the Federal Court in the MacMillan-Bloedel case is limited to the particular facts of that situation. The CRA is not prepared to adopt as a general position that foreign currency gains or losses that arise as the consequence of the sale of currency pursuant to the exercise of a forward contract would be an expense incurred in the year in the course of borrowing money for purposes of paragraph 20(1)(e). The Department finds it

difficult to characterize any loss on such a forward contract as an expense incurred in the course of borrowing money. Similarly, the CRA does not view foreign exchange losses on debt denominated in foreign currency as deductible financing expenses. Foreign currency gains or losses that arise on the realization of an exchange conversion would not be deductible under paragraph 20(1)(e). Furthermore, losses on the exchange of currencies do not meet the definition of an "amount that is not otherwise deductible" that is an expense incurred by a taxpayer in the course of borrowing for the purposes of subparagraph 20(1)(e)(ii). Such exchange losses are incurred in respect of a repayment of a borrowing and not "in the course of a borrowing of money", thus falling outside the scope of paragraph 20(1)(e).

### *Warrants*

The CRA considers that expenses incurred by a corporation in the course of an issuance or sale of warrants are not deductible under subparagraph 20(1)(e)(i) because a warrant is not one of the eligible securities mentioned in that paragraph. However, if the shares supported by the warrants are issued upon the exercise of the warrants, these costs may be deductible under paragraph 20(1)(e) as they would have been incurred "in the course of" an issuance of shares.

### *Guarantees*

As a condition of making a loan, a lender may require that the borrower provide a guarantee, either from another corporation within the group or from an unrelated third party. In order to obtain the guarantee, the borrower may be required to pay the guarantor a fee. As noted earlier, a guarantee fee, to the extent that it is reasonable and that the borrowing satisfies the purpose test, will be deductible either over five years under paragraph 20(1)(e) or, if it can reasonably be considered to relate solely to the year in which it is paid, in the year of payment pursuant to paragraph 20(1)(e.1). An annual guarantee fee would, accordingly, be deductible in full each year.

### *Environmental Approval*

If, as a requirement of obtaining a loan from a bank, the borrower has to obtain approval from Environment Canada that certain land, required as security, complies with an environmental test, the cost of that test and the cost of digging up and replacing the earth may not be expenses that would qualify under paragraph 20(1)(e). The CRA considers that such expenditures may more properly relate to

“improving” the land in order that the land will be acceptable security, and therefore are an addition to the adjusted cost base of the land.

### **20(1)(e.1) - Annual Fees**

The following expenses incurred after 1987 in respect of issuances, sales and borrowings occurring after 1987 may be deducted on a current basis to the extent that they may reasonably be considered to relate solely to the taxation year: a stand-by charge, a guarantee fee, a registrar fee, a transfer agent fee, a filing fee, a service fee or any similar fee. These amounts must be incurred: (1) for the purpose of borrowing money to be used by the taxpayer for the purpose of earning income from a business or property, except money used for the purpose of acquiring property the income from which would be exempt; (2) in the course of incurring indebtedness that is an amount payable to acquire property for the purpose of gaining or producing income from the property or from a business, except property that is an interest in a life insurance policy or property the income from which would be exempt; or (3) for the purpose of restructuring, rescheduling or assuming a debt obligation, provided the debt obligation is in respect of a borrowing of money described in (1) or in respect of an amount payable for property described in (2). Where the expenses are incurred in the course of a rescheduling or a restructuring, the rescheduling or a restructuring must provide for the modification of the terms or conditions of the debt obligation, its conversion to a share or other debt obligation, or its substitution with a share or another debt obligation.

Specifically excluded from the ambit of paragraph 20(1)(e.1) are the following amounts paid in respect of loans containing a participating feature: (1) payments contingent or dependent upon the use or production from property; (2) payments computed by reference to revenue, profit, cash-flow, commodity price or any other similar criterion; or (3) payments computed by reference to dividends paid or payable to shareholders of any class of shares of a corporation.

### ***Interaction of Paragraphs 20(1)(e) and 20(1)(e.1)***

The CRA has adopted a position that expenses that relate to a year or years other than the year in which they are payable are deductible in accordance with the provisions of paragraph 20(1)(e) rather than paragraph 20(1)(e.1). There was a concern that if paragraph 20(1)(e.1) was given precedence, the portion of the fees relating to subsequent years would not be deductible since it would not be payable in those years. An amount paid in a year, whether or not it relates to the year in which it is paid, or other years, would appear to be governed by both paragraphs 20(1)(e) and (e.1) on their wording. Paragraph 20(1)(e.1) may have otherwise applied to allow a deduction for an amount paid on the portion that related “solely” to the particular year in which it was paid.

### *Annual Basis*

It is the Department's position that a one-time fee related to a loan with a term greater than one year, such as a loan structuring fee or loan placement fee, would generally not "... reasonably be considered to relate solely to the year..." in which the loan was made or the services were provided. The examples considered by the Department as being ordinarily subject to paragraph 20(1)(e.1) include a recurring annual agency fee or commitment fee.

### **20(1)(e.2) - Insurance Premiums**

#### *Treatment Prior to Paragraph 20(1)(e.2)*

One condition frequently demanded of a borrower is that during the period for which a loan is to be outstanding, an insurance policy on the life of the managing executive of the borrower must be obtained and assigned to the lender as collateral security. Where a taxpayer is required as part of a financing arrangement to provide life insurance as collateral security, the CRA traditionally allowed the taxpayer to deduct the insurance premiums as a cost of borrowing money provided that the policy (1) was for term insurance only, (2) the amount of insurance was reasonable in relation to the amount borrowed, and (3) the other conditions of subparagraph 20(1)(e)(ii) were satisfied. However, the Federal Court of Appeal in Antoine Guertin suggested that all life insurance premiums may not be deductible in computing income, even where the policy was obtained as collateral for a loan.

Whether the premiums paid by the borrower on such life insurance policies could be regarded as an expense "incurred in the course of borrowing money" for the purposes of paragraph 20(1)(e) was considered in The Queen v. Antoine Guertin Ltée, [1988] 1 C.T.C. 360 (F.C.A.). The Federal Court of Appeal concluded that whole life premiums are clearly not deductible under paragraph 20(1)(e). The Federal Court - Trial Division allowed as a deduction, a portion of the whole life premiums paid with respect to a policy required as collateral by the borrower to secure a bank loan, that were attributable to the cost of the term coverage portion of the policy. The Trial Division held that a portion of the premiums paid on a whole life policy could be deducted, to the extent that the amount claimed was equal to the cost of the insurance corresponding to the principal amount of the loan outstanding. The Court of Appeal rejected the Trial Division's interpretation and the CRA's prior position on this issue.

The reasoning in Antoine Guertin was confirmed by the Tax Court of Canada in Elirpa Construction and Materials Ltd. v. The Queen, [1995] 2 C.T.C. 2968D (T.C.C.) with respect to the denial of a deduction of a portion of insurance premiums where the policy was whole life in nature, as opposed to term. In that particular

case, the insurance premiums were paid in the 1989 year, prior to the application date of subsection 20(1)(e.2).

### *Current Provision*

Paragraph 20(1)(e.2) was enacted, applicable with respect to premiums payable after 1989, to “counter” the decision in Antoine Guertin and to confirm, with some modifications, the administrative practice indicated in former IT-309R. It was the CRA’s position that the annual premiums on a term life insurance policy were regarded as “a similar fee” for purposes of paragraph 20(1)(e.1). Where the policy is assigned to the lender as required collateral security in a loan, premiums may be deductible to the extent previously allowed in former IT-309R. Prior to the enactment of paragraph 20(1)(e.2), where the CRA allowed a deduction (for term insurance premiums), it did not generally require that the amount claimed as a deduction be reduced to reflect a reduction in the principal outstanding except where a major variation in the loan balance occurred.

In order for premiums to be eligible for deduction under paragraph 20(1)(e.2), the following conditions must be satisfied:

- (1) the life insurance policy must be assigned as collateral for a loan;
- (2) the assignment must be required by the lender;
- (3) the lender must be a “restricted financial institution” - that is, a bank, a trust company, a credit union, an insurance corporation, a corporation whose principal business is lending money to, or purchasing debt obligations from, persons with whom it deals at arm’s length, or a corporation controlled by one of the aforementioned entities (subsection 248(1)); and
- (4) the interest payable on the money borrowed must be deductible in computing the borrower’s income, or would be deductible but for the provisions of subsections 18(2), (3.1) or sections 21 or 28.

The amount deductible in respect of eligible premiums is limited to the lesser of the premiums payable under the policy in respect of the year and the net cost of pure insurance in respect of the policy for the same period. The net cost of pure insurance is determined in accordance with Regulation 308 of the Income Tax Regulations by reference to standard mortality assumptions. Basically, Regulation 308 estimates the cost of pure insurance coverage under the policy for the year. When a policy has a saving component or some form of prefunding, the deduction may be limited by the “net cost of pure insurance”. A deduction, within these limits, will be available regardless of whether the policy is for whole life

insurance or term insurance. No deduction is available, however, for premiums paid on a disability insurance policy.

The taxpayer seeking the deduction must also be the policyholder for the premiums to be considered to be “payable by the taxpayer under a life insurance policy” and deductible under paragraph 20(1)(e.2). It is not necessary that a policy be taken out at the time of borrowing; the assignment of an existing policy is acceptable, provided that a formal assignment is actually carried out. In Quantz v. R., [2003] 1 C.T.C. 2714 (T.C.C.), the taxpayer was denied the deduction in respect of an existing policy because there was no evidence that, on his death, the insurer would be obligated to pay the proceeds of the policy to a financial institution, rather than to the named beneficiary. It was not sufficient for a lending institution merely to have assured itself that the taxpayer was adequately insured, as a condition of making the loan.

### *Proration*

If the borrower’s taxation year does not correspond to the policy year, the premiums should be pro-rated on a reasonable basis to the taxation year. The net cost of pure insurance, which is determined by the insurer on a calendar year basis, also should be pro-rated on a reasonable basis to the taxation year.

### *Relation to Amount Owing*

After the maximum deduction in respect of life insurance premiums has been determined, as described above, the amount deductible is further limited to the portion of the amount that may reasonably be considered to relate to the amount owing from time to time during the year under the loan for which the policy has been assigned as collateral. According to the example given in paragraph 2 of Interpretation Bulletin IT-309R2, where the insurance coverage is \$500,000 and the average balance owing under the loan during the year is \$200,000, the amount deductible will be limited to 40% of the lesser of the premiums payable and the net cost of pure insurance for the policy in respect of the year. However, the specific terms of paragraph 20(1)(e.2) do not explicitly reduce the amount of the deduction where the insurance coverage exceeds the loan balance.

The words “as can reasonably be considered to relate to the amount owing from time to time during the year” serves to limit the deductible amount to the portion of the premium that rationally may be regarded as bearing a relationship to the amount of the borrower. It may be that a restricted financial institution, in accordance with industry practice, requires that other assets be pledged as collateral for a loan such that the total value of the collateral exceeds the loan balance. In these cases, a deduction under paragraph 20(1)(e.2) will usually not be denied unless it is

clear that the lender has made the life insurance requirements simply to accommodate the taxpayer. Therefore, deduction for the full amount of the premiums is generally available provided the insurance coverage does not exceed the maximum amount of the loan outstanding during the year.

The CRA takes the position that, for the purposes of determining whether the deductible amount can reasonably be considered to relate to the amount owing, the institution to which the amount is owing must be the same institution as under the original borrowing. Where the financial institution has assigned its rights under the original loan agreement to a securitization vehicle, the taxpayer may be unable to deduct the premiums under paragraph 20(1)(e.2), unless there continues to be an amount owing by the taxpayer to the original financial institution under the original borrowing. The CRA regards this determination as a question of fact. The CRA takes the position that the taxpayer must make sufficient enquires to ensure that, where life insurance is used as collateral for a loan, the amount borrowed continues to be owed under the original borrowing to the original financial institution.

It is the CRA's position that an unused line of credit, even if it is subject to a stand-by charge or commitment fee, is not an amount owing in determining the portion that "can reasonably be considered to relate to the amount owing from time to time during the year" under the debt obligation.

The fact that the face value of insurance coverage plus the total realizable value of all other collateral exceeds the loan balance raises an issue as to whether the assignment of the insurance policy was "required" by the lender. There must be a genuine requirement to provide the specified amount of collateral insurance. It is not enough that the lender simply accept an assignment of insurance where none has been requested; that the borrower offers the insurance without a formal demand; or that the terms and conditions of the borrowing remain intact and unaltered when the lender has formally requested an assignment without the actual assignment being effected or any other similar circumstance.

### **18(9.1) - Penalties, Bonuses and Rate-Reduction Payments**

Until the introduction of new subsection 18(9.1), the Act contained no provision allowing a deduction for a penalty or bonus paid by a taxpayer on the repayment of a debt before maturity, or for a payment made to obtain a reduction in the interest rate on a debt obligation. Subsection 18(9.1) was introduced to deem such a payment to be interest, if paid after 1984, thereby rendering them deductible for the borrower, provided that certain conditions are satisfied. For the recipient, these payments are interest income if paid after July 12, 1990 (other than for a financial institution, as under subsection 142.4(10) they are considered proceeds of disposition).

In order to be characterized as interest under subsection 18(9.1), the rate reduction or early retirement payment must be made in the course of carrying on a business or earning income from property and must be in respect of borrowed money used in the course of such activity or an unpaid balance of the purchase price in respect of property used for such purpose. The deduction will be available to the extent that the payment relates to and does not exceed the value, at the time that it was made, of interest that would otherwise have been paid or payable by the taxpayer in future years as interest on the debt obligation. If it satisfies these tests, the amount is deemed, for all purposes of the Act, to be interest paid by the borrower and received by the lender. This may have withholding tax implications. If the amount paid exceeds the present value of the future interest payments that are eliminated as a result of the payment, it appears that the excess will not be deductible.

A penalty or bonus paid by a borrower to a lender to retire a loan prior to its maturity date is not deductible under paragraphs 20(1)(e) or (e.1), since the expense is not incurred in the course of, or related to, borrowing money or an amount payable, but rather it is incurred in the course of, or related to, repaying money borrowed or an amount payable.

Once an amount is deemed to be interest under subsection 18(9.1), its deductibility will be governed by the general rules of paragraph 20(1)(c). Pursuant to paragraph 18(9.1)(f), the deemed interest amount is further deemed to be paid or payable pursuant to a legal obligation to pay interest. This enables one of the tests imposed by paragraph 20(1)(c) to be satisfied. Paragraph 18(9.1)(f) also deals with the purpose test imposed by paragraph 20(1)(c).

### *Timing of Deduction*

Where a payment made to obtain a reduction from the rate of interest satisfies the aforementioned requirements, it appears that the amount payable will be deductible over the remaining term of the obligation. This also appears to be the case where a bonus or penalty has been paid in connection with the partial prepayment of principal. However, the timing issue is less clear in the case of a penalty or bonus paid for early retirement of the full principal of the debt since there is no longer any outstanding amount. The intention of subsection 18(9.1) seems to require that the deduction of the penalty or bonus be spread over what would have been the remaining term of the obligation. The provision deems the payment to be interest only to the extent that it relates to interest that would have been payable by the taxpayer for a subsequent taxation year. The CRA considers the penalty or bonus payment made by the borrower to be compensation required by the lender for interest foregone over the entire term of the obligation and that it should be deducted on either a straight line, or present value basis over the period in which

the obligation is outstanding or would have remained outstanding but for the prepayment.

*Exclusions*

Specifically excluded from the ambit of subsection 18(9.1) is any fee, penalty or bonus that may reasonably be considered to have been paid for the extension of the term of the debt obligation or as consideration for the substitution or the conversion of a debt obligation into another debt or into a share. These are the types of expenses to which, as discussed above, subparagraph 20(1)(e)(ii.2) may apply. Also excluded is any fee, penalty or bonus that is contingent upon the use or production of property or as computed by reference to revenue, profit, cash flow, commodity price or any similar criterion or by reference to any dividends paid or payable on any class of shares of a corporation.

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