

TaxTalk

CASES OF INTEREST

In recent years, the courts have rendered several decisions with respect to cases dealing with interest expense. Certain decisions of the courts have been contrary to the assessing policy of the Canada Revenue Agency (CRA). In response, the CRA has issued an interpretation bulletin outlining their new policies based on the recent jurisprudence. In addition, the Department of Finance (Finance) introduced new draft legislation that could apply to interest expense. This TaxTalk discusses three of these tax cases as well as the responses from the CRA and Finance with respect to the deductibility of interest.

CONTENTS

Deductions Permitted Under the Income Tax Act	1
Three Cases of Interest.....	2
CRA's New Interpretation Bulletin	3
Finance's Draft Legislation.....	5
Summary	6

Deductions Permitted Under the Income Tax Act

Subsection 20(1) Deductions Permitted in Computing Income From Business or Property

In the *Ludco*¹ and *Singleton*² cases, the CRA disallowed the interest expense claimed by the taxpayers with respect to interest paid on funds borrowed for investment purposes. The specific section of the Income Tax Act (the Act) subject to interpretation was subparagraph 20(1)(c)(i).

¹ *Ludco Enterprises Ltd.*, Brian Ludmer, David Ludmer, and Cindy Ludmer v. the Queen, 2001 SCC 62

² The Queen v. *John R. Singleton*, 2001 SCC 61

In accordance with subparagraph 20(1)(c)(i) of the Act, four elements³ must be present before interest can be deducted, namely:

- 1) The amount must be paid in the year or be payable in the year in which it is sought to be deducted;
- 2) The amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
- 3) The borrowed money must be used for the purpose of earning non-exempt (i.e., taxable) income from a business or property; and
- 4) The amount must be reasonable, as assessed by reference to the first three requirements above.

In the *Ludco* case, the issues in question were whether the funds borrowed were for the purpose of earning income, and whether the interest amount was reasonable. In the *Singleton* case, the issue in dispute was strictly whether the funds borrowed were for the purpose of earning income.

Subsection 8(1) Deductions Permitted in Computing Income from an Office or Employment

In *Gifford*⁴, the question differed. As an employee, Gifford was limited to deductions for expenses incurred to earn employment income as permitted under subsection 8(1) of the Act. With respect to the interest expense, the court examined whether paragraph 8(1)(f) of the Act allowed Gifford, as a commissioned sales person, to deduct the interest paid.

³ These four elements were established in *Shell Canada Ltd. v. the Queen*, [1999] 3 S.C.R. 622

⁴ *Thomas Gifford v. the Queen*, 2004 SCC 15

Three Cases of Interest

The Ludco Case

The taxpayers borrowed money at an interest rate of 10% in 1977 to acquire shares in two Panamanian companies. From 1977 to 1985, the taxpayer incurred and deducted interest of \$6 million. Dividends earned on the shares during the same period were \$600,000, far less than the interest expense. The taxpayers sold their shares in 1985 and reported a capital gain of approximately \$9,240,000 on the sale.

The CRA disallowed the interest deductions on reassessments of the 1981 to 1985 taxation years, arguing that the taxpayers were not entitled to deduct the interest. The CRA's rationale was that the taxpayers could not have borrowed funds **for the purpose of earning income** as contemplated in subparagraph 20(1)(c)(i) of the Act, since the cost of borrowing the funds to acquire the shares far exceeded the income⁵ received.

The Tax Court of Canada upheld the CRA reassessments to deny the interest deductions. The taxpayers appealed to the Federal Court - Trial Division where the court dismissed the appeal. The taxpayers then appealed to the Federal Court of Appeal, which also dismissed the appeal. The taxpayers finally appealed to the Supreme Court of Canada.⁶

Supreme Court of Canada (SCC) Decision

The SCC examined the two issues:

- (i) Was the borrowed money used for the purpose of earning non-exempt (i.e., taxable) income from a business or property?
- (ii) Was the amount reasonable?

The SCC concluded that the term "income" in subparagraph 20(1)(c)(i) does not refer to **net** income (in this case, there was a net loss of \$5.4 million), but to "income subject to tax". The SCC also indicated that the amount of income expected or received is not an issue, unless there is "a sham or window dressing".

⁵ Pursuant to subsection 9(3) of the Act, capital gains may **not** be taken into account when determining income from a property.

⁶ In general, the Supreme Court of Canada (SCC) will only hear cases that are viewed to be of national importance. Many tax cases are not heard by the SCC.

The SCC determined that the taxpayers had made a "genuine investment" by acquiring the shares of the Panamanian companies and the dividends were bona fide receipts of income and did not constitute "window dressing".

In addressing the second issue, the SCC considered the reasonableness of the interest rate charged rather than the reasonableness of the expense (\$6 million) in relation to the dividend income (\$600,000). It determined that since the interest rate on the loan was set between arm's length parties at rates that exceeded the prime rate by only $\frac{3}{4}$ to 1 percent, the interest paid was reasonable.

The SCC concluded that the interest was deductible, thereby reversing the lower court rulings, and **setting a precedent to be followed in other cases**.

The Singleton Case

The taxpayer, a partner in a law firm, withdrew \$300,000 in equity from the practice to acquire a personal residence. On the same day, he borrowed funds from the bank and refinanced his capital account in the practice. The taxpayer claimed interest expense in 1988 and 1989 on the borrowed funds.

The CRA disallowed the interest deductions, arguing that the taxpayer had, in essence, acquired a personal residence with the borrowed funds, and as such the funds had not been used for an income earning purpose.

The Tax Court of Canada agreed with the CRA, dismissing the taxpayer's appeal. The taxpayer then appealed to the Federal Court of Appeal (FCA), which overturned the lower Court's decision to allow the interest deductions. The FCA found that the **direct** use of the funds was to refinance the taxpayer's capital account in the partnership and, therefore, the interest expense was deductible as a valid business expense.

In the FCA's view, the issue was whether the separate transactions undertaken by Mr. Singleton should be treated as independent transactions or as one transaction. The FCA held that the withdrawal of funds from the partnership to acquire the house and the borrowing to replenish the capital account should be considered independently. The CRA appealed to the Supreme Court of Canada.

Supreme Court of Canada (SCC) Decision

The SCC agreed with the FCA. The SCC reasoned that the **direct use** of the borrowed funds was to replenish the taxpayer's capital account in the law firm. Therefore, the funds were borrowed for the purpose of earning income and hence the interest expense was deductible.

The fact that the taxpayer had previously withdrawn funds from his capital account to acquire a home was not relevant in determining the direct use of the borrowed funds. In the absence of "a sham or window dressing", the SCC indicated that one cannot ignore the legal relationship of the transactions.

The Gifford Case

Gifford, a commissioned sales person (employee) paid \$100,000 to a co-worker for a client list, borrowing funds to facilitate the acquisition. Gifford deducted depreciation for the cost of the client list, as well as the interest paid on the borrowed funds. The CRA disallowed the deductions, and Gifford appealed to the courts.

The Tax Court of Canada (TCC) decided that the client list was a marketing expense with no enduring benefit, and allowed the full \$100,000 as a current deduction. Based on the finding that the acquisition was current in nature, the TCC also concluded that the interest was not on account of capital, and as such was deductible under paragraph 8(1)(f) of the Act. The CRA appealed the decision to the Federal Court of Appeal (FCA).

The FCA (reversing the TCC's decision) determined, based on previous jurisprudence, that a client list is not a current expense, but rather is eligible capital property to the purchaser. As such, it disallowed Gifford a deduction under subparagraph 8(1)(f)(v) of the Act, which specifically denies an employee a deduction for "outlays, losses or replacements of capital or on account of capital" unless the amount is in relation to a motor vehicle or aircraft to the extent used for work.

Having determined that the acquisition of the client list was on account of capital, the FCA, influenced by previous decisions of the SCC with respect to interest expense, ruled that the interest expense was also on account of capital and, therefore, not deductible under subparagraph 8(1)(f)(v) of the Act.

Despite its denial of interest, the FCA continued its analysis of the nature of interest (i.e., is it a capital expense or a current expense?) by examining the provisions of the Income Tax Act, and the inherent nature of interest. The FCA concluded that **if** the SCC could rule that interest was not always a capital expenditure in nature, the FCA would determine in the case of Gifford that the interest was a current expense and therefore deductible.

Supreme Court of Canada (SCC) Decision

Gifford appealed to the Supreme Court of Canada. The SCC held that the acquisition of the client list by Gifford was not deductible, but rather was an eligible capital expenditure⁷. As an employee, Gifford was not entitled to a deduction for the acquisition of capital property (with the exception of a motor vehicle or aircraft).

In its judgment, the SCC debated the treatment of the interest payments and concluded when a loan adds to the financial capital of the borrower any interest paid on the loan will be considered a payment "on account of capital". The decision indicates that there could be circumstances where the proceeds from borrowing would be considered inventory, such as for moneylenders.

Unfortunately, the SCC did not go on to provide clear guidelines to determine under which circumstances (beyond moneylenders) interest would not be considered to be "on account of capital". The SCC decision in *Gifford* appears to provide more ambiguity rather than a framework to determine the nature of interest - i.e., whether the expenditure is a current expense or on account of capital and thus only deductible under specific provisions of the Act such as paragraph 20(1)(c).

CRA's New Interpretation Bulletin on Interest

As the discussion of the cases indicates, the CRA suffered two severe losses in the *Ludco* and *Singleton* cases and tax practitioners anticipated a response from the CRA with respect to these losses.

⁷ Following the SCC decision in *Gifford* where the taxpayer lost, many financial institutions have changed their transfer procedures when a client list is passed on from one employee to another, such that the former employee may continue to receive commissions for the transferred clients' transactions.

On October 31, 2003, the CRA released Interpretation Bulletin IT-533 Interest Deductibility and Related Issues. The bulletin was issued in response to the three SCC court decisions, two of which were favourable to the taxpayer.

In IT-533, the CRA discusses the general concept of the deductibility of interest expense based on the Act and jurisprudence. The following points are included in the discussion:

- Interest expense is deductible if the loan proceeds are used for the purpose of earning income from a business or property (income does not include capital gains). Interest expense is **not deductible** if the borrowed funds are used to acquire personal use property or property for the purposes of earning income exempt from income tax.
- It is the **direct use** of the funds that will determine the deductibility of the interest expense, i.e., the direct use must be for an eligible purpose.
- Borrowings may be restructured to meet the direct use test (*Singleton* decision).
- If the original property acquired is replaced with a new property, it is the current use which determines if the interest expense is deductible (i.e., the new property must be used to earn income from a business or property).
- Incoming funds may be segregated (perhaps into separate accounts); funds such as revenues may be used for outlays where an interest expense deduction may be denied if funds were borrowed, while the borrowed funds may be used for expenditures for which the interest expense will be considered deductible.
- If funds are co-mingled, the CRA will allow the taxpayer to choose which expenditures are considered to have been financed by the borrowed funds, i.e., to link⁸ the borrowing to a use for which the interest expense can be deducted.
- If a note is issued to redeem shares, to the extent the redemption is considered “paid” from the retained earnings of the corporation, the interest expense will be deductible, however, interest expense on a note payable issued to pay a dividend or return capital will

⁸ The “linking” concept is more flexible than the “direct use” test and potentially more favourable to allow taxpayers to deduct interest expense.

not be deductible since the corporation did not acquire any property.⁹

- The expected income to be earned from the property acquired with the borrowed funds does not need to exceed the interest cost of borrowing for the interest to be deductible; it is sufficient that there is an expectation of income for the interest to be deductible (*Ludco* decision).
- If an amount is refinanced, interest paid on the new debt will be deductible to the extent interest was deductible on the original debt.

The CRA then lists certain exceptions to the direct use test¹⁰, i.e., situations where interest could be deductible even if the direct use test was not met:

- If borrowed funds are used to replace contributed capital or accumulated profits, such as the payment of dividends to shareholders out of retained earnings or a return of partnership capital to a partner, the funds are considered to be “filling the hole” of capital and the interest would be considered deductible.
- Interest on borrowed funds used to make a loan to a corporation at no interest (or to honour a guarantee) may be deducted where:
 - the shareholders of the corporation make interest-free loans (or honour guarantees) in proportion to their shareholdings, **and**
 - the loan proceeds are expected to contribute to the corporation’s ability to earn income, which has the potential to be returned to the shareholders in the form of dividends.
- Interest on borrowed funds advanced to employees is deductible, however, if the funds are advanced to an employee in his/her capacity as a shareholder, the interest would **not** be deductible.

⁹ Subparagraph 20(1)(c)(ii) requires that the borrowed funds be used to acquire property for the interest to be deductible.

¹⁰ As discussed in *Singleton*, if the direct use of borrowed funds is for the purpose of earning income, then the interest would be deductible.

Finance's Draft Legislation

On October 31, 2003, in coordination with the CRA's release of IT-533, Finance simultaneously released new draft legislation, which is proposed to come into effect for taxation years **commencing after 2004**. The draft legislation relates to the *reasonable expectation of profit* (REOP) doctrine and proposes that losses from a particular business or property may only be deducted if it is reasonable to expect that the taxpayer will realize a cumulative profit (excluding capital gains) from the business or property.

The implications of the draft legislation are onerous:

- It will mitigate the impact of the *Ludco* decision where the SCC determined that a source of income is based on gross, not net income, and that the expected revenue does not need to exceed the expected interest expense for the expense to be deductible.
- The proposals counter the SCC's decisions in the *Stewart* and *Walls* cases¹¹ regarding the notion of a reasonable expectation of profit in determining if a loss from a business or property is deductible.

Moreover, the draft legislation is contrary to the CRA's administrative position expressed in IT-533, where it is stated, based on the *Ludco* decision, that only a source of income must exist and the amount of income does not necessarily need to exceed the interest cost for the interest to be deductible.

- The proposals apply not only to income from a business or property, but also to income from an office or employment and allowable business investment losses.
- The proposals are not just limited to losses occurring due to a claim of interest expense; they are to apply to any expense, which create or increase a loss.
- The determination of a reasonable expectation of profit (REOP) must be made annually. For example, if:
 1. in Year 1, a taxpayer acquires a business (or some real estate with the expectation to sell at a profit, i.e., on account of income),

2. late in Year 4, due to a depression in the market, the value of the business (or property) plummets, and
3. early in Year 5, the taxpayer decides "cut his losses" and sell, realizing a substantial loss,

the proposed legislation appears to deny the deduction of the losses, which may arise on the termination/cessation of the business in Year 5.

The denial of the loss would occur because the taxpayer no longer has a REOP in the year of the loss, despite the fact that the taxpayer had a reasonable expectation of profit at the time of commencement of the business (or acquisition of the property); and in each year preceding Year 5.

In effect, the taxpayer may be punished for an unforeseen down turn of events.

- The proposals do not provide for the application of the denied losses against income (from that source) in a prior year or a future year.
 - The test is cumulative, i.e., one must take into account all income and losses from inception when determining if there is a reasonable expectation of a cumulative profit from a particular source for the period of expected ownership. Profit, for the purposes of the test, will **not** include capital gains or losses.
- This cumulative test does not match the general economics underlying business decisions which consider the viability of a venture on a "long-term" go-forward basis, i.e., past expenditures, which resulted in losses, are a "sunk cost" and not determinative of future profitability.
- There is no grandfathering provision to provide relief to existing income sources. As proposed, the draft legislation will apply to losses arising from all sources of income for taxation years commencing after 2004.
 - The draft legislation seems to preclude an investor from claiming an interest deduction when borrowed funds are used to acquire common shares. Although IT-533 appears to support the deduction of interest when common shares are acquired with borrowed funds, this proposed legislation may deny such a deduction.
 - If enacted without changes, the draft legislation increases the risk of speculative ventures, which may deter entrepreneurs and investors.

¹¹ Discussed in TaxTalk 2002 Issue 3, "Tax Matters of Note".

Summary

Over the past few years, certain taxpayers have successfully argued the deductibility of interest expense in the courts. The CRA has accepted the courts' decisions in various cases regarding interest deductibility and has amended its administrative policies to reflect the courts' decisions in its release of IT-533.

However, the CRA and Finance have taken exception to the SCC's decisions in *Ludco*, as well as earlier decisions regarding the reasonable expectation of profit (*Stewart* and *Walls*). The result: draft proposals to allow losses only in circumstances where a reasonable expectation of profit exists.

The SCC's examination of the *Gifford* case did not provide clear guidance regarding the nature of interest – the age-old debate will continue.

* * * * *

This was to be a 'good news' TaxTalk regarding interest expense, discussing taxpayer victories at the Supreme Court of Canada and the favourable administrative positions announced in the CRA's IT-533 Interest Deductibility and Related Issues.

The good news has become muted after Finance 'dropped' their 'bomb' with respect to reasonable expectation of profit (REOP). The introduction of draft legislation by Finance seems to contradict the administrative policy of the CRA with respect to interest expense. If Finance's proposals are enacted as drafted, a greater level of uncertainty and confusion will be introduced into tax planning. The proposals could allow the CRA to second guess taxpayer investment decisions after the fact, something which the courts have explicitly frowned upon.

The tax planning community has voiced concern over the broad application of the draft REOP legislation to deny losses and expenses.

The draft REOP legislation is to come into effect for taxation years commencing after 2004. As the end of the year approaches, one can hope that Finance will heed the representations of the tax planning community and redraft their proposals regarding REOP to ensure that the new legislation is more in tune with economic reality and will not adversely impact the decisions of businesses and investors.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices 10 Bay Street, Suite 900
(Bay Street and Queen's Quay)
Toronto, Ontario M5J 2R8
Phone: 416-362-0515
Fax: 416-362-0539

8501 Mississauga Road, Suite 100
(Steeles Avenue and Mississauga Road)
Brampton, Ontario L6Y 5G8
Phone: 905-451-4788
Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com)
www.mgca.com.

Please visit our website at