The Joint Committee on Taxation of
The Canadian Bar Association and
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August 6, 2002

Mr. Brian Darling
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Dear Mr. Darling:

Re: Interpretation Bulletins IT-80 and IT-315

We are pleased to provide submissions regarding Interpretation Bulletins IT-80 and IT-315 in connection with your review of administrative positions on interest deductibility. These submissions review the relevant caselaw and conclude that these bulletins are supportable under current jurisprudence. Further to our discussions, we understand that these are the only areas in which submissions would be useful at this time. Please let us know if we can provide further input.

As the purpose of these submissions is to provide input on the current state of the law in respect of IT-80 and IT-315, it is beyond the scope of these submissions to discuss whether they are appropriate in policy terms. Accordingly, the submissions should not be interpreted as an indication of the views of the Joint Committee on policy issues. In addition, it is possible that future jurisprudence in this area might support a more generous interest deduction than is provided in IT-80. We have restricted our submission to our assessment of the current jurisprudence and have not speculated as to future developments.

We are providing a copy of these submissions to Mr. Brian Ernewein for his information. Although we have not had discussions with the Department of Finance regarding this matter, the Department has expressed an interest in knowing the Joint Committee's views.

We appreciate the opportunity of being part of the consultative process on this project and look forward to discussing other matters with the CCRA in future. We look forward to hearing the results of the review in September at the Annual Conference of the Canadian Tax Foundation.

Yours truly,

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Sandra E. Jack
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cc: Mr. Roy Shultis
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INTERPRETATION BULLETIN IT-80

I. SUBMISSION

We respectfully submit that Interpretation Bulletin IT-80 is supportable under current caselaw and should continue to apply.

II. DISCUSSION

A. *Interpretation Bulletin IT-80*

Interpretation Bulletin IT-80 deals with interest deductibility on borrowed money used to redeem shares or to pay dividends. It was issued on November 27, 1972.

Borrowed Money used to Redeem Shares

Paragraph 2 of the Bulletin points out that, because one of the requirements of paragraph 20(1)(c) is that the borrowed money must have been used for the purpose of earning income from a business or property, there is an issue whether borrowed money can be said to be used to earn income from a business where it is paid out to the shareholders on the redemption of their shares. The Bulletin notes that, in *Trans-Prairie Pipelines*, it was held that, where borrowed money is used to redeem shares, the borrowed money replaces the money that was originally obtained through the issuance of the shares. On this basis, the Court held that interest is deductible if the borrowed money is considered to replace money that was used to earn income from a business. The Bulletin states that the Department accepts this decision.

Borrowed Money used to Pay Dividends

With respect to the payment of dividends, the Bulletin states that it is the Department's policy that interest is deductible where borrowed money is used to pay dividends, unless a substantial portion of the accumulated profits of the corporation has (a) not been used for the purpose of earning income, (b) been used to acquire property the income from which is exempt, or (c) been used to acquire a life insurance policy. The Bulletin states that this policy equates a corporation that used profits for expansion and then is required to borrow money to pay dividends with one that paid dividends out of profits and then is required to borrow to finance expansion.

B. *Trans-Prairie Pipelines*

Prior to *Bronfman Trust*, the leading case in this area was *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 D.T.C. 6351 (Ex. Ct.). In that case, the taxpayer was a corporation that was in the business of building and operating pipelines. It was initially capitalized by way of common and preferred shares. It needed additional funds for expansion, but the sinking fund requirements of the preferred shares made it practically speaking impossible to float a bond issue. Accordingly, the taxpayer raised new money by issuing additional common shares and borrowing under a bond issue. A portion of the money so raised was used to redeem the preferred shares and the balance was used for expansion.

The issue was whether interest on the bonds was deductible to the extent that the borrowed money was used to redeem the preferred shares and, in particular, whether the borrowed money was used for the purpose of earning income from the taxpayer's business.

President Jackett held that the correct appreciation of the matter was that, prior to the transactions, the capital used in the taxpayer's business was the amount subscribed by the preferred and common shareholders. After the transactions, the money subscribed by the preferred shareholders was withdrawn and the taxpayer used in its business the amount subscribed by the common shareholders and the borrowed money under the bonds.

In the view of President Jackett, the whole of the borrowed money was used for the purpose of earning income from the business even though, from another point of view, and in a different sense, some of the money was paid for the redemption of the preferred shares. In his view the test for deductibility should not depend upon whether the first use of the money is for the purpose of the business. In his view, the words should be given their "ordinary sense" of "interest on borrowed capital."

He then said:

> Surely, what must have been intended by section [20(1)(c)] was that the interest should be deductible for the years in which the borrowed capital was employed in the business rather than that it should be deductible for the life of a loan as long as its first use was in the business.
>
> The facts of the present appeal provide an even more striking illustration of the inappropriateness of the meaning of the words "money used for the purpose of earning income from a business" that is relied on by the respondent. Prior to the 1956 transactions, the appellant's capital used in its business consisted in part of $700,000 subscribed by preferred shareholders. As a result of those transactions, the $700,000 had been repaid to those shareholders and the appellant had borrowed $700,000 which, as a practical matter of business common sense, went to fill the hole left by redemption of the $700,000 preferred.

The "fill the hole" theory has been discussed in many of the subsequent cases.

C. <u>*Bronfman Trust*</u>

In *The Queen v. Phyllis Barbara Bronfman Trust*, 87 D.T.C. 5059 (Supreme Court of Canada) the taxpayer was a trust all the assets of which were held for investment purposes. The trust's strategy was focussed primarily on capital appreciation rather than income. The trustees determined to make a capital distribution to the beneficiary and, rather than liquidate investments in order to fund the capital allocation, the trust 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 an eligible income-producing purpose. Chief Justice Dickson made a number of comments:

1. Paragraph 20(1)(c) requires a characterization of the use of borrowed money as between the eligible use of earning non-exempt income from a business or property and a variety of possible ineligible uses. The onus is on the taxpayer to trace the borrowed funds to an eligible use.

2. It is the current use rather than the original use of borrowed funds which is relevant. If a taxpayer initially uses borrowed money for an ineligible purpose and later uses the funds for an eligible purpose, the interest should become deductible, subject to the limitation that the borrowed funds must still be in the hands of the taxpayer, as traced through the proceeds of disposition of the preceding ineligible use. Where the taxpayer uses borrowed money for an ineligible use and receives nothing in return, the borrowed money cannot be available to the taxpayer for subsequent use, whether eligible or ineligible. In *Bronfman Trust*, the borrowed money was originally used to make capital allocations to the beneficiary for which the trust received no property or consideration of any kind. Accordingly, the interest was not deductible because the use of the borrowed money was not of an income-earning nature.

3. The courts cannot ignore the direct use of borrowed money. Subsection 20(3) of the Act supports this view because it provides that interest on money borrowed to repay an existing loan is deemed to have been used for the purpose for which the previous borrowings were used. This provision would be unnecessary if interest on borrowed money were deductible on the basis of the indirect use of preserving income-earning properties. With the exception of *Trans-Prairie*, the jurisprudence has generally been hostile to claims based on indirect, eligible uses when faced with direct but ineligible uses of borrowed money.

4. There may be "exceptional circumstances" where interest may be deductible even where there is an ineligible use:

> Even if there are exceptional circumstances in which, on a real appreciation of a taxpayer's transactions, it might be appropriate to allow the taxpayer to deduct interest on funds borrowed for an ineligible use because of an indirect effect on the taxpayer's income-earning capacity, I am satisfied that those circumstances are not presented in the case before us. It seems to me that, at the very least, the taxpayer must satisfy the Court that his or her *bona fide* purpose in using the funds was to earn income. In contrast to what appears to be the case in *Trans-Prairie*, the facts in the present case fall far short of such a showing. ….The taxpayer cannot point to any reasonable expectation that the income yield from the trust's investment portfolio as a whole, or indeed from any single asset, would exceed the interest payable on a like amount of debt.

Although *Bronfman Trust* did not specifically overrule *Trans-Prairie*, the reasoning of the Supreme Court of Canada suggested that it was an "exceptional circumstance." Accordingly, it was not clear whether the "fill the hole" theory in *Trans-Prairie* was generally applicable to other circumstances or whether the judgment should be restricted to its facts.

Revenue Canada's immediate reaction to the *Bronfman Trust* case was to cancel Interpretation Bulletin IT-80. This created considerable concern in the tax community. In response to this 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 Revenue Canada with respect to the deductibility of interest. As a result, Revenue Canada announced that it would continue its former administrative practice on interest deductibility and Interpretation Bulletin IT-80 was reinstated. The Motion was extended a number of times pending review of the rules on interest deductibility by the Department of Finance.

On December 20, 1991, the Minister of Finance released draft legislation on interest deductibility. This legislation was intended to provide legislative support for the manner in which the *Income Tax Act* was being administered by Revenue Canada prior to the *Bronfman Trust* case. These proposals have not been enacted and Interpretation Bulletin IT-80 remains in force.

D. *Post-Bronfman Trust Caselaw*

While the *Bronfman Trust* case may have initially created some doubt as to the correctness of *Trans-Prairie*, the more recent caselaw supports the "fill the hole" theory and also casts some doubt as to the restrictive interpretation given to paragraph 20(1)(c) in *Bronfman Trust*.

Livingston International
In *Livingston International Inc. v. The Queen*, 91 D.T.C. 5066 (Federal Court – Trial Division); 92 D.T.C. 6197 (Federal Court of Appeal) the issue was the deductibility of interest on money borrowed to redeem shares. In that case, there was an amalgamation of two unrelated Canadian

corporations. On the amalgamation, the shareholders of one of the amalgamating corporations exchanged their old shares for 100 first preference shares of the amalgamated corporation with a par value of $0.25 each and 100,000 second preference shares of the amalgamated corporation with a par value of $0.00075. Through a series of steps, the shareholders transferred their shares to a holding corporation. The amalgamated corporation then borrowed money to redeem the first preference shares. The Minister disallowed interest on the borrowed money to the extent it exceeded the paid-up capital of the redeemed shares and the retained earnings of the amalgamated corporation.

In the Federal Court – Trial Division, the taxpayer argued that the full amount of the interest on the borrowed money was deductible based on *Trans-Prairie*. Mr. Justice Pinard disagreed. He referred to *Bronfman Trust* and said:

> In light of the *Bronfman Trust* decision, it would seem to me that one cannot infer from the *Trans-Prairie* case that interest on borrowed money used to redeem shares is *generally* deductible.
>
> Here, in the context of a series of quasi instantaneous transactions where it cannot really be said that the borrowed funds are used to fill a hole left by the "withdrawal" of funds previously used in the borrower's business, it is rather doubtful that the *Trans-Prairie* reasoning can be applied. *It is in any event clear that the excess of borrowed funds over the retained earnings and the paid up capital of the plaintiff as of August 20, 1979 cannot constitute within the reasoning of Trans-Prairie a replacement of capital which has already been used in the business*. I consider, therefore, that the plaintiff has failed to show that such excess of borrowed funds was used at the relevant time for the purpose of earning income from a business or property, and that the interest paid thereon ought not to be deducted pursuant to subparagraph 20(1)(c)(i) of the Act.
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> [Emphasis added.]

The taxpayer appealed to the Federal Court of Appeal where the lower court decision was upheld. MacGuigan, J.A. said that there may be exceptional circumstances in which it may be appropriate to allow a taxpayer to deduct interest on funds borrowed for an ineligible use because of an indirect effect on its income-earning capacity, but no such exceptional circumstances were present in that case. In this case, therefore, the Minister's reassessment followed IT-80 and this reassessment was upheld.

The *Livingston* decision did not deal directly with the application of the "fill the hole" theory to borrowed money not exceeding retained earnings and capital because the Minister was not challenging this portion of the interest deduction. Nevertheless the reasoning by the trial court appears to support the "fill the hole" theory applied by the Minister. The Federal Court of Appeal gave a brief oral judgment which appears to agree with the reasoning of the lower court.

Chase Manhattan Bank

In *The Chase Manhattan Bank of Canada v. The Queen*, 2000 D.T.C. 6018 (Federal Court of Appeal) 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 bank and used the proceeds to pay a cash dividend from the parent. The cash dividend exceeded the subsidiary's retained earnings at the time.

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. In the Tax Court of Canada (97 D.T.C. 349), Judge McArthur held that the interest was not deductible and *Trans-Prairie* did not apply because the borrowed funds were not used to fill a real "hole" but were instead used to pay a dividend. He pointed out that, in *Bronfman Trust*, the Supreme Court of Canada did not disapprove of *Trans-Prairie*, but it appeared that it would not extend the case beyond what had been allowed to the taxpayer in the present case – i.e., to permit interest deductibility the extent of borrowed money used to pay a dividend out of the taxpayer's retained earnings.

The taxpayer appealed to the Federal Court of Appeal. In the Federal Court of Appeal decision, Noel, J.A. said:

> The Minister disallowed the deduction except for a portion computed by reference to the subsidiary's retained earnings as these stood prior to the payment of the dividend. In allowing the deduction of this portion of the interest, the Minister recognized in effect that *the loan, up to the amount of the retained earnings, served to replenish the working capital of the subsidiary.*
>
> The appellant attempted to convince the Tax Court that the balance of the interest paid on the loan was also deductible based on the reasoning advanced by Jackett, P. in *Trans-Prairie Pipelines Ltd. v. MNR* [1970] C.T.C. 537. McArthur T.C.C.J. denied the appeal.
>
> He found that contrary to the situation in *Trans-Prairie*, it has not been shown in this instance that the loan had been used to fill a "real hole" in the capital requirements of the subsidiary.
>
> The direct use of the borrowed funds was to pay the dividend. As to its alleged indirect use, the evidence indicates that at the time of the borrowing, the capital used in the business was constituted by $39 M. of share capital contributed by the appellant shareholder.

> This amount was not redeemed or cancelled. None of the share capital was converted to debt. *Except to the extent of the retained earnings the borrowing was not a replacement of moneys that had been withdrawn for the business.* While the continued operations of a business after the withdrawal of its working capital suggests that other funds are being used in the conduct of the business, no such inference arises here.
>
> [Emphasis added.]

This is another case where the Minister's reassessment was in accordance with IT-80 and therefore the correctness of IT-80 was not directly at issue. Nevertheless, both the Tax Court and the Federal Court of Appeal appear to accept the "fill the hole" theory in *Trans-Prairie* and suggest that it applies to retained earnings as well as subscription proceeds.

Singleton

In *The Queen v. John R. Singleton,* 2001 D.T.C. 5533 (Supreme Court of Canada), the taxpayer withdrew funds from his capital account in a law partnership of which he was a member. These funds were used to purchase a personal residence. Later the same day, he borrowed approximately the same amount from a bank and paid the funds back to the partnership as a contribution of capital. It was held that the interest from the borrowed money was deductible because the direct use of the borrowed funds was to refinance the taxpayer's capital account at the law partnership.

In the course of his judgment, Major, J. made the following reference to *Trans-Prairie:*

> The fact that the money was borrowed in order to allow the respondent to use his own money to purchase the house is of no moment. The *Shell* decision decided that why the money was borrowed is irrelevant. The fact that money was transferred from the firm to the respondent for the purchase of a residential property has no impact on the application of s. 20(1)(*c*)(i) to the interest incurred on borrowed money which was used directly for the purpose of refinancing the capital, and as such used for the purpose of earning income from the law firm.
>
> As the borrowed money was used to refinance the respondent's capital account in his law firm, the issue arises as to whether such refinancing is a direct, eligible use of the funds within s. 20(1)(*c*)(i) of the Act. Relevant to this is the Exchequer Court of Canada decision in *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 DTC 6351. This case involved a corporate taxpayer refinancing equity with debt. In *Trans-Prairie*, the corporate taxpayer's issued capital consisted of redeemable preferred shares with a par value of $700,000 and common shares. The company

> borrowed $700,000 and used $400,000 of this amount, plus $300,000 obtained by issuing additional common shares, to redeem the preferred shares. In effect, the taxpayer refinanced share equity with debt and deducted the interest on the money borrowed to refinance. In allowing the deduction, the court reasoned that prior to the transaction the taxpayer's capital consisted in part of the $700,000 subscribed by preferred shareholders and "as a practical matter of business common sense, [the $700,000 of borrowed money] went to fill the hole left by the redemption of the $700,000 preferred [shares]" (p. 6354).
>
> In *Bronfman Trust*, it was stated that "[f]airness requires that the same legal principles must apply to all taxpayers, irrespective of their status as natural or artificial persons, unless the Act specifically provides otherwise" (p. 46). As indicated by this statement, *if a corporation can refinance equity with debt and deduct the interest on the associated debt*, so too should the respondent be entitled to refinance his partnership equity with debt and deduct the interest.
>
> [Emphasis added.]

The above comments give approval to the "fill the hole" theory in *Trans-Prairie* and, in particular, the principle that a corporation should be able to refinance equity with debt and deduct the interest on the associated debt.

Penn Ventilator Canada Ltd.

In *Penn Ventilator Canada Ltd. v. The Queen*, 2002 D.T.C. 1498 (Tax Court of Canada), the issue was the deductibility of interest on a promissory note issued on the redemption of shares.

One of the issues was whether *Trans-Prairie* applied. The Crown sought to distinguish *Trans-Prairie* on the grounds that, in the present case, there was no depletion of retained earnings. Judge Lamarre Proulx disagreed. She pointed out that the Crown's position seemed to be contrary to the findings made by the CCRA auditor, who stated clearly that interest would have been deductible if, instead of issuing a promissory note, the taxpayer had borrowed to pay the deemed dividend. She thought that in that case the interest deduction would have been in accordance with *Trans-Prairie*.

In her view, interest was deductible in this case because the promissory note replaced paid-up capital and the retained earnings that were used in the business and there was an acquisition of property for the purpose of gaining or producing income from a business within the meaning of subparagraph 20(1)(c)(ii) of the Act.

E. *Meaning of "Fill the Hole"*

The current administrative policy as evidenced in IT-80 and other published statements restricts the deduction of interest to borrowed money not exceeding accumulated profits and capital. We submit that the caselaw does not support a rigid test and that the "fill the hole" theory could in other circumstances encompass borrowings that exceed retained earnings and capital. We submit that the administrative policy should acknowledge that there may be circumstances in which money borrowed would satisfy the "fill the hole" test even though the borrowed money exceeded accumulated profits and capital. The case of *Arthur A. Morscher v. M.N.R.*, 92 D.T.C. 2214 is an example of such a circumstance. Judge Brulé of the Tax Court of Canada held in that case that interest was deductible where borrowed money was used to finance work in progress of a law firm.

F. *Meaning of "Capital"*

In *Trans-Prairie*, the taxpayer used borrowed money to repay capital represented by the subscription price of preferred shares. Interest on the borrowed money was deductible, on the basis that it "filled the hole" left by the redemption of the preferred shares.

In *Chase Manhattan Bank*, the Minister allowed interest deductibility to the extent that borrowed money was used to fund a dividend out of retained earnings. It was held that *Trans-Prairie* did not apply to the rest of the borrowing because, as a legal matter, none of the borrowing was used to repay share capital that had been contributed by the shareholder.

We submit that the proper test for determining a corporation's "capital" is the legal test – i.e., the amount of share capital contributed by the shareholder. In most cases, where a corporation issues shares, the directors are required to add the fair market value of the consideration to the stated capital of the shares. We submit that this is the amount of the corporation's "capital" for purposes of the *Trans-Prairie* test. Where, however, a corporation issues par value shares in exchange for assets with a value in excess of par value or where it makes use of the specific provision in the corporate statutes that enables it to add an amount to the stated capital of the shares which is less than the consideration received for the shares, we submit that it is the full amount of the consideration for the shares which should be viewed as "capital" because, as in *Trans-Prairie*, the full fair market value of the consideration for the shares is the amount subscribed for by the shareholder.

Although IT-80 deals only with a return of capital by way of a redemption of shares, we submit that the same principle applies where borrowed money is used to pay a return of capital to a shareholder without a redemption of the shares.

G. *Meaning of "Accumulated Profits"*

IT-80 permits a corporation to deduct interest on money borrowed to pay dividends unless a substantial portion of the "accumulated profits" of the corporation immediately before the payment of the dividends was not used for an eligible purpose. In the *Chase Manhattan Bank* case, the Minister permitted the deductibility of borrowed money used to pay a dividend, up to the amount of the retained earnings of the taxpayer corporation. In its judgment, the Federal Court of Appeal suggested that the “fill the hole” theory applied to the retained earnings. There were similar comments in *Livingston International* and *Penn Ventilators*. Accordingly, we submit that the term “accumulated profits” in Interpretation Bulletin IT-80 should be equated to accounting retained earnings.

The administrative position on accumulated profits was clarified in the Revenue Canada panel at the 1987 Corporate Management Tax Conference. In Question 8 at that panel, Revenue Canada stated that “appraisal surplus and profits resulting from non-arm’s length transactions designed to transform appraisal surplus into profits would not form part of accumulated profits.” We submit that this modification is generally appropriate but that this determination should be made on a case by case basis.

In IT-80, it was pointed out that the policy of permitting interest deductibility on money borrowed to pay dividends equated a corporation that borrowed to pay dividends with a corporation that used retained earnings to pay dividends and borrowed to finance expansion. We submit that this logic is supportable. Similar logic was used in *Singleton* to support interest deductibility in that case. In *Singleton* it was pointed out that allowing interest deductibility in that case avoided the inconsistency of permitting interest deductibility where a partner’s initial capital investment was financed with borrowed funds, but denying deductibility were the partnership capital was initially funded with personal equity and then refinanced with debt.

H. *<u>“Exceptional Circumstances”, “Direct Link”</u>*

In *Bronfman Trust*, it was held that, except in “exceptional circumstances,” interest on borrowed money is deductible only where the taxpayer can trace the use of the borrowed funds to an eligible direct use. The direct versus indirect use requirement was not at issue in the *Shell Canada Ltd. v. The Queen,* 99 D.T.C. 5669, but McLachlin, J. (as she then was) cited Mr. Justice Iacobucci’s judgment in *Tennant v. M.N.R.*, 96 D.T.C. 6121 as follows:

> The deduction is therefore not available where the link between the borrowed money and an eligible use is only indirect. Interest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use.

We note that McLachlin, J. uses the work “link” in the above whereas the term used in *Bronfman Trust* was “trace”. The work “link” was also used in *Ludco Enterprises Ltd. v. The Queen*, 2001 D.T.C. 5505 (Supreme Court of Canada) and *Singleton*. In *Ludco*, Mr. Justice Iacobucci said that “link” is a more flexible concept than “trace.”

We submit that the concept of “linkage” and the “exceptional circumstances” exception should permit interest deductibility in some cases were borrowed money is used to fund a corporate distribution, even if the “fill the hole” theory in *Trans-Prairie* is not applicable.

An example of this is *The Queen v. Canadian Helicopters Limited*, 2002 D.T.C. 6805 (Federal Court of Appeal) where it was held that interest on money borrowed to make an upstream interest-free loan was deductible because, under the circumstances, it enabled the borrower to earn income in the form of management fees. We submit that, in the appropriate circumstances, similar reasoning could apply to an upstream dividend or distribution of capital.

III. SUMMARY

Interpretation Bulletin IT-80 is based on the "fill the hole" theory in *Trans-Prairie*. In *Bronfman Trust*, it was suggested that, except in "exceptional circumstances," interest is deductible only where the use of borrowed money could be traced to an eligible direct use. Accordingly it was held that a trust could not deduct interest on borrowed money used to pay a capital distribution to its beneficiary. In *Bronfman Trust*, however, the Court did not overrule *Trans-Prairie*.

Notwithstanding *Bronfman Trust*, CCRA and its predecessor have continued to follow IT-80 and no reported case has suggested that the Bulletin is incorrect in the sense that it is too generous. To the contrary, the practice under IT-80 was implicitly approved by the Federal Court of Appeal in *Chase Manhattan Bank* and, in *Singleton*, the Supreme Court of Canada referred to *Trans-Prairie* with approval. In particular, the Court in *Singleton* approved of the principle that a corporation can refinance equity with debt and deduct the interest on the associated debt. Accordingly, we submit that the CCRA's practice under IT-80 is fully supportable.

INTERPRETATION BULLETIN IT-315

I. SUMMARY AND STATUS QUO

Interpretation Bulletin IT-315, "Interest Expense Incurred for the Purpose of Winding-up or Amalgamation" dated May 10, 1976, was released shortly after the implementation of tax reform in 1972. IT-315 states that interest on money borrowed to acquire shares continues to be deductible after the acquired corporation is subsequently amalgamated or wound-up, provided the property acquired on the merger continues to be used to earn income.[1]

The CCRA's status quo position has been that IT-315 is an administrative concession rather than a legal result. The decision in *Palmer-McLellan*, discussed below, raises certain issues on an amalgamation. In addition, apparently due to concerns over the avoidance of the parameters set forth in IT-80, the CCRA's status quo has been to apply IT-315 only to arm's length takeovers, although neither IT-315 itself nor the jurisprudence distinguishes between arm's length and non-arm's length takeovers.

The first apparent qualification of IT-315 was provided in Technical Interpretation 9531575 dated March 11, 1996, wherein the CCRA confirmed its position in IT-315, provided the parties deal at arm's length. There was further elaboration of this position in response to question 19 at the 1998 APFF Congress. That question involved a corporation (X) that wished to buy back shares held by another corporation (Y), in circumstances where X had insufficient paid-up capital and accumulated earnings to qualify for interest deductibility under IT-80 on a loan incurred to repurchase its shares from Y. The question proposed that a third corporation (B), itself a shareholder of X, incorporate a wholly-owned subsidiary (C) which would borrow to invest in X; the money invested in X would be used to acquire the X shares from Y, and thereafter C would be merged with X. The CCRA indicated that the facts did not allow it to conclude that interest was deductible for the corporation resulting from the amalgamation. Moreover, the CCRA noted that in its view the loan was essentially made to buy back shares of X in a series of transactions designed to circumvent the rules set out in IT-80.

In the course of providing its response, the CCRA publicly indicated that the position stated in IT-315 was "applicable when transactions are made between persons who deal at arm's length."

Based on the evolving jurisprudence, including very recent decisions from the Supreme Court of Canada, it is submitted that the statements in IT-315, as written (*i.e.*, unqualified), are sound. Further it is submitted that no distinction should be made between arm's length and non-arm's length transactions.

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[1] These comments are consistent with those made in paragraph 39 of *Interpretation Bulletin* IT-488R2, "Winding-up of 90% owned Taxable Canadian Corporations", dated June 24, 1994 and paragraph 31 of *Interpretation Bulletin* IT-474R, "Amalgamation of Canadian Corporations", dated March 14, 1986.

II. INTEREST DEDUCTION – AMALGAMATIONS

The continued deductibility of interest in a situation where shares are acquired with borrowed funds and the acquired corporation is subsequently amalgamated with the purchaser was considered by the Exchequer Court in *Palmer-McLellan (United) Ltd.* v. *M.N.R.*, [1968] C.T.C. 448. In this case, the amalgamation was effected under the provisions of the New Brunswick *Companies Act*. The amalgamation agreement and the letters patent provided that on the amalgamation all of the property of the acquiring company ("Old United") and the acquired company ("Shoe Company") became the property of the amalgamated company (the "appellant"), the unissued capital stock of Shoe Company ceased to exist and the issued capital stock of Shoe Company should form part of the no par value common stock of the appellant. The corporate statute provided that on the amalgamation the companies continued as one company and the amalgamated company possessed all the property of each of the amalgamating companies.

The issue before the Court was whether the interest on the debt initially used to acquire the shares of Shoe Company was deductible after the amalgamation on the basis that the appellant, the amalgamated company, continued to carry on the businesses of the predecessors with the property of the predecessors. The Court stated as follows, at paragraphs 10 – 12:

> … though the precise effect of the amalgamation on the capital stock of the amalgamating companies, and in particular that of the Shoe Company, is not as clear as it might be, it is I think apparent that from the moment of the amalgamation the appellant … had no asset representing the capital stock of the Shoe Company. This appears to me to be so *either because the capital stock of the Shoe Company had disappeared in the amalgamation or because it* had in fact, as the amalgamation agreement and the letters patent provided, become part of the Class B stock of the appellant and *had been treated as issued to the shareholders of Old United, share for share, and on a fully paid up basis.*
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> *The appellant from the moment of the amalgamation did have the assets of the Shoe Company, but those assets were not what the money borrowed by Old United on its First Mortgage Bonds and its General Mortgage Bonds had been used to purchase and I do not see any way in which these assets can even be regarded as having been acquired in exchange for the shares.* The shares went, if anywhere, to the shareholders of Old United. The assets of the Shoe Company went nowhere. They simply became part of the property of the amalgamated company of which the Shoe Company itself was a continuing element just as Old United as well was a continuing element.

> *Nor, on reflection, do I think the assets of the Shoe Company can be regarded as representing the capital stock of that company formerly held by Old United.* Those assets, as I view the matter, became property of the appellant by virtue of the amalgamation procedure and not, in any legal sense, by reason of Old United's ownership of or its giving up of the shares.
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> [Emphasis added.]

The *Palmer-McLellan* case considered the application of paragraph 11(1)(c) of the former Act, which is substantively similar to paragraph 20(1)(c) as it applies currently. However, under the former Act, dividend income was not subject to taxation. Accordingly, the Court noted that the interest payable by Old United prior to the amalgamation would not have been deductible by Old United because the income from the shares would have been exempt from taxation.

With respect to the interest payable after the amalgamation, the Court concluded that the interest was not deductible, stating at paragraph 13:

> … there is no basis for the deduction under section 11(1)(c) of the interest paid by the appellant on the bonds issued by Old United, not, as I see it, because the property acquired through their issue, that is to say, the shares of the Shoe Company were property the income from which would, while they were held by Old United, be exempt or because such shares were not acquired for the purpose of gaining income from such property, but because the amalgamated company from the time of its inception never held such shares or anything representing them from which to gain or produce income, whether exempt or not exempt, and from the point of view of the appellant in any subsequent taxation year there is nothing upon which to characterize the use to which the borrowed money and bonds were put as anything but what it was originally, that is to say, used to acquire property the income from which would be exempt.

It is debatable whether the *Palmer-McLellan* decision was correctly decided. The Court described the issue as whether the shares of Shoe Company were "replaced" by Shoe Company's assets on the amalgamation. The Court concluded that the borrowed money continued to be traced to the shares of Shoe Company, which was an ineligible use since technically the amalgamation did not result in a "replacement" of assets for shares.

If the Court had formulated the issue according to the words of the statute, namely, whether the borrowed money after the amalgamation was "used" by the corporation to earn income from Shoe Company's assets, then the legal form of the amalgamation should not have been relevant. If the issue had been expressed in this manner, it should have been relatively easy for the Court to conclude in favour of the interest deduction. Before the amalgamation, the corporation borrowed the money to earn income from the shares of the subsidiary (a non-eligible use) and after the amalgamation, it was not used for that purpose but instead the appellant was earning income from assets. With respect, whether the change in use was achieved by way of an exchange of shares for assets or by some other mechanism should be irrelevant.

The *Palmer-McLellan* case was considered in the more recent case of *The Queen* v. *Pan Ocean Oil Ltd.*, 94 D.T.C. 6412 (FCA). *Pan Ocean* dealt with the deduction of certain oil and gas expenses after an amalgamation where the Act did not contemplate a flow through of these types of expenses on the amalgamation. The Federal Court of Appeal acknowledged that an amalgamation did not result in a formal acquisition of property but did acknowledge that property of the predecessor companies "became" property of the amalgamated entity on the amalgamation. This supports the view that borrowed money originally used to acquire shares of subsidiary can subsequently be traced to the assets of the predecessor subsidiary following an amalgamation.

Regardless of whether *Palmer-McLellan* was correctly decided, there has been considerable jurisprudence since 1968 and it is submitted that a court today would have little difficulty in finding that the borrowed money can be traced to the subsidiary's assets. For example, in *Trans-Prairie Pipelines Ltd.* v. *M.N.R.*, 70 D.T.C. 6351 (Ex. Ct.), decided only two years later, the Court endorsed an indirect approach as being "practical" and in accord with "business common sense." Further judicial developments such as the *Ludco* decision which endorses a flexible approach to tracing, are discussed below.

III. WIND-UPS AND OTHER LIQUIDATIONS

Unlike an amalgamation, corporate legislation concerning winding-up or liquidation contemplates the "distribution" of a corporation's property to its shareholders and therefore an acquisition of such property by the shareholders.[2]

Accordingly, in a wind-up of a subsidiary the shares of which were acquired with borrowed money, it appears to be clear that the original borrowing by the parent can be linked to the property of the subsidiary. We submit that strict tracing is not necessary as a result of recent jurisprudence but we also submit that, if tracing were the appropriate test, it would be satisfied on a winding-up. On a typical wind-up, the first corporate step is that the subsidiary's assets are conveyed to, and liabilities assumed by, the parent. Some time later, the subsidiary is formally dissolved and its shares are cancelled. Although the subsidiary's assets are not directly exchanged for shares at a particular point in time, the shares become valueless at the time of the distribution of assets so that, in effect, at that time, the parent accepts the subsidiary's assets in consideration of giving up shares with value.

IV. RECENT JURISPRUDENCE

The jurisprudence with respect to the deductibility of interest has developed significantly. In *Tennant* v. *The Queen*, [1996] 1 C.T.C. 290, the Supreme Court of Canada established the

[2] See, for example, sections 210 through 212 of the *Canada Business Corporations Act* and section 211 and 212 of the *Business Corporations Act* (Alberta).

principles applicable in situations where property originally acquired with borrowed money has been replaced by other property. In that case, the taxpayer borrowed $1,000,000 and used it to acquire shares of Realwest Energy Corporation ("Realwest") in 1981. In 1985, the taxpayer sold the Realwest shares to TWL Holdings Ltd. ("TWL"), a corporation dealing at arm's length with the taxpayer, at the current fair market value of the Realwest shares, $1,000, using a section 85 rollover. The taxpayer received 1,000 Class B shares of TWL with a par value of $1 per share as consideration for the Realwest shares. In 1987, Realwest paid a dividend to its shareholders and TWL used a portion of this dividend to pay a dividend to its Class B shareholders. The taxpayer received a dividend of $316,232.62 and used a portion of that amount to partially repay the original loan.

The Court concluded that, subject to tracing the replacement property to the loan, the basis for the interest deduction in situations where replacement property was acquired was the amount of the original loan, not the value of the replacement property.

In *Shell Canada Limited* v. *The Queen*, [1999] 4 C.T.C. 313, the Supreme Court of Canada considered whether the taxpayer was entitled to deduct interest on a loan denominated in New Zealand dollars when the borrowed funds were immediately exchanged for U.S. dollars that were used in the business. In holding that the New Zealand dollars were used for the purpose of earning income from the business, the Court stated in paragraph 33 as follows:

> The mere fact that an exchange had to occur before usable money was produced is not particularly significant. Except where the borrower is a money trader, borrowed money can rarely itself produce income. It must always be exchanged for something, whether it be machinery or goods, which then produces income. The necessity of such an exchange does not mean that the eventual production of income is an indirect use of the borrowed money. *If a direct link can be drawn between the borrowed money and an eligible use, the third criterion is satisfied.*
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> [Emphasis added.]

The Supreme Court recently considered the effect of a section 85 rollover on the deductibility of interest in *Ludco* v. *The Queen*, 2001 D.T.C. 5505. The taxpayers borrowed $6,500,000 and invested $7,500,000 by acquiring shares of two offshore investment companies ("Companies"). Assets owned by Ludco Enterprises Ltd. ("Ludco"), including the shares, were subsequently transferred at their fair market value of $12,685,000 to 2154-7203 Québec Inc. ("Québec"), a wholly-owned subsidiary, in accordance with the rollover provisions of subsection 85(1) of the Act. The consideration received by Ludco included income producing assets, being an interest bearing note and redeemable preferred shares of Québec with a value of $5,305,000, and non-income producing assets, being non-interest bearing notes with a value of $7,380,000. At the time of the transfer, the shares of the Companies had a fair market value of $8,645,715 and the outstanding debt owed by Ludco was $4,800,000.

After reviewing the principles established by the jurisprudence to be applicable to the deduction of interest, the Court considered whether interest remained deductible after the rollover, noting that the principles applicable to that question were established in the *Tennant* case. On the facts, however, the shares of the Companies had been transferred to Québec as part of a group of assets, for which Ludco had received both income producing and non-income producing consideration. After noting that the general principle established in the *Bronfman Trust* case, that the taxpayer had the onus of tracing borrowed funds to eligible uses, had been interpreted in the *Tennant* case as requiring that replacement property be traced to the entire amount of the loan, the Court stated in paragraphs 76 and 78 as follows:

> However, *nowhere* in *Tennant*, supra [sic], *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 Court spoke in broader terms, referring to the need to "establish a link"* between the original and current eligible use property. *Based upon 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 purposes of the interest deductibility provision, *the shares in the Companies can be traced to any of the specific assets received by Ludco as a result of the rollover*. In this case, the taxpayer can trace the shares in the Companies to the income-producing assets. Therefore, the appellant has established the required link.
>
> …
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> In summary, although the appellant Ludco initially received a mix of income-earning and non-income-earning assets as consideration for the shares in the Companies, the value of the income-earning assets (or current eligible use property) exceeded the amount of the borrowed money. In these circumstances, the income producing replacement property can be linked to the entire amount of the loan and it can be said that the interest charges were "wholly applicable" to the source of the income. Consequently the entire amount of the interest payment continued to be deductible after the rollover occurred.
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> [Emphasis added.]

This statement indicates that the Supreme Court of Canada favours a flexible approach which does not require strict tracing, but rather the establishment of a link between the source of income and the debt.

This "linking" approach is more flexible than requiring a strict exchange or replacement (*i.e.*, corresponding acquisition and disposition) of property. In the circumstances of IT-315, even though the parent corporation may not, under corporate law concepts, acquire any property on an amalgamation, once the shares of the subsidiary are cancelled and the property of the subsidiary becomes property of the amalgamated corporation, that property clearly can be linked to the parent's borrowing. The same holds true on a wind-up.

V. NON-ARM'S LENGTH

The CCRA has limited the application of IT-315 to where the "parties" are dealing at arm's length. It is submitted that this restriction is not supported by the jurisprudence and is not appropriate.

One of the concerns expressed by the CCRA in respect of non-arm's length situations is that IT-315 can be used to circumvent the restrictions in IT-80 which require that the amount of the distribution not exceed the corporation's capital and accumulated profits. The concern appears to be that, even if a non-arm's length transaction using IT-315 technically satisfies the tracing test, the transaction would not satisfy the tracing test if it had been structured as a redemption.

It is submitted that the Supreme Court of Canada decisions in *Shell* and *Singleton* v. *The Queen,* 2001 D.T.C. 5533 are complete answers to this concern. These cases lay to rest the obiter in *Bronfman Trust* and provide that the "use" test in paragraph 20(1)(c) should be determined based on the legal form of a transaction rather than its substance. Thus, the fact that the tracing rule gives different results to different fact situations is the very essence of the tracing rule.

Further, there should be no inference that IT-80 gives a better tax policy result and in fact we would submit that from a policy perspective IT-80 is too restrictive. Generally, there is no tax policy reason to restrict money borrowed by a corporation to redeem shares or pay a dividend in the manner set forth in IT-80. Money borrowed by a corporation whether for the payment of dividends or otherwise is generally connected to the business activities of the corporation. Thus, from a policy perspective we do not believe that it is appropriate to deny a deduction of interest in computing business profits, regardless of whether a transaction is structured in accordance with IT-315 or as a redemption of shares.

VI. CONCLUSION

It is submitted that IT-315 is well supported by the jurisprudence, particularly as it has recently evolved. For the reasons discussed above, the correctness of *Palmer-McLellan* can be questioned. Regardless of whether the case is right, however, the recent jurisprudence clearly adopts a less strict approach to the tracing requirement and clearly supports the approach in IT-315.

It is also submitted that there should not be a concern with IT-315 in non-arm's length circumstances. The substance of the concern is the fact that the tracing rule provides different results in different fact situations. While the obiter in *Bronfman Trust* might have given some support to this concern, this substance over form approach has been put to rest by *Singleton*.