

The Joint Committee on Taxation of
The Canadian Bar Association and
The Canadian Institute of Chartered Accountants

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February 26, 2003

Mr. Paul Lynch
Director, Financial Industries Division
Income Tax Rulings Directorate
Canada Customs and Revenue Agency
16th Floor, 320 Queen Street
Ottawa, Ontario
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Dear Mr. Lynch:

Subject: Discounts on Commercial Paper

We are enclosing a submission on the taxation of discounts on commercial paper pursuant to the Income Tax Act (Canada) (the "Act").

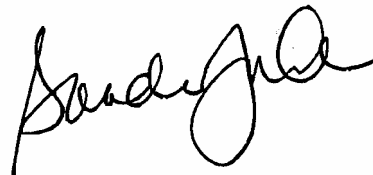
For the reasons set out in that submission, it is our view that discounts constitute interest and are deductible by the payor in computing income pursuant to the Act.

At our previous meetings, we also discussed the application of section 16 of the Act to a discount to treat a portion of the discount as interest. The enclosed submission approaches the issue in a different manner and does not include a discussion of section 16. If you wish us to provide you with submissions on section 16, please advise us and we would be pleased to do so.

Yours truly,



Roger D. Ashton, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants



Sandra E. Jack
Chair, Taxation Section
Canadian Bar Association

MEMORANDUM

To: Paul Lynch
From: •
Date: February 7, 2003
Re: **DISCOUNTS ON COMMERCIAL PAPER**

We understand that you are reviewing the legal characterization of a discount in the context of non-interest bearing commercial paper, specifically whether the discount should be considered interest for purposes of paragraph 20(1)(c). This is a significant issue for many Canadian corporations and we set forth below for your consideration a summary of our legal analysis.

Description of Commercial Paper

Commercial paper is a type of security providing issuers (mostly large companies, banks and insurance companies) with short-term borrowing in the capital markets and commonly is issued through programs that cap the borrowing at a stated maximum amount. Commercial paper is usually unsecured, sometimes guaranteed and typically rated by a recognized national rating agency. It is sold either at a discount or bearing interest, in bearer or certificate form and with varying maturities of up to 365 days, although most matures in one or two months. An issuer typically engages an investment bank to establish the program, act as a dealer in finding buyers in return for a commission and to perform paying and redemption agency services. Commercial paper is not usually underwritten and the issuer is not under any obligation to issue.

Discount as Interest

Determining what is interest for Canadian tax purposes is a surprisingly difficult exercise and, based on recent jurisprudence, the legal meaning of interest continues to evolve. In general, the accepted meaning is derived from non-tax case law and, in such law, there is not much judicial guidance on whether a discount is interest. For the most part, noted authors conclude that while there is no case law directly on point, the better view is that a discount on a non-interest bearing instrument is interest. See excerpts from literature at Tab 2. All but one of these articles predate the 1998 decision of the Federal Court of Appeal in *The Queen v. Sherway Centre Limited*, 98 DTC 6121, reproduced at Tab 3. While by no means definitive, it seems clear that the preponderant view is that a discount is interest, which view we believe is based in substantial part on well-established commercial usage and practice.

In this connection, the case of *Sherway Centre* is instructive. The taxpayer issued long term bonds which bore interest at a below-market rate of 9.75%. The bonds also provided for participating interest payments (based on rental payments) that were designed to increase the overall yield to a market rate of interest. In a well-reasoned decision that reviewed the jurisprudential history of the definition of interest, the Federal Court of Appeal held that the participating payments were deductible as interest under paragraph 20(1)(c).

We believe that *Sherway Centre* is the leading authority on what is interest for purposes of paragraph 20(1)(c). Clearly, the Court's reasons for concluding that

the participating payments were interest as a matter of law should be equally applicable in supporting the conclusion that a discount on non-interest bearing commercial paper is interest. Some have questioned whether *Sherway Centre* is good authority insofar as it disregards or stretches what, before the case, had been considered by many to be two of the fundamental requirements of interest—that interest accrues day-to-day and is referable to a principal sum. We believe that *Sherway Centre* is good authority on these points and, in this connection, reference should be made to the 1998 article by Ms. Karen Sharlow (now a Justice of the Federal Court of Appeal) at Tab 4.

More importantly, even if *Sherway Centre* is wrong on these points, the case dealt with participating payments where it is difficult to comply strictly with the two tests described above. In contrast, a discount on non-interest bearing commercial paper accrues day-to-day and can easily be restated as a percentage of a principal sum. The result is that a discount satisfies the two troublesome criteria. Thus we do not believe that any of critical comment of the *Sherway Centre* decision should be interpreted as criticizing its application to situations such as discounts on commercial paper. In any event, the *Sherway Centre* decision is the leading authority on the meaning of interest for purpose of paragraph 20(1)(c) at the present time.

Relevance of Terminology

To our mind, *Sherway Centre* provides almost a complete answer to the question of the characterization of a discount on non-interest bearing commercial paper. It

does not however, address the relevance of the terminology used by the parties. In *Sherway Centre*, the participating payments were described as interest in the bond instruments. This may not be the case with a discount on commercial paper although we note that in certain cases a discount on commercial paper has been described as representing an ‘interest factor’ (see Tab 5). Therefore, the relevance of the nomenclature used in the commercial paper documentation needs to be considered.

We believe that in ordinary commercial usage and practice, a discount on the issue of commercial paper is treated by all parties, including the issuer, the seller and the buyer, as interest. In some cases the parties may describe the discount as interest in the commercial paper itself, but based on our experience, this is unusual. But the absence of such nomenclature in the commercial paper is, we submit, not that relevant in determining whether the discount is interest as a matter of law. The commercial reality is that the amount of the discount is, and is treated by all parties, as compensation for the use of borrowed money. In cases where commercial paper specifies that a payment at maturity will be paid as interest, the amount is computed in the same way as the discount in cases where no interest payment is stipulated.

The fact that parties may stipulate in some commercial paper instruments that interest will be paid should not mean that where no interest is stipulated, the discount is not interest. We would have thought that the opposite conclusion is the more logical one. The buyer of commercial paper at a discount clearly must intend to be compensated for the use of the buyer’s money and that compensation is the

discount. The terminology used by the parties might be relevant where the commercial instrument provides for both interest payments and a discount, but that is not normally the case—it is usually one or the other. It seems like a perverse result that describing the same amount (which all the relevant parties treat as the basic compensation that is to be paid by the borrower for the use of the borrowed money) as interest, on the one hand, or as a discount, on the other, could have much relevance, let alone be determinative, as to its character as interest as a matter of law.

Therefore it is necessary to look to other factors to determine the nature of the payment.

The relevance of the intention of the parties to the characterization of transactions was recently discussed in the non-tax case of *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*, (Ontario Superior Court of Justice, unreported) at Tab 6. Page 11 of that judgment discusses the relevance of the intention of the parties in determining whether a securitization transaction is a sale or loan. The court determined that, in the particular context, the parties expressed intention of effecting a sale rather than a loan was very relevant because the parties were conscious of ensuring that they would obtain the legal results that would flow from a sale transaction as opposed to a loan. For example, if the transaction were a financing transaction, the securitization could have resulted in a breach of covenant in a Trust Deed. There are no such considerations that would apply to a discount on commercial paper. Parties to commercial paper are generally indifferent (absent tax) as to whether the discount is interest.

Conclusion

For the above reasons, we submit that a discount on a non-interest bearing commercial paper obligation is interest for purposes of paragraph 20(1)(c).