

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

The Canadian Bar Association
500-865 Carling Avenue
Ottawa, Ontario
K1S 5S8

The Canadian Institute of
Chartered Accountants
277 Wellington Street West
Toronto, Ontario M5V 3H2

September 17, 2004

Mr. Brian Ernewein
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Floor, East Tower,
140 O'Connor Street,
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

Re: Second Submission - October 31, 2003 Draft Proposals Regarding the Deductibility of Interest and Other Expenses ("Draft Proposals")

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "Joint Committee") made a submission to the Department of Finance ("Finance Canada") on February 19, 2004 (the "February Submission") concerning the Draft Proposals. We provide these additional comments to assist Finance Canada in advancing matters. All statutory references are to the *Income Tax Act* (the "Act").

A. FEBRUARY SUBMISSION – A SUMMARY

The Joint Committee continues to stand by the views expressed in the February Submission. The major points in the February Submission are as follows.

1. The Draft Proposals do not accomplish a return to the past. Instead, the Draft Proposals would effect a fundamental change to the Act that goes well beyond "restoring continuity with the expected consequences" before, *inter alia*, *Ludco*, which is the Government's stated objective as enunciated in the February 2003 Budget.
2. *Stewart and Walls* enunciate the appropriate test in circumstances where a personal or hobby element underlies a taxpayer's activities or where the activities are otherwise not carried out in a commercial fashion.
3. The Draft Proposals create unacceptable uncertainties for common share investments.
4. If Finance Canada is concerned with the deduction of outlays and expenses in circumstances where the underlying motivation is to realize a capital gain, that concern should be dealt with through targeted amendments.

B. ALTERNATIVE APPROACH - PROFIT PURPOSE

If Finance Canada is of the view that a more general approach is necessary to accomplish the Government's objectives in restoring the law to what it was understood to be before *Ludco*, the Joint Committee recommends that serious consideration be given to a profit purpose approach as an alternative to the Draft Proposals. In our view, the profit purpose approach would accomplish the Government's stated objective most directly and would be most consistent with the Canada Revenue Agency's ("CRA") application of the law prior to *Ludco*. As such, the profit purpose approach should allow for the continued application of the CRA's pre-*Ludco* administrative practice in this area.

1. Profit Purpose Test

The 2003 Federal Budget referred to the need to consider amendments concerning the deductibility of interest and other expenses as a consequence of recent court decisions that raised uncertainties in this regard. These court cases changed a longstanding interpretation of the law by the CRA in that "income" as it is used in certain provisions of the Act was found to refer to any amount that comes into income for taxation purposes, and not "net income".

The Joint Committee views this development in jurisprudence as the only issue that needs to be addressed in order to restore continuity and certainty in the application of the Act. Accordingly, the Joint Committee is of the view that the objective of restoring the law to what it was understood to be before *Ludco* could be accomplished by a substitution of the phrase "for the purpose of earning profit" (the "Alternative Amendment") in place of the existing phrases "for the purpose of earning income" and "for the purpose of gaining or producing income" in all those provisions of the Act where the existing reference to the purpose of earning "income" has historically been interpreted by Finance Canada and the CRA as a reference to the purpose of earning "net income" or "profit".

By way of example, paragraph 18(1)(a) would be restated to read as follows:

In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of earning profit from the business or property;

We appreciate that Finance Canada might have some apprehension that the substitution of the term "profit" for "income" in the relevant provisions could raise doubt as to the meaning of "income" as it would continue to be used elsewhere in the Act. However, we do not believe this would be a problem given the context of the provisions in which we suggest the term "profit" be substituted. The word "profit" is already used in certain tests in the Act (for example, in subsection 111(5)), yet this has not created any confusion concerning the meaning of "income".

In making the Alternative Amendment, any uncertainty created by the recent court decisions would be addressed directly. As Iacobucci J. stated in the *Ludco* decision, "If Parliament had intended interest to be deductible only in circumstances where borrowed money was used for the purpose of earning "net income", it could have expressly said so." The Court thus pointed to how the issue could be resolved. The Joint Committee suggests that this guidance be followed and that Parliament make its intention express in the relevant provisions by referring to "profit".

2. Capital Gains and Losses Excluded

Consistent with the desires expressed by Finance Canada, the Joint Committee suggests that, for the purpose of the Alternative Amendment, a provision be added to ensure that “profit” does not include capital gains or capital losses. In particular, a provision along the following lines is suggested.

For the purpose of each provision of this Act and the *Income Tax Regulations* that refers to the purpose of earning profit from a business or property, profit shall be determined without reference to capital gains and capital losses.

3. Application Rule

The Joint Committee also recommends that Finance Canada take this opportunity to add an application rule that provides legislative guidance in situations in which there has traditionally been a degree of uncertainty as to the application of the income or profit purpose test. We suggest an application rule along the following lines (the “Application Rule”).

If a taxpayer makes an outlay or incurs an expense that would be deductible in computing the taxpayer’s income from a business or property if the business were carried on, or the property were held, for the purpose of earning profit, the outlay or expense is deemed to be made or incurred for the purpose of earning profit from the business or property if it relates to an obligation incurred, or an activity or undertaking engaged in, at a time when the business was carried on, or the property was held, for the purpose of earning profit.

(a) *Loss of Profit Expectation and Deductibility*

The purpose of the Application Rule is to ensure the deductibility of expenses in circumstances where, for example, there is currently no prospect of future profit, but the legal obligation giving rise to the expense arose at a time when the taxpayer had a profit purpose. This rule should provide greater certainty with respect to the deductibility of a variety of expenses, including such things as employee expenses, lease termination expenses, on-going litigation costs, and legally-mandated reclamation costs.

(b) *Capital Expenditures and Interest Expense*

Capital expenditures are, for the most part, incurred in taxation years prior to the year in which capital cost allowance and cumulative eligible capital deductions are claimed in respect of the capital property. While the property may have been acquired at a time when the profit purpose test was met, that profit potential may evaporate before the capital expenditure deductions are taken in full.

Similarly, debt obligations may be incurred for the purpose of earning income from a business that subsequently loses its profit potential, but the taxpayer may choose to nevertheless continue carrying on the business for a time. We note that this circumstance is not dealt with in existing section 20.1, though that section does address the situation where borrowed money was used to acquire property that ceases to be used for the purpose of earning income, or was used to earn income from a business that ceases to be carried on.

The suggested Application Rule, as stated above, does not deal directly with deductions in respect of capital expenditures and interest. However, we wish to make it clear that, in the Committee's view, it is appropriate that such deductions, like those for income account outlays and expenses, continue to be allowed if, after acquiring capital property for the purpose of earning profit, or incurring a debt obligation for the purpose of earning profit from a business, that profit-earning potential no longer exists.

(c) *Termination Expenses*

Another circumstance in which there might be uncertainty about whether a current outlay or expense on income account meets the income or profit test is where the outlay or expense is made or incurred in connection with the termination of a business or the disposal of property that was last carried on or held for the purpose of deriving income. By their very nature, such outlays and expenses are not made in the pursuit of future income from the business or property. The Joint Committee believes that there is merit in adding a provision that would make it clear that such "termination" costs are deductible.

4. No Profit Purpose

Outlays and expenses made or incurred to earn gross revenue in the absence of a current or previous profit purpose would not be deductible pursuant to the Alternative Amendment and suggested Application Rule. An example is interest on borrowed money used to acquire preferred shares where the fixed dividend rate on the shares is lower than the interest rate charged on the borrowed money.

To ensure some degree of equity while balancing this against the objective of simplicity, the Joint Committee recommends a mechanism that would permit a deduction, in computing income from a business or property, of such expenses incurred in a year up to the total of amounts required to be included in computing the income from that source for the year. The Committee suggests that any "excess" of such expense over the total income inclusions in the year (effectively being the "loss" amount) be permitted to be carried over.

The Joint Committee believes that the business expenses deductible under this mechanism should include deductions in respect of capital expenditures, notwithstanding that the profit purpose was not met at the time the property was acquired.

Whatever form the amendments take, the Joint Committee recommends additional steps to minimize uncertainty. First, the Joint Committee recommends that certain concerns be addressed expressly in appropriate government publications such as technical notes and CRA bulletins. Comprehensive technical notes accompanying any amendments would be warranted because of the importance and magnitude of the deductions that could be impacted by these amendments. Of particular benefit would be an express affirmation in the technical notes of current practices concerning the deductibility of interest, including the deductibility of interest on money borrowed to purchase common shares. The Joint Committee would be pleased to assist in the development of such explanatory materials.

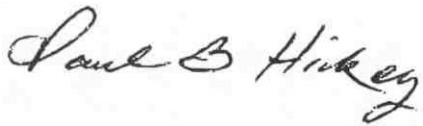
Second, the Joint Committee believes it is critical that the CRA reinforce and supplement the technical notes with its own commentary on how any amendments will be interpreted and applied. Amongst other issues, the Joint Committee would like the CRA to confirm in such commentary (ideally *Interpretation Bulletin* IT-533) that it will continue with its current audit and interpretive practices concerning the deductibility of interest on money borrowed to purchase common shares.

C. GRANDFATHERING

The Joint Committee recommends that any amendments be brought into force in such a way that they do not apply in respect of any outlay or expense made or incurred before the new rules take effect.

We appreciate the opportunity to provide these additional comments. We hope that you will find them helpful. We look forward to a follow up meeting with you and your officials in the near future to initiate a more focussed discussion on this suggested alternative approach.

Yours truly,



Paul B. Hickey, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants



Brian R. Carr
Chair, Taxation Section
Canadian Bar Association

cc: Mr. Kevin Lynch
Deputy Minister
Department of Finance Canada

Mr. Bob Hamilton
Assistant Deputy Minister
Tax Policy Branch
Department of Finance Canada

Mr. Len Farber
General Director
Tax Legislation Division, Tax Policy Branch
Department of Finance Canada