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Technical Amendments to the
Interest Deductibility Rules in the Income Tax Act
As Proposed on 20 December 1991

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The deductibility of interest expense under the Income Tax Act\(^1\) has been permitted generally where borrowed funds were used, whether directly or indirectly, for the purpose of earning income from business, subject to certain restrictions. The Bronfman Trust\(^2\) case, decided in 1987, caused an upset in the tax community by requiring that the borrowed funds be tracked to an eligible use, and by criticizing the indirect use approach. Since the Bronfman Trust decision, Revenue Canada, Taxation, has attempted to re-establish the pre-Bronfman Trust rules on interest deductibility through various Notice of Ways and Means Motions. It was promised that legislation would be enacted to confirm past administrative practice concerning interest deductibility, and to provide new rules with respect to future borrowings. This paper reviews the 20 December, 1991 draft legislation in an attempt to determine whether these uncertainties have been addressed, and whether new concerns have been raised.

GENERAL BACKGROUND

Generally, interest and financing charges have been viewed as being non-deductible for the purposes of the ITA, the reason being that these expenses have traditionally been regarded as on account of capital. Payments on account of capital were denied deductibility under paragraph 18(1)(b). Only the interest and financing charges incurred by taxpayers engaged in the business of borrowing or lending money were deductible expenditures. Paragraphs 20(a)(c), (d), (e) and (e.1) were subsequently introduced in order

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1 R.S.C. 1952, c.148, as am. by S.C. 1970-71-72, c.63 and subsequent [hereinafter ITA].
to permit the deduction of certain interest and financing charges. Paragraph 20(1)(c), which is the subject matter of this portion of the paper, permits the deduction of interest where certain conditions discussed below are met.

**Paragraph 20(1)(c)**

Under paragraph 20(1)(c), interest is deductible if it is paid or payable: in the year or in respect of the year; pursuant to a legal obligation to pay interest; and in respect of borrowed money used for the purpose of earning income from a business or property, or in respect of the unpaid purchase price of property acquired to earn such income.

Interest on borrowed money used to produce tax exempt income is not deductible and neither is interest on borrowed money used to buy life insurance policies. Paragraph 20(1)(c) also precludes the deductibility of interest on funds borrowed for personal consumption or the generating of capital gain. This limitation is due to the wording of the paragraph, which requires that the borrowed money be "used for the purpose of earning income from a business or property."

There is no definition of "interest" in the *ITA*. However, the caselaw establishes that a sum must meet three criteria before it may be characterized as interest. The amount must be: (1) calculated on a day-to-day accrual basis; (2) calculated on a principal sum; and (3) compensation for the use of the principal sum or right to the principal sum.

The caselaw has also historically established that in order for the interest expense to be deductible, there must be a borrower-lender type of relationship and payment must not be contingent or discretionary.

**Used for the purpose of earning income**

The most important and controversial requirement with respect to the deductibility of interest has been the requirement that the borrowed money be used for the purpose of earning income from a business or property. This requirement is consistent with the general rule established under paragraph 18(1)(a) that no expenditure may be deducted except to the extent that it was made or incurred for the purpose of gaining or producing income from property or from a business. A taxpayer who mortgages his house and incurs an interest expense thereon cannot claim the expense as a deduction since the money borrowed was not used to earn income. This requirement has often been referred to as an "eligible" or "qualifying" use of the borrowed funds.

The "use" which is to be examined for the purpose of determining deductibility is the current use of the funds and not past or original use. As a
result, where money is borrowed by a taxpayer and used to produce non-exempt income in the business, or used to acquire an income-producing property, the interest is deductible. If subsequently the taxpayer sells its income-producing property and uses the proceeds of disposition for non-eligible purposes, the interest on the money borrowed would no longer be deductible. The taxpayer is not permitted to continue deducting interest payments simply because the original use of the funds was an eligible one.

The purpose underlying the use of borrowed funds is therefore very important. It is not the purpose of the borrowing itself which is relevant, but rather the purpose behind the use of the borrowed funds. The question arose as to whether the "indirect" use of funds may be examined to determine deductibility of interest expense. The decision rendered in Canada Safeway Ltd. v. M.N.R.\(^3\) established the rule that it is the direct use of the funds which is relevant in determining the deductibility of the interest paid thereon. In the Canada Safeway case, the corporate taxpayer was seeking to deduct interest on a series of debentures which the corporation used to finance the purchase of other shares in a related corporation. At that time, dividends from shares of Canadian corporations were exempt income. The deduction of the interest expense was therefore denied as the debentures were used to produce exempt income from shares. Although the shares purchased did indirectly increase the taxpayer's taxable income by giving it control over a supplier, the interest deduction was denied on the basis that this connection was too remote and indirect.

Thirteen years after the Canada Safeway case, the Trans-Prairie Pipelines\(^4\) case approved the indirect use of funds. In this case, the corporate taxpayer raised $700,000 by issuing bonds. Of this amount, $400,000 was used by the taxpayer to redeem previously issued preferred shares and $300,000 was used to expand its business. The Minister disallowed the deduction of 4/7 of the interest paid on the bonds on the basis that this portion of the money borrowed was used to redeem the preferred shares and was therefore not used to earn income from business or property.

Judge Jackett of the Exchequer Court disagreed with the respondent. It was held that although the direct use of the money borrowed was for a non-business purpose (the redemption of the preferred shares), the interest paid on the entirety of the borrowed funds was deductible. His finding was based on the principle that deductibility of interest expense is not determined necessarily by the direct

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3 [1957] 11 D.T.C. 1239 (S.C.C.) [hereinafter Canada Safeway].
use of the funds. In the case at hand, the Court found that the borrowed money went to fill the hole left by the redemption, and as the original funds raised from the issuance of the preferred shares were used for the purpose of earning income, the interest on the bonds was deductible. The money borrowed could be considered as being used for the same purpose as the capital was used prior to repayment.

The *Trans-Prairie Pipelines* case therefore sanctioned the “indirect use test” for the purpose of determining whether interest paid on borrowed funds is indeed deductible. Two years after the *Trans-Prairie Pipelines* case was rendered, Revenue Canada Taxation issued Interpretation Bulletin IT-80, which accepted the indirect use test put forth in *Trans-Prairie Pipelines*. The interpretation bulletin expressly states that where money is borrowed to redeem shares, interest on the borrowed funds will be deductible provided that the borrowed money was replacing money that was being used to earn income from a business. The same interpretation bulletin also discusses a second situation, the payment of dividends, and claims that it is Revenue Canada’s policy not to disallow the deduction of interest on borrowings used to pay dividends where the corporate taxpayer’s accumulated profits are used to earn income from a business which is not exempt income.

During the course of the years between *Trans-Prairie Pipelines* and *Bronfman Trust*, Revenue Canada developed an administrative practice of acquiescing to the indirect use approach. The basic rules concerning interest deductibility were relatively simple at the time. Essentially, an amount borrowed had to be traced to a qualifying use (income yielding) in order to be able to deduct the interest paid there on. As a result of the *Trans-Prairie Pipelines* case, and in limited circumstances, taxpayers were entitled to deduct interest paid on borrowings used indirectly to generate income. These limited circumstances were, and still are, important ones being share redemptions and payment of dividends. The deductibility of interest paid on funds borrowed to make capital distributions was not as clear prior to Interpretation Bulletin IT-80 and the *Trans-Prairie Pipelines* case. An important tax planning technique was therefore to ensure the streaming of funds. A taxpayer could borrow funds for eligible purposes and use any accumulated savings for non-eligible purposes. Accordingly, the interest paid would be deductible.

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5 Revenue Canada, IT-80, *Interest on Money Borrowed to Redeem Shares or to Pay Dividends* (Ottawa: Queen’s Printer, 27 November 1972).
INTEREST DEDUCTIBILITY

BRONFMAN TRUST

The Bronfman Trust\(^6\) decision was rendered on 29 January 1987 and cast a cloud of uncertainty over the entire tax community. The decision not only put Trans-Prairie Pipelines\(^7\) in doubt, but also caused Revenue Canada to respond immediately by issuing a press release on 12 February 1987 cancelling Interpretation Bulletin IT-80 effective from the date of the decision.

The facts of the case are straightforward. The trustees of the respondent trust chose to make a discretionary capital allocation to its beneficiary in 1969 and 1970. Rather than liquidating capital assets in order to make the distribution, the trustees elected to borrow the money and retain its investments. Both the Tax Review Board and the Federal Court, Trial Division, upheld the Minister’s decision to disallow the deductions. The Federal Court of Appeal allowed the taxpayer’s appeal and essentially extended the rationale in the Trans-Prairie Pipelines case to trust distributions.

On appeal, the issue before the Supreme Court of Canada was whether the interest paid to the bank by the Trust on the borrowings was deductible. More specifically, the Court was asked to review the “use test” or “indirect use” test laid out in Trans-Prairie Pipelines. The question was therefore whether the interest deduction was available only where the borrowings are used directly to produce income, or, whether the deduction is also available when the direct use may not produce income, but the loan can be viewed as preserving an income-producing asset which might otherwise have been liquidated.

There was no dispute as to the direct use of the funds. The money borrowed was directly applied to make the capital allocations to the beneficiary and not to acquire any income-generating properties. At trial, an accountant testified on behalf of the Trust that the funds were borrowed because a disposition of the investment assets would have been commercially inadvisable. In fact, the majority of the Trust’s investments at the time were not readily realizable due in part to the fact that the marketable securities dropped in value and in part because securities law constraints prevented their sale.

The Trust argued that even if the loans were used to pay the allocations, they were used for the purpose of earning income from property because they permitted the Trust to retain income-producing investments until a more advantageous time for their disposal. The end result of the transaction was the same as if the trustees had sold the assets to pay the allocations and subsequently borrowed money to replace them. In this latter scenario, the interest paid on the

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\(^6\) Supra note 2.
\(^7\) Supra note 4.
borrowings would have been deductible, which in fact the Crown conceded.

The Crown argued that the borrowings were directly used to pay the discretionary capital allocations to the beneficiary and as such, were not used to earn income from business or property.

The Supreme Court’s decision, delivered by Chief Justice Dickson (as he then was), was to the effect that the interest payable on the funds borrowed to make the distribution to the beneficiary was not deductible because the funds were not used for the purpose of earning income.

The Trans-Prairie Pipelines case was distinguished on the basis that in that case, the money previously subscribed for by the preferred shareholders had been used by the company for the purpose of earning income from the business. In the case at hand, it was found that the money paid to the beneficiary had not already been so used but rather, used to pay the capital allocations. In the Trans-Prairie Pipelines case, the total capital employed by the corporation in the business was not diminished. In the Bronfman Trust scenario, the investment capital of the Trust was reduced by the amount distributed to its beneficiary. Furthermore, the interest expense on the borrowings exceeded the income from the Trust capital preserved by the borrowings. Consequently, it was concluded that the borrowed funds were not used to earn income.

Although the Court did not expressly overrule the Trans-Prairie Pipelines case, it did raise questions as to the principles established therein and relied upon by the tax community. The Supreme Court held that, barring exceptional circumstances, all taxpayers must trace borrowed funds back to an eligible use. Interest would not be deductible if borrowed money is used directly for an ineligible purpose. In the Trans-Prairie Pipelines case, the direct use of the funds was the redemption of shares and clearly ineligible. However, the Court did suggest that where the direct use of the funds is for an ineligible purpose, an indirect use of the borrowed money will serve to support the deduction of interest in exceptional circumstances such as those in the Trans-Prairie Pipelines case.

POST-BRONFMAN REACTIONS

As mentioned above, shortly after the release of the Bronfman Trust decision, Revenue Canada announced the cancellation of Interpretation Bulletin IT-80 dealing with the deductibility of interest on money borrowed to pay dividends or redeem shares. Many tax practitioners were of the view that Revenue Canada may have reacted too quickly in cancelling the interpretation bulletin. Revenue Canada took a case on a trust and personal investments and applied its rulings throughout the business community. It had obviously come to the conclusion
that the Bronfman Trust case effectively overruled the Trans-Prairie Pipelines case.

On 2 June 1987, a press release and a Notice of Ways and Means Motion was introduced by the government in order to amend the rules for the deduction of interest in respect of money borrowed before 1989 and to reinstate Interpretation Bulletin IT-80. The Notice of Ways and Means Motion proclaimed the retention of pre-Bronfman Trust rules on interest deductibility. The government also announced that it would study the issue and introduce new rules effective 1 January 1989.

The same Notice of Ways and Means Motion has been annually extended. It was first extended to cover money borrowed before 1990, then to money borrowed before 1991 and subsequently to money borrowed before 1992. As a result, Revenue Canada's administrative practice, as it stood prior to Bronfman Trust, remains in effect for borrowings made before 1992.

The Notice of Ways and Means Motion essentially includes within the umbrella of “borrowed money used for the purpose of earning income from a business or property,” the following five types of borrowing.

Dividend Payments

The first type is borrowed money used by a corporation to pay dividends not exceeding its accumulated profits determined immediately before the dividends were paid, or borrowed money used by a partnership to make distributions of profits not exceeding its accumulated profits determined immediately before the distributions were made.

These types of borrowings would qualify for interest deductibility purposes to the extent that the accumulated profits were used by the corporation or partnership for an eligible purpose. That is, the borrowings must have been used to earn income, and not to acquire property the income of which is exempt, or to acquire a life insurance policy.

The term “accumulated profits” was not new. It was used in 1972 when Interpretation Bulletin IT-80 was first issued. At the time, Revenue Canada consistently indicated that interest on borrowed funds used to redeem shares or pay dividends would be deductible as long as the borrowed funds were replacing capital previously contributed to the corporation by its shareholders in the case of share redemptions, or were replacing the corporation’s accumulated profits in the case of the payment of dividends. At the 1987 Corporate Management Tax Conference, Revenue Canada indicated that “accumulated profits” meant a

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corporation's accounting profits, computed on a non-consolidated basis, with investments in other corporations accounted for on a cost basis. The concept of accumulated profits is important in the application of the use test to determine the purpose of the borrowings. Borrowed funds will be considered to be replacing profits that would otherwise have been paid as dividends or as a partnership distribution, to the extent that they do not exceed the accumulated profits. If the accumulated profits were employed for income earning purposes, the borrowed funds are similarly considered to have been so employed. The concept of accumulated profits will be compared to the concept of equity used in the recent Draft Legislation.

The first clause of the Notice of Ways and Means Motion, therefore, confirms Revenue Canada's past administrative policy as set out in Interpretation Bulletin IT-80 which, as previously mentioned, was withdrawn following the Bronfman Trust decision, and subsequently reinstated.

Redemptions, Acquisition and Cancellation of Shares

The second type is borrowed money used by a corporation to return capital to its shareholders by way of redemption, acquisition, cancellation of any shares, reduction of capital or otherwise, or borrowed money used by a partnership to make a distribution of capital.

As discussed above, these types of borrowings would also be qualifying to the extent that such capital was used by the corporation or partnership for a qualifying purpose. Therefore, the Notice of Ways and Means Motion reflects the administrative acceptance of the Trans-Prairie Pipelines case.

Loans as per Section 80.4 ITA

The third type of borrowed money dealt with is shareholder and employee loans, as described in s. 80.4 of the ITA.

The third clause of the Notice of Ways and Means Motion deals with shareholder and employee loans. Revenue Canada's administrative position on these types of loans was laid out in Interpretation Bulletin IT-498, dated 6 October 1983.9 That Interpretation Bulletin states that interest on money borrowed used to relend to an officer or employee (or the spouse of an officer or employee), is considered deductible by the employer to the extent that such interest, together with all other remuneration to the officer or employee, is reasonable. Whether the interest, along with the remuneration, is reasonable will

9 Revenue Canada, IT-498, *The Deductibility of Interest on Money Borrowed to Relend to Employees or Shareholders* (Ottawa: Queen's Printers, 6 October 1983).
Interest deductibility depends on the value of the services rendered by the officer or employee. The requirement that the employee's total remuneration, including the benefit from a low interest loan, be reasonable is not found in clause 1(c) of the Notice of Ways and Means Motion. Revenue Canada has, however, indicated that they intend to continue the practices of the department as set out in the interpretation bulletins.  

Interest on money borrowed to reloan to shareholders or anyone related to a shareholder is also deductible by the corporate taxpayer to the extent that interest is received from the shareholder or related person.

Loans to the Corporation or Subsidiary

The fourth type of money borrowed is to be used by a person or partnership who is a shareholder of a Canadian corporation to make a loan to the corporation or its Canadian subsidiary, or to make a payment under a guarantee given in respect of a loan made to the corporation or subsidiary where: (i) the proceeds of the loan are used by the borrowing corporation or by its Canadian subsidiary in carrying on its business to gain or produce income from a business or property that will be subject to Part I tax in Canada; (ii) the borrowing corporation is unable by reason of its own financial position to obtain financing on comparable terms without the guarantee of the person or partnership; and (ii) the deduction of interest on the borrowed money or the loan would not result in an artificial or undue reduction of the income of the person or partnership or the borrowing corporation.

This fourth clause is a reflection of the policy in Interpretation Bulletin IT-445 dated 23 February 1981, regarding loans to and guarantees in favour of Canadian corporations. Revenue Canada indicated that it will continue its existing practices with respect to the administration of Interpretation Bulletin IT-445.  

Generally, where borrowed money is loaned at a less than reasonable rate of interest or interest-free, the interest expense incurred on the borrowed money would not be deductible in whole or in part. However, Interpretation Bulletin IT-445 does provide that where the borrowed money is loaned at a less than reasonable rate of interest to a Canadian corporation of which the taxpayer-

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11 Revenue Canada, IT-498, The Deductability of Interest on Money Borrowed to be Loaned at a Less Than Reasonable Rate of Interest or to Honour a Guarantee Given for Inadequate Consideration in Non-Arm’s Length Circumstances (Ottawa: Queen’s Printer, 23 February 1981).
lender is a shareholder or to the corporation's subsidiary, the interest expense incurred on the loan would be deductible if certain conditions are met. These conditions are almost identical to those set out in the fourth clause of the Notice of Ways and Means Motion and discussed above. The fifth clause of the Notice of Ways and Means Motion extends the policy laid out in the fourth clause to partnerships.

**Non Income Producing Property**

The last paragraph of the Notice of Ways and Means Motion provides that where a taxpayer borrows money to acquire property, and the interest on the money borrowed is not deductible because the property was not acquired to produce income therefrom, the interest may, however, be deducted to the extent of the borrower's income for the year from the property. Apparently, this clause is intended to permit the deductibility of interest on money borrowed to purchase preferred shares bearing a fixed dividend and money borrowed to be reloaned to a shareholder to the extent that the interest is received from the shareholder on the borrowing. This interpretation of the final clause of the Notice of Ways and Means Motion was given at the 1987 Corporate Management Tax Conference. The question asked concerned the purchase of a condominium in Florida for personal use, which was later used to earn rental income for a portion of the year, and whether interest on the mortgage would be deductible from income the property produced. Revenue Canada confirmed that interest payable in these circumstances would not be deductible.

The Notice of Ways and Means Motion dealt with four important issues concerning interest deductibility. It recognized the indirect use of funds in the context of borrowings by a corporation or partnership to redeem shares, pay dividends or otherwise effectuate a capital distribution. The Motion recognized also the indirect use of funds to make advances to a corporation or partnership by a shareholder or partner. Granted, these types of qualifying, albeit, indirect uses of borrowed money were previously sanctioned by both interpretation bulletins and the *Trans-Prairie Pipelines* case. Were it not for the *Bronfman Trust* decision, their legitimacy would probably not have been questioned.

The Notice of Ways and Means Motion was, therefore, a promise to enact legislation covering borrowings prior to 1989 originally and later, 1992, which would confirm Revenue Canada's past and current practices concerning interest deductibility. The government kept promising as of 1987 to table the necessary legislation implementing the amendments for future borrowing and confirming past administrative practices with respect to past borrowings. Draft legislation was finally released on 20 December 1991 dealing with the problem of interest
deductibility. For many tax practitioners, the draft legislation was of limited scope in that it merely covered the issues dealt with in the Notice of Ways and Means Motions tabled since Bronfman Trust and left other issues still open.

**DRAFT LEGISLATION OF 20 DECEMBER 1991**

The draft legislation released on the 20th of December 1991 is intended to fulfil two objectives. First, it is intended to provide legislative support for the manner in which the system has been, and is currently being administered. The Notice of Ways and Means Motion settled some of the confusion arising from Bronfman Trust. Greater detail was required, however. Consequently, provisions in the draft legislation provide rules for the deductibility of interest on borrowings used before the draft legislation is issued in final form. These borrowings are referred to herein as current borrowings. A fixed date has not been set for the implementation of any of these changes.

The second objective of the draft legislation is obviously to address the issue of future borrowings by adding rules regarding borrowings used after the legislation is issued in final form. Most of the amendments respecting future borrowings concern interest on funds borrowed for the purpose of distributions of retained earnings or capital by corporations in the form of share redemptions, acquisitions, or cancellations, and dividends. The modifications will have the effect of henceforth relating the deductibility of interest on borrowed funds used to make distributions to a corporation's equity as determined under the new rules, rather than to its accumulated profits. The draft legislation also includes provisions concerning borrowings made by shareholders in order to loan money to a corporation or to honour a guarantee of its indebtedness. Interest on share purchases is also dealt with, as are employer and shareholder loans. Each subject will be discussed separately. The proposed legislation also sets out explicit rules with respect to partnerships which are, for all intents and purposes, identical to those concerning corporations with the necessary modifications.

**Borrowed funds used to distribute retained earnings or capital**

Under the draft legislation, new sections 20.1 and 20.2 will be added to the ITA to provide for the deductibility of interest on funds borrowed to pay dividends or redeem shares. Section 20.1 will provide for the treatment of interest on borrowed money used to make distributions after the date on which the legislation will be issued in final form (future borrowings). Section 20.2 will apply to borrowings associated with distributions made before that time (current borrowings).
Future borrowings

Section 20.1 not only provides for two alternative methods to determine deductibility of interest; it also ties deductibility to a corporation’s equity rather than its accumulated profits as in the past. The same rules apply whether the funds are borrowed to redeem shares or to pay dividends; and in both cases, the amount paid is referred to as a “distribution.”

Under the basic method for determining deductibility, all outstanding amounts of borrowed money used to make past and current distributions will be totalled, and the total will be compared to the distributing corporation’s total equity at the beginning and end of the year in question. The treatment of interest on borrowings used to finance distributions is therefore reviewed over the period during which the borrowings remain outstanding. If the total amount outstanding on account of borrowed money used to make distributions is less than, or equal to, the lesser of the distributor’s equity at the beginning or end of the particular year, the full amount of the borrowings will be treated as having been used to earn income from business or property.

Any excess of non-capital losses incurred in the distribution year, or after the distribution year and before the particular year, over income of the distributor for those years, will be added to the distributor’s equity for the purpose of the test. If, on the other hand, the money borrowed on account of current and past distributions exceeds the distributor’s equity, as defined in the draft legislation, and any excess non-capital losses incurred over income, the excess borrowings will not be deemed as being used to earn income.

This test measures the distributor’s equity from year to year. Essentially, a distributor’s equity is the tax cost of its assets which were acquired for the purpose of earning income therefrom or from a business, less its liabilities. The concept of equity is therefore defined by reference to holdings of income producing properties. Any liabilities in respect of the distributions made in or after the distribution year are ignored. The starting point for the definition of “equity” is subsection 20.1(7). That subsection provides that a distributor’s equity is computed by totalling the cost amount to the distributor of property, other than Canadian resource property, foreign resource property, eligible capital property and properties a deduction for which is available under paragraph 37(1)(b). Shares of the capital stock of a corporation of which the distributor is a specified share holder as well as specific interests in partnerships are also excluded to avoid duplication in equity.

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13 Proposed subsections 20.1(1) and 20.1(2).
14 This exclusion is due to the fact that the value of a share in a corporation represents part of the value of the corporation’s assets. If the value of the share is allowed to be included
The provisions dealing with the computation of equity also provide particular rules dealing with cumulative eligible capital, undeducted resource expenditures, and undeducted pools of scientific research and experimental development expenditures. Furthermore, amounts owing by the distributor will reduce its equity with several exceptions. These exceptions include liabilities which relate to the acquisition of property, the cost of which is not included in equity (e.g., foreign resource property, see list above). As previously mentioned, outstanding liabilities related to distributions will not reduce the distributor’s equity. Also, lease and rental payments, which are not yet required to be paid, do not reduce equity.

Subsection 20.1(2) makes certain adjustments to the calculation of a distributor’s equity under 20.1(7) for the purpose of the basic method under subsection 20.1(1). The adjustments provide for the exclusion from the computation of the distributing corporation’s equity of: (1) property not acquired for the purpose of earning income therefrom or from a business; (2) any interest in a life insurance policy; (3) any property the income of which would be exempt; (4) any land, other than land used in a business (except a real estate business) or held primarily for the purpose of producing income therefrom; and (5) any property in respect of which interest payable would, due to subsection 18(3.1), not be deductible. Proposed section 20.1 therefore will govern the treatment of interest on borrowed money used to make distributions after the date on which the draft legislation will be issued. This new mechanism for determining deductibility is different from past practice in that it uses the concept of equity rather than accumulated profits as the determining factor.

Furthermore, deductibility is tested on a yearly basis and all outstanding borrowings an account of current and past distributions are taken into account. Another important difference is that under this proposed system, both dividends and share redemptions will be covered by the same rules. Finally, under the new system, an alternative method to determine deductibility of interest on borrowings used to make distribution is available. This method is the allocation method.

**Allocation Method**

Subsection 20.1(3) of the draft legislation allows a corporation to apply the alternative allocation method to determine deductibility of interest on borrowed money used, after the date on which the legislation is passed in final form, to pay dividends, redeem, acquire or to cancel shares of its capital stock.

in the shareholder’s equity and the value of the assets are allowed to be included in the corporation’s equity it would include the same
A partnership may also use this optional allocation method to determine the deductibility of interest on borrowings used to distribute profits or capital or to otherwise reduce the interest of any person in the partnership.

A written designation must be made allocating the borrowed funds to one or more properties or to a "qualified expenditure". A qualified expenditure is defined as one that is included in a resource pool, or research and development pool of the distributor. The designation will have the effect of treating such borrowed funds as having been used to acquire the property. Limits do exist on the amount that may be allocated to a given property or qualified expenditure. Subsection 20.1(4) provides that no more may be allocated to an asset than its net tax cost. In other words, the maximum amount allocated is that by which the tax cost of the asset, at the time of distribution, exceeds any amount owing in respect of the asset. Special rules also exist for eligible capital property, resource properties and properties in respect of which a deduction is permitted for research and development.

Subsection 20.1(5) sets a global limit on allocations under a given designation. The total of all amounts so allocated may not exceed the distributor's equity determined under the new subsection 20.1(7). Global limits are also provided for amounts designated to a particular expenditure pool.

The procedure for making the designation is described at subsection 20.1(6) of the draft proposals. A corporation wishing to apply the allocation method has two options. It can designate its adoption of the allocation method in its return of income under Part I of the ITA for the taxation year that includes the time of distribution. Alternatively, a corporation can so designate in a prescribed form, filed within 90 days of the day on which an assessment of its Part I tax for the year is mailed. Subsection 20.1(5) provides for the repudiation of a designation.

Current Borrowings

The proposed subsection 20.2 provides rules which would apply in respect of borrowings made before the date on which the legislation is issued in final form. The purpose behind section 20.2 is to provide legislative confirmation of Revenue Canada's past and current practices regarding deductibility of interest on money borrowed to make distributions of retained earnings or capital. However, although section 20.2 should be consistent with the Notice of Ways and Means Motions tabled since 1987 and Interpretation Bulletin IT-80, it may not be completely so.

The mechanism provided for determining deductibility of interest on these types of borrowings refers to the "adjusted equity" of the distributor. Money borrowed to make a distribution will be treated as having been used for the
purpose of earning income from a business or property to the extent of the distributors “adjusted equity” immediately before the distribution. The adjusted equity is computed in reference to the accounting value of the distributor’s property, determined under generally accepted accounting principles (“GAAP”), or their carrying value, rather than their tax value as in the basic method for future borrowings. The distributor’s adjusted equity is computed in subsection 20.2(2) by subtracting from the total carrying value of property, the total amount, as determined under GAAP, of the distributor’s liabilities (with certain exceptions) and the total amount of any profits or gains, determined according to GAAP, of the distributor, from the disposition of property to non-arm’s length persons. It should be noted that such profits or gains are reflected in the carrying value of the distributor’s property.

In computing the distributor’s total liabilities, an interest, a life insurance policy, liabilities in relation to borrowed money used to acquire non-income producing property, or any property the income from which would be exempt, are excluded.

The expression “carrying value of the distributor’s property” is defined at subsection 20.2(3). That subsection begins by stating that carrying value of property is determined according to GAAP. It then excludes the equity and consolidation methods of accounting. Other restrictions are imposed in determining the cost of property. The only amounts that may be added to, or deducted from, the original cost of a property are those in respect of depreciation, depletion, or the cost of improvements. Also, the carrying value to the distributor of any property received by it from a person with whom it does not deal at arm’s length is deemed to be the lessor of its carrying value otherwise determined, and the cost amount of the property. Finally, the carrying value of any property not acquired for the purpose of earning income, an interest in a life insurance policy, or any property the income from which would be exempt, is deemed to be nil. As discussed above, liabilities in respect of the acquisition of these properties will not reduce the distributor’s adjusted equity and therefore accordingly, their accounting value will not be included in the adjusted equity.

The concept of adjusted equity is not, at face value, identical to that of accumulated profits used in Interpretation Bulletin IT-80 and the Notice of Ways and Means Motions. The accumulated profits test was defined in a 1987 Corporate Tax Management Conference as accounting profits computed on an unconsolidated basis with investments accounted for on a cost basis. It was also mentioned 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. Depending on the facts of each case, it is not clear whether the adjusted equity method employing the “carrying value” yardstick
will achieve results similar to those under the accumulated profits test.

Furthermore, under this system, the same method is employed to determine the deductibility of interest on borrowed funds used to pay dividends and to redeem shares. Previously, the accumulated profits test was applied only for dividends. Where money was borrowed to redeem shares, the interest was deductible to the extent that the capital was used by the corporation for an income earning purpose.

On a final point, it should be reminded that these current rules for borrowings used to pay dividends and redeem shares will be applicable to borrowings made before the draft legislation is finally issued. Consequently, non-statute barred years could conceivably be reassessed under the rules provided for current borrowings in the draft proposals.

Interest on Borrowed Money Reloaned to a Corporation or Partnership

The proposed legislation generally adopts the administrative policies set out in Interpretation Bulletin IT-445 with certain exceptions. In the past, Revenue Canada has permitted the deduction of interest incurred by a taxpayer on money borrowed to reloan to a Canadian corporation of which he is a shareholder, or its Canadian subsidiary, at no interest or at a less than a reasonable rate of interest in certain limited circumstances. These circumstances were discussed above in the context of the Notice of Ways and Means Motion which essentially embodied Interpretation Bulletin IT-445. In summary, the conditions were: (1) the proceeds of the loan must be used by the borrowing corporation in its own operations to produce income from business or property which will be subject to Part I tax; (2) the borrowing corporation is unable, although it has made every possible effort, to borrow the funds through usual commercial money markets, without the guarantee of the shareholder, at interest rates at which the shareholder can borrow; and (3) the loan does not result in any undue tax advantage being conferred on either the shareholder or the corporation (whereas the Notice of Ways and Means Motion referred to an undue or artificial reduction of income).

The proposed subsections 20(3.1) and (3.2) of the draft legislation will deal with these issues. These subsections will be applicable in respect of borrowed money used by a taxpayer for one of three purposes: (1) to make a loan to a taxable Canadian corporation of which the taxpayer is a shareholder, or to a taxable Canadian corporation that is controlled, either alone or together with others, by the taxpayer (who is the shareholder) or the first corporation; (2) to honour a guarantee given by the shareholder on a liability of such a corporation; or (3) to acquire shares of a corporation that the shareholder controls.
These borrowings will be treated as having been used for the purpose of earning income from property and thereby enabling the interest on the borrowings to qualify for a deduction in the computation of the shareholder’s income. However, two conditions must be met. First, the corporation must use the proceeds generated from the shareholder’s loan, the property acquired with the shareholder’s guarantee, or the proceeds arising from the share holder’s additional share subscription, for the purpose of earning Canadian-source, non-exempt income. Secondly, as with Interpretation Bulletin IT-445, the corporation’s financial situation must be such that it could not, on its own, have procured the loan on terms comparable to those obtained by the shareholder from a non-arm’s length person. However, the language in the draft legislation is not as harsh as that in Interpretation Bulletin IT-445. The interpretation bulletin provided that the corporation must have made every effort to borrow the funds through the usual commercial money markets but was unable to obtain the financing without the guarantee of the share holder at interest rates which were available to the share holder. The draft legislation merely provides that the corporation must have been unable to borrow on comparable terms from any non-arm’s length person without the shareholder’s guarantee. Furthermore, the requirement that the loan does not result in any undue tax advantage on the share holder or the corporation has been dropped, based on the view that the general anti-avoidance rules would apply.

Where the shareholder ceases to have a qualifying interest in the corporation, or the corporation ceases to use the funds or property in question for the purpose permitted in the draft legislation, the borrowings will no longer be treated as being used to produce income.

Where a controlling shareholder uses borrowed funds to acquire shares of the corporation, the deductibility of interest on the borrowed funds will be determined according to the same rules discussed above for loans to corporations. However, the shareholder must control the particular corporation and continue doing so for the interest to be deductible. These provisions are found in clause 20(3.1)(a)(iii) and may allow the deductibility of interest on money borrowed that previously would not have been eligible for a deduction.

These rules, which are detailed at subsection 20(3.1) with respect to corporations, would apply only with respect to future borrowings; that is, borrowings used before the draft legislation is passed. As for current borrowings, other than borrowing for the purpose of acquiring shares, interest on these borrowings would only be eligible where two conditions are met. The borrowings must have been used to make a loan to, or otherwise assume a liability of, a taxable Canadian corporation of which the taxpayer is a shareholder or that is a subsidiary controlled by such a corporation. Second, the
borrowings used to acquire shares would be eligible only if the shareholder acquiring the shares owns the majority each class of issued and outstanding shares of the capital stock of the corporation.

Subsection 20(3.2) provides the version of these rules applicable to members of Canadian partnerships that use borrowed money to make loans to the partnership or to make a payment in respect of a loan made to the partnership or an amount payable for property acquired by the partnership. There are no modifications to the partnership rules with respect to borrowings incurred before the draft legislation is issued in final form.

Interest on Share Purchases

It is proposed that paragraph 20(1)(qq) be added to the ITA to apply in circumstances where shares of a corporation are acquired, using borrowed funds, for a purpose other than to earn income. Generally, in the past, Revenue Canada has permitted the deduction of interest where the net income test has been met and where the shares acquired with the borrowed funds were preferred shares with fixed dividends. The net income test precluded the deduction of an interest expense where the income earned on the share did not exceed the interest on the borrowings used to acquire the share.

The draft legislation does not explicitly limit the deduction to interest on borrowed funds used to acquire preferred shares with fixed dividends. The explanatory notes accompanying the draft legislation do provide that these proposals generally will not be applicable to interest on borrowings used to acquire common shares.

Paragraph 20(1)(qq) would therefore be applicable to 1972 and subsequent years. Separate rules for current and future borrowings were not proposed in this regard. The paragraph provides an interest deduction on the borrowed funds, up to the amount included in the borrowers income (dividends) from the shares that were acquired with the borrowings in question. In the case of an individual shareholder, the deduction of interest would be permissible to the amount of the actual dividends received and the gross-up.

Employee and Shareholder Loans

The draft legislation adopts Revenue Canada's past practice with respect to interest deductibility on money borrowed by an employer to reloan to an employee interest free, or at a low rate of interest. As with the Notice of Ways and Means Motion, the requirement that the amount of the loan be reasonable when considered with total remuneration, in relation to services rendered by the employee, has been abandoned. Presumably, such a provision is considered
unnecessary.

In the past, loans by a corporation to its shareholder could qualify for an interest deduction, according to Interpretation Bulletin IT-498, where the shareholder paid interest on the loan. This practice has been reflected in proposed clause 20(1)(c)(vi).

CONCLUSION

The draft amendments to the ITA may have had, as one of their main objectives, the legislative confirmation of Revenue Canada's past and current practices with respect to interest deductibility. It is unclear whether this objective has been attained.

In the past, deductibility of interest on money borrowed to pay dividends was tied to a corporation's accumulated profits. Under the proposed rules for current borrowings, it is tied to the corporation's adjusted equity. Furthermore, the old accumulated profits test was applicable only with respect to money borrowed for the payment of dividends, whereas the adjusted equity test is to be applied to both dividend payments and share redemptions. The rules for current borrowings are the same whether the funds are borrowed to pay dividends or to redeem shares.

The draft legislation has also left many questions unanswered. The concept of interest has yet to be defined in the legislation and the loss of source problem has yet to be addressed. That is, loans taken out to acquire property which has subsequently been disposed of, and the proceeds, if any, are neither used for consumption, nor applied to an ineligible use. Subject to the proposed paragraph 20(1)(qq), rules regarding interest on money borrowed to acquire speculative investments have also been omitted, as were rules on loans incurred to acquire property which would yield a capital gain.

A final comment with respect to the draft legislation concerns the questionable need for such detailed and complex legislation which imposes a heavy administrative burden on taxpayers. Proposed section 20.1 dealing with the rules for future borrowing requires that a taxpayer continuously monitor its equity to ensure that a declining equity base does not prejudice its ability to deduct interest on outstanding loans.15 \(^{15}\) Distributors would also have to ensure that they keep track of the tax cost of their assets and all amounts owing. All records would have to be kept current to ensure a proper monitoring of any

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15 Joint Committee on Taxation of the Canadian Bar association and the Canadian Institute of Chartered Accountants "Submissions to the Minister of Finance on the December 20, 1991 Draft Legislation Relating to the Tax Treatment of Interest Expense" (September 1992) at 13.
outstanding balances on loans for distributions and the distributor’s equity. The bulk of the complexity stems from the need to define “equity”. As the test for deductibility is based on a distributor’s equity, it appears that the complexity would be difficult to avoid.