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Justice Bowman's Decisions on the Deductibility of Interest

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CONTENTS

INTRODUCTION

As a judge and chief justice of the Tax Court of Canada, Donald Bowman decided a number of cases that dealt with the deductibility of interest. This article reviews and provides comment on those decisions. First, however, some background on the interest deductibility provisions is in order so that Justice Bowman's decisions can be better understood in the context of the legislative, judicial, and administrative history of the income tax considerations.

Historical Background

The historical background and related purpose of the enactment of the interest deduction provisions has not been the subject of much review and analysis, although it has become increasingly important in light of the textual, contextual, and purposive approach adopted by the Supreme Court of Canada in interpreting income tax

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legislation.[1] In reference to the deductibility of interest, Canada's highest court has stated:

> I agree with Marceau J. as to the purpose of the interest deduction provision. Parliament created s. 20(1)(c)(i), and made it operate notwithstanding s. 18(1)(b), in order to encourage the accumulation of capital which would produce taxable income.[2]

Where did this statement of purpose originate? Is "the accumulation of capital" the only way in which borrowed funds can be used to produce taxable income? Marceau J was the judge in the Federal Court Trial Division decision in the *Bronfman Trust* case.[3] He was commenting on the argument by the plaintiff's counsel "that the end result of the transactions was the same as if the trustees had sold assets to pay the allocations and then borrowed money to replace those assets, in which case the interest on the loans no doubt would have been deductible."[4] Marceau J, in disagreeing with the argument, gave the following reply:

> If assets had been sold, these would have remained income producing and therefore tax producing, and the borrowed money would have been added to the total amount of income and tax producing capital; whereas here, no money was added to the tax producing capital. That is a difference which, to my mind, is decisive in view of the rationale that lies behind the rules laid down by Parliament with respect to the deductibility for income tax purposes of interest payable by a taxpayer on borrowed money. (Compare *Joel Sternthal v. The Queen*, 74 DTC 6646.)[5]

On a careful reading, Marceau J's comments clearly make reference only to "the rationale that lies behind the rules laid down by Parliament," and not to the suggested purpose of Parliament's enactment of the interest deductibility provisions. Marceau J, in this regard, refers to Kerr J's comments in the *Sternthal* case, which neatly sum up the apparent rationale behind Parliament's enactment of the rules.[6]

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1 See the guidelines set out by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*, 2005 DTC 5523, at 5526 (SCC).

2 *The Queen v. Bronfman Trust*, 87 DTC 5059, at 5064 (SCC), per Dickson J. This dictum has been repeated in several Supreme Court of Canada decisions referencing the *Bronfman Trust* case, including *Tennant v. The Queen*, 96 DTC 6121, at 6125 (SCC), per Iacobucci J; *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669, at 5679 (SCC), per McLachlin J; and *Ludco Enterprises Ltd. et al. v. The Queen*, 2001 DTC 5505, at 5515 (SCC), per Iacobucci J.

3 *Bronfman Trust v. The Queen*, 79 DTC 5438 (FCTD). In *Bronfman Trust*, the taxpayer had borrowed money to make a capital distribution from the trust to a beneficiary and had deducted the interest thereon on the basis that although the direct use of the borrowed money was to make a distribution, the indirect use was to earn income since the borrowing permitted the trust to retain its income-producing assets.

4 Ibid., at 5439.

5 Ibid., at 5440.

6 *Sternthal v. The Queen*, 74 DTC 6646, at 6649 (FCTD).

Kerr J was commenting on the *Trans-Prairie Pipe Lines* case,[7] where Jackett P of the Exchequer Court had rejected as a test of the deductibility of interest, whether the first expenditure of the money after it was borrowed was an expenditure for the purpose of the company's business. Jackett P reasoned that what must have been intended by the interest deductibility provisions 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 the loan as long as its first use was in the business. Kerr J went on to comment on the *Trans-Prairie* decision as follows:

> There is in the rationale of that decision the rule that the borrowed money must be used for the purpose of earning income from the business, and the President's appreciation of the matter in the *Trans-Prairie* case was that the appellant was using the borrowed money in its business to earn income.[8]

The Tax Review Board decision in *Bronfman Trust*[9] also made reference to Kerr J's comments noted above. It made no reference to Parliament's purpose in enacting the interest deductibility rules, because there was nothing to refer to in the comments made in Parliament on the introduction of amendments to the original interest deduction provision. The only point of reference in attempting to understand the intent of the provision was the apparent rationale of Parliament. It was only at the Supreme Court of Canada in *Bronfman Trust*, in the statement by Dickson J quoted above, that reference was made to Parliament's purpose (as opposed to an explanation of the rationale for the rules), that purpose being "to encourage the accumulation of capital which would produce taxable income."

The reference to the purpose of Parliament by Dickson J may simply have been a poor choice of words. As noted, nowhere in the discussions in the House of Commons on the introduction of the original provision is any reference made to its purpose. Parliament only made general comments to the effect that the provision was introduced as a clarifying measure—that is, to affirm that interest paid in any form in respect of a business is a proper charge against the income of the business.[10]

There was no initial provision made for the deduction of interest on the enactment and implementation of The Income War Tax Act, 1917.[11] It was not until 1923 that paragraph (h) was added to subsection 3(1) to provide for the following deduction:

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7 *Trans-Prairie Pipe Lines Ltd. v. MNR*, 70 DTC 6351 (Ex. Ct.).

8 *Sternthal*, supra note 6, at 6649.

9 *Bronfman Trust v. MNR*, 78 DTC 1752 (TRB).

10 Canada, House of Commons, *Debates*, June 27, 1923, 4492-94. Also see the article by Paul K. Tamaki, "Interest Deductibility," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004) 1:1-21, where this issue is discussed.

11 SC 1917, c. 28.

(h) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer. To the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction. The rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable.[12]

Over the years, several amendments have been made to what we now know as paragraph 20(1)(c) of the Income Tax Act.[13] The most significant of those amendments was made in 1948,[14] when paragraph (c) was added to what was then subsection 11(1) to allow the following amounts to be deducted in computing the income of a taxpayer for a taxation year:[15]

(c) an amount paid in the year, or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to

12 An Act To Amend The Income War Tax Act, 1917, SC 1923, c. 52, section 2.

13 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

14 The Income Tax Act, SC 1948, c. 52.

15 The current version of paragraph 20(1)(c) reads as follows:

> 20(1) Notwithstanding paragraphs 18(1)(a), . . .
>
> (c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),
>
> (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),
>
> (iii) an amount paid to the taxpayer under
>
> (A) an appropriation Act and on terms and conditions approved by the Treasury Board for the purpose of advancing or sustaining the technological capability of Canadian manufacturing or other industry, or
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> (B) the *Northern Mineral Explorations Assistance Regulations* made under an appropriation Act that provides for payment in respect of the Northern Mineral Grants Program, or
>
> (iv) borrowed money used to acquire an interest in an annuity contract in respect of which section 12.2 applies (or would apply if the contract had an anniversary day in the year at a time when the taxpayer held the interest) except that, where annuity payments have begun under the contract in a preceding taxation year, the amount of interest paid or payable in the year shall not be deducted to the extent that it exceeds the amount included under section 12.2 in computing the taxpayer's income for the year in respect of the taxpayer's interest in the contract.

> a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), but, if the rate at which the interest was computed was unreasonably high, only such part of the amount so paid or payable as would have been paid or payable if the rate had been reasonable may be deducted.

There was no discussion of the 1948 amendments to the interest deduction provision in the House of Commons debates,[16] either as to the reasons for the changes or as to their purpose. The disconcerting aspect of this background is that many decisions of the Supreme Court of Canada, as well as those of lower courts, are based upon an assumption that is unsupported. The Supreme Court's statement as to Parliament's purpose gives a binding effect in the interpretation of paragraph 20(1)(c), particularly in light of today's textual, contextual, and purposive approach to statutory interpretation. On the other hand, an interpretive guideline in respect of Parliament's intention gives the courts much greater elasticity in being able to accept factually based arguments evidencing a different underlying rationale for Parliament's enactment of the interest deductibility rules.

Has the statement by Dickson J in *Bronfman Trust* and its subsequent endorsement in other Supreme Court of Canada decisions resulted in questionable or flawed judicial decisions? Probably not, on reading the cases, but the issue as stated nonetheless remains with us and needs to be corrected.

The Four Elements of Paragraph 20(1)(c)

There are four basic elements to paragraph 20(1)(c),[17] which require that, in order to be deductible, interest must be

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

The Use of Borrowed Money

It is the third element that has resulted in most of the considerable litigation and resulting judicial commentary over the years. It focuses not on the purpose of the borrowing per se, but on the taxpayer's purpose in using the borrowed money. The focus of the inquiry must be centred on the use to which the taxpayer put the borrowed funds. Further, it is the current use of the borrowed money that is relevant, and

16 Canada, House of Commons, *Debates*, June 8, 1948, 4893-4900.

17 *Shell Canada*, supra note 2, at 5674, per McLachlin J.

the provision generally requires tracing the use of the borrowed funds to a specific eligible use.[18]

In the *Singleton* case,[19] the Supreme Court of Canada rejected the notion that "overall purpose" is synonymous with "true economic purpose," the latter test having been applied by Bowman J in the Tax Court decision.[20] The Supreme Court concluded that the only issue to be determined in this respect is the direct use of the borrowed funds.[21] In reviewing each transaction independently, the Supreme Court concluded that the funds were borrowed for the purpose of earning income from the taxpayer's law firm. There was a direct link between the borrowed money and an eligible use, and, in this regard, the taxpayer was not required to demonstrate a bona fide purpose. Thus, the court held that the taxpayer was entitled to the interest deduction claimed.[22]

The Direct Link Test

The current use of the borrowed funds requires a sufficiently direct link between the borrowed money and a current income-earning use. In the *Bronfman Trust* case, this linkage did not exist, on the basis that the funds borrowed by the trust (the taxpayer) were originally used to make capital allocations to the beneficiaries for which the trust received no property or consideration of any kind. The Supreme Court concluded that the use of the borrowings was indisputably not of an income-earning nature and, unless the direct use of the money ought to be overlooked in favour of an alleged indirect income-earning use, the taxpayer could not be permitted to deduct the interest paid.

The linkage factor was also questioned in the *Tennant* case,[23] where the Supreme Court of Canada indicated that the taxpayer had to establish a link between the shares that had been acquired with the original borrowing and the subsequent proceeds on the disposition of those shares. The court indicated that the taxpayer satisfied this requirement on the basis that the shares initially acquired with the borrowed funds were the first source of income and were simply exchanged for shares in a second corporation, which were the taxpayer's replacement source of income.

18 *Bronfman Trust*, supra note 2, at 5064, also supported in *Shell Canada*, supra note 2, at 5674.

19 *The Queen v. Singleton*, 2001 DTC 5533 (SCC).

20 Infra note 28.

21 The Supreme Court also indicated that, even though a number of other transactions had occurred on the same day as the borrowing of the funds in question, it was an error to treat the entire series of transactions as one simultaneous transaction.

22 The tests enunciated in *Singleton* regarding the deductibility of interest were confirmed in *Lipson*, infra note 30, a recent decision of the Supreme Court of Canada dealing with the general anti-avoidance rule. (The taxpayers lost for other reasons, which are not the subject of this particular article.)

23 Supra note 2.

Continuing Source of Income

One of the guiding principles in obtaining a deduction for interest is that the source of income to which the interest relates must continue to exist and any additional borrowed money must be traceable to an existing or another income-producing source. In *Emerson v. The Queen*,[24] the Federal Court of Appeal confirmed this principle where the taxpayer had disposed of shares for a loss and at the same time borrowed a sum to repay the loan that had originally been obtained to purchase the shares. The court held that an essential requirement for an interest deduction under paragraph 20(1)(c) is the continued existence of the source of income to which the interest relates. In this instance, the source had been eliminated.

Section 20.1 now allows for the continued deduction of interest even where, in certain circumstances, there has been a loss of the source of income. The provision is applicable where a taxpayer who has used borrowed money for the purpose of earning income from a capital property, other than real property or depreciable property, ceases to use that money for that purpose after 1993 and there has been a decline in the value of the property.

In *Ludco Enterprises*,[25] the Supreme Court indicated that the main focus in interpreting paragraph (20)(1)(c) was to determine whether the taxpayer's purpose in using the borrowed funds to purchase shares was to earn income within the meaning of that paragraph. The court held that, of the various tests proposed to be used to determine the taxpayer's purpose, only the reasonable expectation of income test is consistent with the wording of the paragraph. The court went on to say that, with respect to the meaning of "income" as that term is used in paragraph 20(1)(c), the reference is clearly to income generally—that is, an amount that would come into income for taxation purposes and not just net income. This is supported by the wording of paragraph 20(1)(c), as explained by Iacobucci J:

> [W]hen one looks at the immediate context in which the term "income" appears in s. 20(1)(c)(i), it is significant that within the provision itself the concept of "income" is used in contradistinction from the concept of tax-exempt income. Viewed in this context, the term "income" in s. 20(1)(c)(i) does not refer to net income but to income subject to tax. In this light, it is clear that "income" in s. 20(1)(c)(i) refers to income generally, that is an amount that would come into income for taxation purposes and not just net income.[26]

Thus, income for the purposes of paragraph 20(1)(c) equates to gross income and not merely net income, so that the language of paragraph 20(1)(c) refers to a reasonable expectation of gross income.

24 86 DTC 6184 (FCA).

25 Supra note 2.

26 Ibid., at 5515.

THE JUSTICE BOWMAN CASES—A COMMENTARY

The "overall purpose" test is a central part of Bowman J's commentary in the *Mark Resources*,[27] *Singleton*,[28] and *Lipson*[29] decisions, three cases in which the central issue was the deductibility of interest. While the purpose of the interest deductibility provisions appears to be clear in Bowman J's mind, and applied consistently by him both before and after the enactment of the general anti-avoidance rule (GAAR), the decisions in these cases often do not provide sufficient guidance for taxpayers on what differentiates a legitimate business transaction from a transaction whose purpose falls within paragraph 20(1)(c) as a "purpose of earning income." The Supreme Court disagreed with the overall purpose approach in both *Singleton* and *Lipson*, thus overturning Bowman J's decisions in these cases, and clarified that it is the overall result rather than the overall purpose of a transaction that should be the focus of the court's analysis. In *Lipson* (a GAAR case), the Supreme Court cautioned that

> care should be taken not to shift the focus of the analysis to the "overall purpose" of the transactions. Such an approach might incorrectly imply that the taxpayer's motivation or the purpose of the transaction is determinative. In such a context, it may be preferable to refer to the "overall result," which more accurately reflects the wording of s. 245(4) and this Court's judgment in *Canada Trustco*.[30]

Furthermore, the court in *Lipson* acknowledged that Bowman J's decision in that case did not provide sufficient guidance as to the meaning of "overall purpose":

> Turning to the Tax Court judge's reasons, it is not entirely clear what Bowman, C.J.T.C. meant by "overall purpose." He cited and applied the *Canada Trustco* analysis (paras. 17-30), but also appeared, at times, to rely on the taxpayers' motivation and on the economic substance of the transactions. For example, in para. 31, he mentioned that the primary objective of the transactions was to make the interest on the purchase of the house tax deductible. However, as I mentioned above, Bowman, C.J.T.C. seems to have focussed on the result of the series of transactions.[31]

The discussion below indicates that the economic motivation analysis that is central to Bowman J's decisions was rejected by the higher courts, in favour of a more taxpayer-friendly analysis that focuses on the actual transactions undertaken rather than their ultimate goal.

27 *Mark Resources Inc. v. The Queen*, 93 DTC 1004 (TCC).

28 *Singleton v. The Queen*, 96 DTC 1850 (TCC).

29 *Lipson et al. v. The Queen*, 2006 DTC 2687 (TCC).

30 *Lipson et al. v. The Queen*, 2009 DTC 5528, at paragraph 34 (SCC).

31 Ibid., at paragraph 39.

Mark Resources

In *Mark Resources*, a Canadian company borrowed money from a Canadian bank in order to make a capital contribution to a US wholly owned subsidiary. The US subsidiary invested the money in a term deposit. The interest earned on the term deposit was in turn paid back to the Canadian parent company in the form of dividends. The Canadian parent company claimed the interest paid to the Canadian bank with respect to the money borrowed as a deductible expense pursuant to paragraph 20(1)(c). Bowman J disallowed the interest deduction.

Bowman J summarized the issue in this case as follows:

> Where a Canadian company borrows funds in Canada to contribute as capital to its U.S. subsidiary with the admitted ultimate object of utilizing losses sustained by the subsidiary and with no expectation of ever receiving a return that is equal to or greater than the interest it pays on the borrowed funds, is the interest that it pays, or any portion thereof, deductible?[32]

His comments on the application of paragraph 20(1)(c) in this case are particularly interesting for the analysis of the purpose of the interest deductibility provisions. In keeping with the statements of McLachlin J in *Shell Canada*,[33] Bowman J stated that the wording of the Act is directed at examining the purpose of the use of the borrowed funds rather than the borrowing itself. He disagreed with the contention that the earning of dividend income was the real purpose of the borrowed funds, and argued that it represented a "subservient and incidental" step within the arrangement.[34] He explained the true economic purpose of the arrangement as follows:

> It is true that the overall economic result, if all of the elements of the plan work, is a net gain to the appellant, but this type of gain is not from the production of income but from a reduction of taxes otherwise payable in Canada. I am cognizant of the fact that the dividends, although deductible in computing taxable income, are nonetheless income. It is, however, this feature of our Canadian tax system whereby such dividends are deductible in computing taxable income that gives to the plan its apparent economic viability.[35]

Bowman J went on to discuss the fact that the "true purpose is a broader one that subsumes all of the subordinate and incidental links in the chain."[36] His comments indicate that it is the overall purpose of a series of transactions that must be analyzed in order to determine whether it fits within the purpose of earning income contemplated by paragraph 20(1)(c).

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32 Supra note 27, at 1007.

33 Supra note 2.

34 Supra note 27, at 1011.

35 Ibid., at 1012.

36 Ibid., at 1011.

Bowman J's closing remarks on this case are particularly interesting because they focus on the fact that while the purpose of the arrangement in question was correct from a business perspective, it was nevertheless not a purpose that fit within the intended application of paragraph 20(1)(c).

> The absorption of business losses of a foreign subsidiary is unquestionably a legitimate objective. Its overall purpose is to increase the net worth of the corporate group as a whole. This is an entirely commendable business purpose and any chief financial officer who failed to try to do so would not be doing his or her job. It is not, however, a purpose that falls within paragraph 20(1)(c) as a "purpose of earning income."[37]

It is unclear from the judgment what would differentiate this transaction from one that not only has a legitimate business purpose but also meets the purpose test of paragraph 20(1)(c). This distinction appears to be clear in Bowman J's mind; however, the decision provides insufficient guidance for taxpayers as to what types of transactions undertaken for legitimate business purposes may ultimately be considered not to be undertaken for the purpose of earning income when subjected to a rather vague judicial smell test.

Singleton

In the *Singleton* case, the taxpayer successfully restructured his financial affairs to obtain an interest deduction for borrowed funds that could be traced to an income-earning use but were used indirectly to purchase a personal residence.

The taxpayer in this case was a partner in a law firm in which he had in excess of $300,000 in equity. The firm distributed the taxpayer's $300,000 in capital to him, and the taxpayer used the money to purchase a house. On the same day, the taxpayer borrowed $300,000 on the security of the home and contributed the funds to replenish his partners' capital account.

Bowman J once again applied his approach of looking to the overall purpose of the transactions, which he ultimately found to be a borrowing where the direct use related to a contribution to partnership capital. As a result, he found in favour of the Crown and dismissed the taxpayer's appeal on the basis that the borrowed money had been used, as a "matter of economic reality,"[38] for the purpose of buying a house. According to Bowman J, the "true economic purpose for which the borrowed money was used was the purchase of a house, not the enhancement of the firm's income earning potential by a contribution of capital."[39]

The Federal Court of Appeal reversed Bowman J's decision[40] and found in favour of the taxpayer on the basis that the transactions should be treated independently to

37 Ibid., at 1016.

38 Supra note 28, at 1852.

39 Ibid., at 1853.

40 *Singleton v. The Queen*, 99 DTC 5362 (FCA).

reflect the reality of what had happened. The Supreme Court of Canada subsequently upheld the decision of the Court of Appeal and held that, absent a sham or a specific provision in the Act to the contrary, the economic realities of a transaction cannot be used to recharacterize a taxpayer's bona fide legal relationships. Major J stated that the court should just apply subparagraph 20(1)(c)(i) of the Act, "rather than search for the economic realities of the transaction."[41]

This approach is contrary to Bowman J's long-held view that the role of the court is precisely that: to search for the true purpose of the transaction as a whole, rather than to analyze each step in the transaction in a vacuum. In a dissenting judgment, LeBel J agreed with Bowman J's conclusions on "the question of the economic realities of the transaction that occurred."[42] Citing *Mark Resources* as support for his argument, he said that in his opinion, the role of the courts is to look to the economic realities of the situation and "not merely to the legal technique adopted by the taxpayer."[43]

It is important to note that *Singleton* was a pre-GAAR case. After the introduction of GAAR, the Supreme Court of Canada commented in the *Lipson* decision that GAAR can apply to "*Singleton*-like" refinancing transactions.[44]

Lipson

In *Lipson*, the minister sought to apply GAAR (section 245 of the Act) to deny an interest deduction in a series of transactions between a husband and wife. Accordingly, Bowman J's analysis focused on section 245, along with the interest deduction provisions in paragraph 20(1)(c) and subsection 20(3), and the spousal attribution rules in section 74.1. However, his comments were consistent with those in *Mark Resources* and *Singleton*, in that he applied an "overall purpose" test to his analysis of the facts and concluded that the courts should search for the economic reality of the transaction as a whole, rather than each individual step undertaken as part of a series of transactions.

The facts in this case are relatively straightforward. Mrs. Lipson borrowed approximately $560,000 and used the loan proceeds to purchase shares of the family investment company from her husband. Mr. and Mrs. Lipson then borrowed $560,000, secured by a mortgage on their home. The loan proceeds were used to repay Mrs. Lipson's original loan. The plan was that any gain or loss and any income or loss realized by Mrs. Lipson in respect of the shares would be attributed back to Mr. Lipson by virtue of the application of the income attribution rules in subsections 74.1(1) and 74.2(1). Therefore, Mr. Lipson claimed as a deduction the interest expense net of the dividends on the shares. Mr. Lipson took the position that the interest deduction was justified on the basis of subsection 20(3)—interest on borrowed money used to repay a loan made for an eligible purpose. The minister

41 Supra note 19, at 5537.

42 Ibid., at 5540.

43 Ibid.

44 Supra note 30, at paragraph 36.

disagreed and reassessed to deny the interest deduction, and the taxpayers appealed to the Tax Court.

The sole issue at trial was whether the transactions involved, which were admitted to be avoidance transactions within the meaning of subsection 245(3), constituted an abuse or misuse as contemplated by section 245. At the centre of the case was the notion that the economic substance of a series of transactions should be determinative of whether abusive tax avoidance is taking place.

In his judgment, Bowman J held that the transactions in question did constitute an abuse or misuse and therefore dismissed the taxpayers' appeals.

> The purpose of the series of transactions was to make the interest deductible that would not be deductible if the money was simply used to buy the house.[45]

> Not one of the purposes of the provisions that I referred to above is being fulfilled by this series of transactions. The overall purpose as well as the use to which each individual provision was put was to make interest on money used to buy a personal residence deductible.[46]

> [I]f section 245 is to serve any purpose it must be applied to the very sort of contrived transaction such as this one at which it is obviously aimed.[47]

In reaching his decision, Bowman J cited the decision of the Supreme Court of Canada in *Canada Trustco*[48] and pointed out that the Supreme Court directed the courts to apply a unified textual, contextual, and purposive analysis, not only of the sections giving rise to the tax benefit but also of section 245. He concluded that the series of transactions resulted in a misuse of the provisions of the Act, since none of the relevant provisions contemplated making interest on money used to buy a personal residence deductible. This decision constituted a marked departure from the approach mandated by the Supreme Court in *Singleton*, where the court clearly stated that judges should abstain from searching for the sometimes elusive economic reality of a particular transaction and should focus instead on the application of the relevant section of the Act to the transactions that actually occurred.

On appeal to the Federal Court of Appeal, the taxpayers argued that Bowman J had erred "by improperly importing into the GAAR analysis the concepts of economic purpose and reality and by . . . [conducting] the abuse and misuse analysis on the basis that the borrowings were used to buy the home rather than by reference to the transactions as they actually took place and the legal relationships which were

45 Supra note 29, at paragraph 16.

46 Ibid., at paragraph 23.

47 Ibid., at paragraph 33.

48 Supra note 1.

created."[49] In the taxpayers' view, Bowman J strayed from the "principled approach" set out in *Canada Trustco* and *Kaulius*.[50] The Court of Appeal dismissed the taxpayers' appeal and was of the opinion that Bowman J was entitled to give substantial weight to the series of transactions, and most importantly to its purpose.

On further appeal to the Supreme Court of Canada, LeBel J, contrary to the decision of Bowman J, and (even more surprisingly) contrary to his own comments in his dissenting judgment in *Singleton*, found that it was the "overall result" of the transactions rather than their "overall purpose" that was the proper focus of the GAAR analysis.

Concluding Comment

The notion of an economic substance test, while applied consistently by Bowman J throughout the decisions discussed above, was ultimately rejected by the Supreme Court of Canada in *Lipson*. The court's decision in *Lipson*, while consistent with its decision in *Canada Trustco*, and ultimately favourable to taxpayers in that it elevates the determination of whether abusive tax avoidance has occurred to a standard higher than a judicial smell test, is contrary to Bowman J's repeated attempts to impart a notion of economic substance to the analysis of both the interest deductibility provisions and the anti-avoidance provisions of the Act.

49 *Lipson et al. v. The Queen*, 2007 DTC 5172, at paragraph 25 (FCA).

50 *Mathew v. Canada* (sub nom. *Kaulius v. The Queen*), 2005 DTC 5538 (SCC).