Subparagraph 20(1)(c)(i): What Is Its Purpose?

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PRÉCIS

Par suite de la décision rendue par la Cour suprême du Canada dans l'affaire *Sa Majesté la Reine c. Bronfman Trust*, plusieurs questions sur l'interprétation juste de l'alinéa 20(1)c) sont demeurées sans réponse. Certaines décisions plus récentes de ce tribunal et de la Cour d'appel fédérale ont soulevé d'autres points à ce sujet. Cet article porte sur l'interprétation juste des dispositions contenues dans l'alinéa 20(1)c), plus particulièrement sur le critère « en vue de gagner un revenu ». L'interprétation analysée du point de vue de la formulation de la disposition, du contexte dans lequel elle se situe et de l'utilisation de critères similaires dans d'autres dispositions contenues dans la Loi de l'impôt sur le revenu. L'analyse vise à fournir une démarche pour interpréter l'alinéa 20(1)c) qui soit conforme au langage utilisé dans les lois et applicable aux situations réelles.

ABSTRACT

The decision of the Supreme Court of Canada in *The Queen v. Bronfman Trust* left many questions unanswered as to the proper interpretation of paragraph 20(1)(c). More recent decisions of that court and the Federal Court of Appeal have raised additional issues regarding the proper interpretation of the provision that have yet to be fully resolved. This article will consider an appropriate interpretation of paragraph 20(1)(c) with particular focus on the "purpose of earning income" test. This interpretation of paragraph 20(1)(c) will be developed having regard to the language of the provision, the context in which it is placed, and the use of similar tests in other provisions of the Income Tax Act. The objective of the analysis is to provide a framework for the interpretation of paragraph 20 (1)(c) that is both consistent with the statutory language and practicable in real world situations.

This article will consider, within the confines of the generally accepted rules of statutory interpretation applicable to taxing statutes, the "purpose of earning

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income" test in subparagraph 20(1)(c)(i) of the Income Tax Act[1] and the manner in which that test has been applied by the courts. The objective of the analysis is to develop an interpretation of the test that is consistent with both the statutory language and the scheme within which the provision operates. It is hoped that this analysis will provide a comprehensive framework for applying the provision that is consistent with purpose of earning income tests in other provisions of the Act.[2]

THE STATUTORY SCHEME

Subparagraph 20(1)(c)(i) is one of a number of provisions in subsection 20(1) that authorize the deduction of amounts that would not otherwise be deductible because of the restrictions in paragraph 18(1)(a), (b), or (h). Generally, those paragraphs deny the deduction of

- outlays or expenses except to the extent that they are made or incurred to gain or produce income from a business or property;[3]
- capital outlays or payments, replacements of capital, and allowances that reflect depreciation, obsolescence, or depletion;[4] and
- personal and living expenses.[5]

The received wisdom, supported by several judgments of the Supreme Court of Canada,[6] is that paragraph 20(1)(c) is required in order to override the restriction on the deduction of capital outlays found in paragraph 18(1)(b).[7] In the absence of subparagraph 20(1)(c)(i), interest on borrowed money would constitute a non-deductible capital outlay.

This received wisdom explains the presence of the purpose test in subparagraph 20(1)(c)(i). Specifically, the provision had to include a self-contained

1 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 and the regulations thereunder, as amended to September 21, 1999.

2 I do not address other issues raised by paragraph 20(1)(c), such as the questionable need for much of the opening language of the provision.

3 Paragraph 18(1)(a).

4 Paragraph 18(1)(b).

5 Paragraph 18(1)(h).

6 *Canada Safeway Ltd. v. MNR*, [1957] CTC 335 (SCC); *The Queen v. Bronfman Trust*, [1987] 1 CTC 117 (SCC); *Tennant v. The Queen*, [1996] 1 CTC 290 (SCC); and *Shell Canada Ltd. v. The Queen*, [1999] 4 CTC 313 (SCC). It is of interest to note that in *Shell Canada* the court left the door open to reconsideration of this issue.

7 For a history of paragraph 20(1)(c), see Brian J. Arnold and Tim Edgar, "Deductibility of Interest Expense" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1217-43, at 1218-20, where the authors provide a detailed description of the amendments to the provision since its introduction in 1923. For a criticism of the notion that interest is a capital outlay, see Brian J. Arnold, "Is Interest a Capital Expense?" (1992), vol. 40, no. 3 *Canadian Tax Journal* 533-53.

purpose of earning income test because the general rules for the computation of income applicable under section 9 and its predecessors would not apply to a deduction expressly sanctioned by the Act. Moreover, the interest deduction is stated to apply notwithstanding the prohibitions in paragraphs 18(1)(a), (b), and (h), and their predecessor provisions. Accordingly, if the interest deduction provided in subparagraph 20(1)(c)(i) is to be restricted to interest on borrowed money used for income-earning purposes, the restriction has to be included in the language of the provision itself.[8]

The rationale for including a purpose test in subparagraph 20(1)(c)(i) is illustrated by the Supreme Court of Canada's analysis in *Symes v. The Queen*[9] of the general scheme in the Act for the deduction of business expenses found in subsection 9(1) and paragraphs 18(1)(a) and (h).[10] There, Iacobucci J confirmed four basic principles:

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8 Arnold and Edgar, supra footnote 7, at 1218 and 1225, express the point in the following terms:

> The first and most fundamental question to be asked concerning the deduction of interest is why it should be treated differently from other expenses. All income-earning expenses, including interest, should be deductible; all other expenses should not be deductible, because they represent a cost of personal consumption. However, interest expense has been treated differently from other expenses for Canadian tax purposes. The most significant difference is the specific statutory authorization for the deduction of interest. Paragraph 20(1)(c) allows a taxpayer to deduct interest with respect to borrowed money or the unpaid purchase price of property if the money or property is used to earn business or property income that is not exempt from tax. This statutory basis for the deduction of interest is based on the premise that interest would otherwise be considered a non-deductible capital expense. . . .
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> Under an ideal tax system, it is necessary to distinguish between expenses incurred to earn income, which are deductible, and expenses incurred for personal consumption, which are not deductible. This distinction, which applies to all expenses, including interest, is evident in the basic test for the deduction of interest under paragraph 20(1)(c). Borrowed money (or property in the case of interest on the unpaid purchase price of property) must be used for the purpose of earning income from a business or property. It is not necessary that income be in fact earned, but only that the funds be used for an income-earning or "eligible" purpose. This purpose test is a common feature of deductions for tax purposes because it is necessary to permit deductions where the taxpayer's business or investment property actually results in a loss.

9 [1994] 1 CTC 40 (SCC). These principles were again confirmed by the Supreme Court of Canada in *Canderel Ltd. v. The Queen*, [1998] 2 CTC 35.

10 In *Symes*, supra footnote 9, at 51-52, Iacobucci J describes the scheme as follows:

> *In other words, the "profit" concept in subsection 9(1) is inherently a net concept which presupposes business expense deductions. It is now generally accepted that it is subsection 9(1) which authorizes the deduction of business expenses; the provisions of subsection 18(1) are limiting provisions only*. See *MerBan Capital Corp. v. R.*, [1989] 2 C.T.C. 246, 89 D.T.C. 5404 (F.C.A.). . . .
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> Adopting this approach to deductibility, *it becomes immediately apparent that the well accepted principles of business practice encompassed by subsection 9(1) would*

1) Subsection 9(1) authorizes the deduction of business expenses. This follows from the fact that the concept of profit in that provision is inherently a net concept that presupposes the deduction of business expenses.

2) The provisions of subsection 18(1), including paragraphs 18(1)(a) and (h), are limiting provisions only.

3) The accepted principles of business practice encompassed by subsection 9(1) generally operate to prohibit the deduction of expenses that lack an income-earning purpose or are personal expenses, just as paragraphs 18(1)(a) and (h) operate to prohibit such deductions.

4) Although there is an element of redundancy in paragraphs 18(1)(a) and (h), they do serve to reinforce the point that the determination of profit under subsection 9(1) is a legal determination rather than an accounting determination. As well, they summarize what might otherwise be abstract principles of commercial practice.

In light of the fact that the rules inherent in subsection 9(1) and explicit in paragraph 18(1)(a) do not apply to an express statutory deduction, one can understand why the legislature included a purpose test in subparagraph 20(1)(c)(i).[11] Also, on the basis of the purpose test incorporated into the general scheme created by subsection 9(1) and paragraph 18(1)(a), one can reasonably conclude that the purpose test in subparagraph 20(1)(c)(i) is simply intended to ensure that the interest deduction will be available only if the borrowed money

> *generally operate to prohibit the deduction of expenses which lack an income earning purpose, or which are personal expenses, just as much as paragraphs 18(1)(a) and (h) operate expressly to prohibit such deductions*. For this reason, there is an artificiality apparent in the suggestion that one can first examine subsection 9(1) in order to determine whether a deduction is authorized, and can then turn to subsection 18(1) where another analysis can be undertaken: N. Brooks, "The Principles Underlying the Deduction of Business Expenses" in B.G. Hansen, V. Krishna and J.A. Rendall, eds., *Essays on Canadian Taxation* (1978), 249, at pages 253–54; V. Krishna, *The Fundamentals of Canadian Income Tax* (4th ed. 1992), at page 365, footnote 44, and page 367.
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> Although paragraphs 18(1)(a) and (h) may, therefore, simply be analytically repetitive or confirmatory of prohibitions already embodied in subsection 9(1), they may serve to reinforce the point already made, namely, that the subsection 9(1) test is a legal test rather than an accountancy test. At the same time, they conveniently summarize what might otherwise be abstract principles of commercial practice [emphasis added].

See also Neil Brooks, "The Principles Underlying the Deduction of Business Expenses," in Brian G. Hansen, Vern Krishna, and James A. Rendall, eds., *Canadian Taxation* (Don Mills, Ont.: De Boo, 1981), 189-249.

11 This also explains the existence of regulation 1102(1)(c) and the purpose test in the definition of "eligible capital expenditure" in subsection 14(5). Specifically, since the capital cost allowance and cumulative eligible capital provisions authorized by paragraphs 20(1)(a) and (b) operate outside the general scheme for the deduction of business expenses, they must also include a stand-alone purpose test.

is used for an income-earning purpose rather than a personal or other non-income-earning purpose. Exactly what this means is explored below.

THE STATUTORY LANGUAGE

To paraphrase, subparagraphs 20(1)(c)(i) and (ii) allow a taxpayer to deduct in computing income from a business or property 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

- borrowed money *used for the purpose of earning income* from a business or property, and
- 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.

Earning Income

The first question raised by the language of the purpose test in subparagraph 20(1)(c)(i) is why this provision refers to "earning income" while subparagraph 20(1)(c)(ii) refers to "gaining or producing" income. Although one could no doubt concoct a litany of reasons why the legislature chose to employ an "earning" test in subparagraph 20(1)(c)(i) in order to narrow the scope of the deduction,[12] the most logical explanation is that the draftsperson did not think to adopt the new phrase "gaining or producing" in paragraph 11(1)(c) when the Act was revised in 1948.[13]

The original version of subparagraph 20(1)(c)(i) was added to the Income War Tax Act in 1923 as paragraph 3(1)(h). Following the consolidation of the

12 In *Symes*, supra footnote 9, at 56, Iacobucci J states, "In 1948, the statutory language which governed in the above cases was replaced by the immediate forerunner of paragraph 18(1)(a): the *Income Tax Act*, S.C. 1948, c. 52, paragraph 12(1)(a). It is important to highlight the changes which were thus introduced. First, whereas the old provision required that an expense be incurred 'wholly, exclusively and necessarily' for the stated purpose, the current provision does not relate the purpose requirement to any modifier. Second, whereas the old provision stated that a business expense was an expense incurred for the 'purpose of *earning* the income,' the current provision speaks of '*gaining or producing*' the income [emphasis added]." This statement could be interpreted as suggesting that the word "earning" imparts a narrower meaning than "gaining or producing." It is more likely, however, that His Lordship was simply recognizing the effect of the more restrictive language in the original version of paragraph 18(1)(a) and, in particular, the fact that it referred to "earning *the* income," which is on its face more narrow than "earning income." This interpretation is supported by Iacobucci J's immediately subsequent reference to the comments of Martland J in *Premium Iron Ores Ltd. v. MNR*, [1966] CTC 391 (SCC), reproduced in the text following, at footnote 16.

13 The purpose language used in subparagraph 20(1)(c)(i) is identical to the purpose language used in paragraph 11(1)(c) of the Income Tax Act of 1948, SC 1948, c. 52.

Income War Tax Act, 1917, in 1927, paragraph 3(1)(h) became paragraph 5(1)(b) and the structure of the Act was slightly modified. However, the scheme of the Act remained considerably different from that which exists today. Section 3 of the Income War Tax Act set out a comprehensive definition of "income" intended to capture all sources of income then recognized as being taxable by Parliament. Section 5 set out the exemptions and deductions allowed in computing income as defined, and section 6 set out the limitations applicable to that computation. Paragraph 5(1)(b) stated in part:

> Income as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions . . .
>
> (b) Such a reasonable rate of interest on borrowed capital used in the business to *earn the income* as the Minister in his discretion may allow [emphasis added].

The narrow language reflected the general approach in the pre-1948 statute of requiring a close connection between income and the expenses incurred to earn that income.[14] In the same statute, paragraph 6(1)(a)[15] stated:

> In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of—
>
> (a) disbursements or expenses not *wholly, exclusively and necessarily* laid out or expended for the purpose of *earning the income* [emphasis added].

In 1948, the Income War Tax Act was substantially overhauled and became the Income Tax Act. The comprehensive definition of income was dropped in favour of the profit concept in section 9, and paragraph 5(1)(b) was replaced in its entirety with paragraph 11(1)(c), which stated in part:

> Notwithstanding any other provision in this Division, the following amounts may, subject to subsections (2) and (3) of section 12, be deducted in computing the income of a taxpayer for a taxation year: . . .
>
> (c) an amount paid in the year, or payable in respect of the year . . . pursuant to a legal obligation to pay interest on borrowed money used for the purpose of *earning income* from a business or property [emphasis added].

Paragraph 6(1)(a) was likewise replaced with paragraph 12(1)(a), which stated:

14 In *Symes*, supra footnote 9, at 55, Iacobucci J comments on the more restrictive nature of the pre-1948 Act and the difficulty this presents in applying to paragraph 18(1)(a) the case law interpreting that regime: "There is some difficulty associated with determining how an expense can otherwise satisfy paragraph 18(1)(a), however. Several cases which gave important consideration to the question did so with respect to the more restrictive language of the *Income War Tax Act,* R.S.C. 1927, c. 97, subsection 6(a). That section prohibited the deduction of expenses to the extent that they were not '*wholly, exclusively and necessarily* laid out or expended for the purpose of *earning the income*' [emphasis added]."

15 Paragraph 6(1)(a) was the 1927 version of paragraph 18(1)(a).

> In computing income, 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 *gaining or producing income* from property or a business of the taxpayer [emphasis added].

One could fasten on the fact that paragraph 11(1)(c) used "earning" while paragraph 12(1)(a) used "gaining or producing." An emphasis on this point of difference, however, misses the focus of the amendments, which was to eliminate the requirement that the expense, whether interest or some other expense, had to be incurred to earn, gain, or produce "the income," as defined in the pre-1948 statute. The 1948 provisions required only that the expense be incurred to earn, gain, or produce "income." The significance of this change was recognized by Martland J in *Premium Iron Ores Ltd. v. MNR*:

> It seems clear that the present wording of paragraph [12(1)](a), which first appeared in *The 1948 Income Tax Act*, Statutes of Canada 1948, c. 52, was intended to broaden the definition of deductible expenses. The *Income War Tax Act* defined "income" as meaning "the annual net profit or gain or gratuity." Under Section 6(1)(a), in computing such profit or gain it was only permissible to deduct expenses wholly, exclusively and necessarily expended for the purpose of earning *that income*. The present Act does not contain this definition of "income." It frequently uses the phrase "income for a taxation year," which appears in Section 11(1) dealing with allowable deductions. *The phrase does not appear in Section 12(1)(a) which, as now worded, permits the deduction of any expense made for the purpose of producing income from a property or business* [emphasis added].[16]

It also seems unlikely that the legislature intended to impose a different standard for deductibility under subparagraph 20(1)(c)(ii) from the standard under subparagraph 20(1)(c)(i). The former provision was added as subparagraph 11(1)(c)(ii) in 1950 in response to the Supreme Court of Canada's decision in *MNR v. T.E. McCool Ltd*.[17] That case held that interest on the unpaid purchase price for property was not interest on "borrowed money" and therefore was not deductible under paragraph 11(1)(c). The use of "gaining or producing," rather than "earning," in the new subparagraph cannot be explained by the judgment or by the purpose of the provision; reasonably, it can only be attributed to the draftsperson using the then accepted terminology—an approach that was inexplicably overlooked when paragraph 11(1)(c) was introduced two years earlier.

For the foregoing reasons, I submit that it is not appropriate to read anything into the use of the word "earning" in subparagraph 20(1)(c)(i) and that it should be viewed as synonymous with the much more common phrase "gaining or

16 Supra footnote 12, at 394-95.

17 [1949] CTC 395 (SCC).

producing."[18] While this point may seem trivial, it is important in that it confirms the relevance of other similarly worded provisions of the Act to the interpretation of the purpose test in subparagraph 20(1)(c)(i).[19]

The Use Requirement

The statutory language of subparagraph 20(1)(c)(i) requires that the borrowed funds be "used" for a qualifying purpose. As a matter of grammatical construction, it is reasonable to conclude that the use of the borrowed money must be ascertained before any assessment of purpose can be made. Moreover, the determination of use can reasonably be made only by reference to the actions of the taxpayer in deploying the borrowed funds, since a reference to use must be a reference to actual use, and not intended or proposed use.[20] In effect, by virtue of the reference to "used," a court is compelled to make an assessment of the objective circumstances surrounding the borrowing of the money as a prerequisite to determining whether the purpose test in subparagraph 20(1)(c)(i) has been satisfied—a condition that distinguishes subparagraph 20(1)(c)(i) from other provisions employing a purpose test that do not require a two-stage inquiry, including paragraph 18(1)(a) and regulation 1102(1)(c).[21] The courts have adopted this interpretation of the "used" requirement in subparagraph 20(1)(c)(i).

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18 In *74712 Alberta Ltd. v. The Queen*, [1997] 2 CTC 30, at 64 (FCA), Robertson JA stated, "I do recognize that there is a difference in the wording of paragraph 18(1)(a) of the Act and subparagraph 20(1)(c)(i). The former speaks of an expense incurred for the purpose of 'gaining or producing' income from a business. The latter speaks of funds borrowed for the purpose of 'earning' income from a business. In my view, the distinction cannot be deemed significant if only because *Imperial Oil* was decided at a time when the equivalent of paragraph 18(1)(a) spoke of an expense incurred for the purpose of 'earning' income from a business: see paragraph 6(1)(a) of the *Income War Tax Act*."

19 To be consistent with the language employed in subparagraph 20(1)(c)(ii) and elsewhere in the Act, subparagraph 20(1)(c)(i) should be amended to adopt the more common "gaining or producing" phrase.

20 In *Evans v. The Queen*, [1987] 1 CTC 316, at 318 (FCTD), Collier J interpreted the phrase "was used" in regulation 1100(17) as follows: "The words 'was used' must, in my opinion, be given their plain ordinary meaning. The leasing property must have, in fact, been used. Hoped for, or intended use, is not included." See also the comments of Bowman J in *Glaxo Wellcome Inc. v. The Queen*, [1996] 1 CTC 2904 (TCC), noted infra footnote 36.

21 In *The Queen v. Byram*, [1999] 2 CTC 149, at 154 (FCA), the court distinguished the purpose test in subparagraph 40(2)(g)(ii) from the test in paragraph 20(1)(c) on the basis that the latter was subject to the "used" requirement: "Unlike paragraph 20(1)(c) this section only requires a single stage inquiry, namely what was the purpose for acquiring the debt. The two stage inquiry laid down in *Bronfman* clearly indicates that there is a distinction between use and purpose. Therefore, while there are some similarities in the general language of paragraph 20(1)(c) and subparagraph 40(2)(g)(ii), it is significant that section 40 does not contain a 'source' directed preamble nor does it refer to use as well as purpose. Accordingly, it would be wholly inappropriate to apply the direct/indirect use limitation imposed in *Bronfman* to this section."

In *Canada Safeway Ltd. v. MNR*,[22] the notion of looking beyond the objective use of the borrowed money in favour of the purpose of the borrowing[23] was rejected by the Supreme Court of Canada. In that case, Canada Safeway borrowed money to acquire the shares of another company that distributed groceries and with which Canada Safeway did a significant amount of business. At that time, dividend income was exempt from tax, and therefore the purchase of income-producing shares could not qualify for the interest deduction. Canada Safeway argued that the court should ignore the direct use of the borrowed funds in favour of the more remote purpose of the borrowing—the enhancement of the company's income-earning capability brought about by its control of the new subsidiary. The court rejected this argument:

> No doubt there is in fact a causal connection between the purchase of the stock and the benefits ultimately received; but the statutory language cannot be extended to such a remote consequence; it could be carried to any length in a chain of subsidiaries; *and to say that such a thing was envisaged by the ordinary expression used in the statute is to speculate and not interpret. . . .*
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> [The language] "borrowed money used for the purpose of earning income from [. . .] property (other than property the income from which is exempt)" in (i) *means the income produced by the exploitation of the property itself*. There is nothing in this language to extend the application to an acquisition of powers annexed to stock, and to the indirect and remote effects upon the company of action taken in the course of business of the subsidiary [emphasis added].[24]

In *Bronfman Trust*, the Supreme Court stated categorically that it is the direct use of the borrowed money that determines the eligibility for an interest deduction:

> The statutory deduction thus requires a characterization of the use of the borrowed money as between the eligible use of earning non-exempt income from a business or property and a variety of possible ineligible uses. . . .
>
> The interest deduction provision requires not only a characterization of the use of borrowed funds, but also a characterization of "purpose." *Eligibility for the deduction is contingent on the use of borrowed money for the purpose of earning income*. It is well-established in the jurisprudence, however, that it is not the

22 Supra footnote 6.

23 The purpose of borrowing money could subsume many objectives, both direct and indirect. However, the language of subparagraph 20(1)(c)(i) makes it clear that the legislature chose to focus only on the use of the borrowed money to assess purpose. Such an approach centres the inquiry on the purpose that can reasonably be drawn from the objective use of the funds and thus allows the court to disregard any purpose that cannot be extracted from that use. It also avoids the need to consider a possible multitude of subjective purposes that are not directly connected to the use of the funds but could nevertheless be viewed as a purpose of the borrowing.

24 *Canada Safeway*, supra footnote 6, at 343 and 345-46.

> purpose of the borrowing itself which is relevant. What is relevant, rather, is the taxpayer's purpose in *using* the borrowed money in a particular manner. *Auld v. M.N.R.*, 28 Tax A.B.C. 236, 62 D.T.C. 27 (T.A.B.). *Consequently, the focus of the enquiry must be centered on the use to which the taxpayer put the borrowed funds*. . . .
>
> In my view, neither the *Income Tax Act* nor the weight of judicial authority permits the court to ignore the direct use to which the taxpayer puts borrowed money [emphasis added].[25]

The judgments in *Canada Safeway* and *Bronfman Trust* recognize that a taxpayer may have many objectives or purposes in mind when borrowing money; however, on the basis of the plain words employed in subparagraph 20(1)(c)(i), only the direct use to which the taxpayer puts the borrowed money is germane in determining whether the income-earning purpose test is satisfied.[26]

Although the plain wording of subparagraph 20(1)(c)(i) does require a court to determine the use of borrowed money as a precursor to assessing whether the purpose test has been satisfied, the wording does not explain how use is to be determined. On the basis of general legal principles adopted in the tax jurisprudence, a reasonable approach would be for the court to consider the legal and

25 *Bronfman Trust*, supra footnote 6, at 124-25 and 126.

26 See also *Shell Canada*, supra footnote 6, at 331, where the court states, "Yet, as Dickson, C.J. made clear in *Bronfman Trust*, *supra*, at p. 46, the reason for a particular method of *borrowing* is irrelevant to a proper consideration of s. 20(1)(c)(i). The issue is the *use* to which the borrowed funds are put. It is irrelevant why the borrowing arrangement was structured the way that it was or, indeed, why the funds were borrowed at all." Generally speaking, legal commentators accept this interpretation of the use test. Arnold and Edgar, supra footnote 7, at 1225-26, observe:

> The task of developing an appropriate approach to the determination of the use of borrowed funds has been left to the courts. In general, the case law has established that a taxpayer must trace borrowed funds to an eligible use in order to deduct interest. According to the Supreme Court in *Bronfman Trust*, this tracing approach means that borrowed funds must be used directly for an income-earning purpose, subject perhaps to some limited exceptions discussed below. Moreover, the current or continuing use of the borrowed funds, rather than the original use, determines whether or not the interest is deductible. For example, interest on funds borrowed for an eligible purpose (say, the acquisition of a rental property) ceases to be deductible if the funds are later used for an ineligible purpose (say, the rental property is converted to a personal residence or is sold and the proceeds are used for personal consumption).
>
> Although the tracing approach is well established, its precise meaning has not been discussed extensively and it is not very well understood. It is important to understand that, as applied by the courts, tracing does not involve the patently foolish task of following the use of particular pieces of currency. Money is simply a medium of exchange. The crucial point is what goods or services are acquired with the money. Under a tracing approach, the actual use of borrowed money is determined on the basis of all the facts and circumstances that indicate a link between the borrowed money and the acquisition of particular services or property. If the property or services are used for a qualifying purpose (that is, to earn income), the interest is deductible; otherwise, it is not.

practical effect of the taxpayer's actions with respect to the borrowed money.[27] Although this approach is straightforward in principle, some confusion has resulted from the following comments of Dickson CJ in *Bronfman Trust:*

> I acknowledge, however, that just as there has been a recent trend away from strict construction of taxation statutes . . . so too has the recent trend in tax cases been towards attempting to ascertain the true commercial and practical nature of the taxpayer's transactions. There has been, in this country and elsewhere, a movement away from tests based on the form of transactions and towards tests based on what Lord Pearce has referred to as a "common sense appreciation of all the guiding features" of the events in question: . . .
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> This is, I believe, a laudable trend provided it is consistent with the text and purposes of the taxation statute. Assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.[28]

The meaning of this paragraph has been the subject of much speculation.[29] Revenue Canada has sometimes taken the position that it empowers a court to

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27 In *Antosko v. The Queen*, [1994] 2 CTC 25, at 31 (SCC), Iacobucci J made the following observation regarding the application of the Act to a particular transaction: "While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain *and where the legal and practical effect of the transaction is undisputed* [emphasis added]." Further elaboration on this general approach was provided by Bowman J in *Sussex Square Apartments Ltd. v. The Queen*, [1999] 2 CTC 2143, at 2150-51 (TCC), as follows:

> I can see no reason for applying some vague principle of "economic substance" over form.
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> In *Continental Bank of Canada v. R*, 94 D.T.C. 1858 (T.C.C.) at 1871 I summarized my view of the substance versus form doctrine as follows:
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> > The principle to be deduced from these authorities is simply this: the essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs. The Minister, conversely may not say to the taxpayer "You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one."
>
> Once it is determined that the legal relationships are what they purport to be the court must give effect to them. I find that the legal relationships in this case are valid, binding and real. They were certainly not shams.

28 *Bronfman Trust*, supra footnote 6, at 128.

29 See, for example, Brian A. Felesky and Sandra E. Jack, "Is There Substance to 'Substance Over Form' in Canada?" in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 50:1-63.

disregard the legal relationships of taxpayers in favour of an economic analysis of those relationships.[30] I suggest that Dickson CJ was simply referring to the fact that a taxpayer should not be entitled to an interest deduction if he or she manipulates events so as to give the appearance that the borrowed money is used for one purpose when in fact and in law it is used for another purpose.[31] This is a reasonable approach to take in applying the use test and one that accords with the general proposition in Canadian tax law that the incidence of tax should follow the legal, not the economic, substance of a taxpayer's actions.[32]

30 See, for example, the minister's arguments in *The Queen v. Shell Canada Ltd.*, [1998] 2 CTC 207 (FCA).

31 Dickson CJ highlights this point in the penultimate paragraph of his judgment in *Bronfman Trust*, supra footnote 6, at 129-30, where he says, "If, for example, the trust had sold a particular income-producing asset, made the capital allocation to the beneficiary and repurchased the same asset, all within a brief interval of time, the courts might well consider the sale and repurchase to constitute *a formality or a sham* designed to *conceal* the essence of the transaction, namely that money was borrowed and used to fund a capital allocation to the beneficiary [emphasis added]." If one accepts that formality and sham are being used interchangeably—an interpretation that is supported by the fact that both are used in the context of concealment—then Dickson CJ is simply saying that the courts must ascertain the true nature of the legal relationships in order to determine use.

32 The recent judgments of the Supreme Court of Canada in *Duha Printers (Western) Ltd. v. The Queen*, [1998] 3 CTC 303; *Continental Bank Leasing Corporation v. The Queen*, [1998] 4 CTC 119; and *Shell Canada*, supra footnote 6, all support the view that the substance of a transaction is to be drawn from the bona fide legal relationships created by the parties to the transaction, not from an analysis of the economics of the transaction. In fact, in *Shell Canada*, supra footnote 6, at 328-29 and 330, the court appeared to put to rest the suggestion that *Bronfman Trust* supported an economic substance-over-form analysis:

> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form: *Bronfman Trust, supra,* at pp. 52-53, *per* Dickson, C.J.; *Tennant, supra,* at para. 26, *per* Iacobucci J. But there are at least two *caveats* to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterizations are only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect: *Continental Bank of Canada v. R.,* [1998] 2 S.C.R. 298 (SCC), at para. 21, *per* Bastarache, J.
>
> Second, it is well established in this Court's tax jurisprudence that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied. . . .
>
> *Obiter* statements in earlier cases that might be said to support a broader and less interpretative principle have therefore been overtaken by our developing tax jurisprudence.

One should not, however, lose sight of the fact that *Canada Safeway* and *Bronfman Trust* involved the use of borrowed money outside a business context[33] and that the word "used" is a term of wide import. In *Qualico Developments Ltd. v. The Queen*,[34] the Federal Court of Appeal considered whether houses built for sale by the taxpayer were used by the taxpayer for the purpose of gaining or producing income from its business. On this point, Mahoney J concludes:

> The inventory in issue is part, at least, of the appellant's stock in trade. As I appreciate it, the stock in trade of a business is that which the business offers for sale in the ordinary course of its trade. An item not so offered for sale is not properly to be included in the inventory of stock in trade. In my respectful opinion, an item offered for sale by a business in the ordinary course of its trade is an item used by it in that business. I do not agree that the use occurs only when the offer is accepted and the item is sold.[35]

In *Glaxo Wellcome Inc. v. The Queen*, Bowman J provides the following comments on the word "used" as employed in subsection 44(1):

> Let us then start with the word "used." About as garden-variety a word as one is likely to find anywhere. A company uses a piece of land on which it locates its factory, and carries on its business. A farmer uses land on which he plants crops. Indeed, I would extend the word "use" to cover land that a farmer summer-fallows for a season. Unless some principle of interpretation compels me to ascribe a broader meaning to the word "use" connotes actual utilization for some purpose, not holding for future use. "Used primarily for the purpose of gaining or producing income from a business" would, *prima facie*, imply that the land be put to some productive use in the business.[36]

These cases support the argument that the word "used" requires a common-sense appreciation (based on the legal and practical effect of the taxpayer's actions) of how the taxpayer has employed the borrowed money. Such a determination

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33 Canada Safeway acquired shares in a corporation that became its subsidiary while the Bronfman Trust held investment assets.

34 [1984] CTC 122 (FCA). See also *Shell-Mex and BP Ltd. v. Clayton*, [1956] 3 All ER 195, at 191-92 (HL), which is cited in *Qualico*.

35 *Qualico Developments*, supra footnote 34, at 129.

36 *Glaxo Wellcome*, supra footnote 20, at 2908-9. It is noteworthy that Bowman J cites in support of his analysis the decision of Hugesson J in *Qualico Developments* to the effect that "used" does not include the holding of inventory for sale. This position was directly at odds with the position of Mahoney J (implicitly adopted in the reasons of Thurlow CJ) reproduced above. Given that Bowman J was dealing with vacant land held for the possible future expansion of the taxpayer's business while Hugesson J was dealing with inventory held for sale, one might suggest that Bowman J's adoption of Hugesson J's minority view on this point was unnecessary. However, Bowman J's general comments regarding the meaning of "used" remain valid.

clearly involves more than simply tracing dollar bills.[37] This is important because in many cases where borrowed money is used in a business, the asset typically resulting from the borrowing (that is, cash) leaves the taxpayer's control, and therefore direct tracing of the actual money that is borrowed could lead to an inappropriate denial of the interest deduction.[38] For example, the cash

37 The traditional approach to the use test traces the use of the cash, not the cash itself, although the test is sometimes expressed in different terms. For example, see Arnold and Edgar, supra footnote 7, at 1225-26, where the authors suggest that one looks to the goods and services acquired presumably with the cash. While such an approach will no doubt yield the correct result where borrowed money is used outside a business context (for example, to acquire shares or other income-producing property), as discussed below, I believe that in a business context, this approach requires the court to be more sophisticated in its analysis, taking into account such factors as the circumstances of the particular business and the inherent fungibility of money.

38 See also Robert Couzin, "Three Observations on Interest," in *Income Tax and Goods and Services Tax Considerations in Corporate Financing*, 1992 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1993), 2:2-14, where the author makes the following comments at 2:5-6:

> But is the current use of borrowed (or any other) money really a tracing question? If borrowed money is used to pay salaries, or to buy inventory that is sold, we have little difficulty concluding that the interest is deductible pursuant to paragraph 20(1)(c) so long as the mass of capital remains committed to the business. We can also understand why deductibility may be questioned if that capital is later committed to an ineligible use. This result cannot be based on tracing, as that word is commonly understood. The money has, after all, been spent.
>
> This is not a metaphysical conundrum created by the current use test. The application of paragraph 20(1)(c) can be difficult, but it is not impossible. *Trans-Prairie* had it right. The decision merits reading and rereading. It is so sensible that one wonders how we ever strayed from the course it set for us. President Jackett is too succinct and clear to require paraphrasing.
>
>> When a business person has borrowed money for use in business, he is, according to the ordinary use of language, using that borrowed money in his business to earn income therefrom even though part of it has been converted into "bricks and mortar" and part of it was paid out during the first year for inventory and by way of salaries. Indeed, except in very unusual circumstances, he is using that borrowed money in his business to earn income until the loan matures and is paid off. By contrast, the actual money borrowed will, according to the ordinary use of language, have been "used" to acquire plant and machinery and to pay running expenses and will, in fact, have completely ceased to belong to the business man once it has been so used.
>
> But we did stray, succumbing to the siren song of tracing and its derivatives, cash damming and streaming. Even before *Bronfman Trust*, and especially after, taxpayers have tried to ensure deductibility of interest by such methods. After all, if the law is really trying to follow dollar bills about, putting borrowed ones in a sock and emptying it for a qualifying use seems like good planning. This process seeks to accomplish the physical tracing of money (an oxymoron).

acquired as a consequence of borrowing money may be used by a lawyer to buy lunch for a potential client as part of a business development strategy. Direct tracing of the cash would suggest that it has left the lawyer's control and thereafter is no longer used in the business, since the cash is in the hands of the restaurant owner. Moreover, the lawyer cannot say that the cash still forms part of the circulating capital of the business or that it has been converted into a productive asset, since the meal is consumed by the potential client, who (to add insult to injury) rejects the lawyer's overtures. Accordingly, under a test that traces the cash, it would be reasonable to conclude that the borrowed money is no longer used for the purpose of earning income from the lawyer's business, and therefore the interest on that money is not deductible. However, nobody would quarrel with the common-sense conclusion that the borrowed money was used (that is, consumed) and continues to be used in the lawyer's business (because it cannot be used in any other way, having been consumed), so that interest on the borrowed money continues to be deductible, even after the cash acquired as a consequence of the borrowing is spent.[39]

The above analysis determines the use of the borrowed money by reference to the use of the cash that is the borrowed money. However, in some cases, the asset that is expended may not be the borrowed money itself. This is consonant with the concept of money, which is generally understood to mean "something accepted as a medium of exchange, a measure of value or a means of payment."[40] A taxpayer may borrow US $100 but take delivery of Cdn. $150 in cash. The taxpayer has borrowed, and will be required to repay, US $100 even though the asset held is Canadian dollars—the measure of the borrowing is US $100 and the asset obtained is Cdn. $150. If the taxpayer then spends the Canadian dollars to obtain services for its business, the common-sense conclusion is that the borrowed money (that is, US $100) has been used in the taxpayer's business

In *Bronfman*, supra footnote 6, at 129, Dickson CJ suggests that the Act requires tracing of the use of the borrowed money, not tracing of the borrowed money: "In my view, *the text of the Act requires tracing of the use of borrowed funds to a specific eligible use,* its obviously restricted purpose being the encouragement of taxpayers to augment their income-producing potential. This, in my view, precludes the allowance of a deduction for interest paid on borrowed funds which indirectly preserve income-earning property but which are not directly 'used for the purpose of earning income from . . . property' [emphasis added]."

39 In effect, the concept of use does not require a court to continue tracing the borrowed money beyond the consumption (that is, use) of the borrowed money in the lawyer's business. This is appropriate because once the borrowed money is consumed for an eligible purpose and therefore can no longer be used for any other purpose, it is not reasonable to deny the interest deduction on the basis that the money acquired as a consequence of the borrowing can no longer be traced to the business.

40 *Webster's Third New International Dictionary*.

even though the asset expended (that is, Cdn. $150) is Canadian dollars and is gone. In this case, the determination of use is made by reference to the use of the cash asset that represents the borrowed money, even though it is not the borrowed money itself.[41]

The nature of money therefore allows the courts to apply a simple use of the cash test, even where the asset expended is not strictly speaking the borrowed money but cash representing the borrowed money. But what if the facts are more difficult to interpret? Is it appropriate for the courts to limit their analysis to the use of the cash asset that is, or represents, the borrowed money? Couzin argues that

> paragraph 20(1)(c) neither mandates nor endorses crude attempts to follow around bits of money. The fungibility of money is not a theory; it is a fact. That is why courts of equity had to develop their notion of tracing, and why it remains so limited. That is why cash damming is inherently illogical. Businesses do not and should not be asked to behave that way. A more flexible notion of tracing might therefore serve us well.[42]

Consider a manufacturing corporation that has all of its equity ($5 million) tied up in its business assets, including land, building, equipment, and inventory. One may reasonably conclude that the equity is used in the corporation's business. The corporation then borrows $1 million and now has its business assets and $1 million in cash. If the corporation uses the cash to repay $1 million of its equity to its shareholders, has the corporation used the borrowed money in its business, or to repay its shareholders? The conventional wisdom is that the latter is the case. This conclusion is based on a simple determination of the use of the cash asset acquired as a consequence of the borrowing. But is that approach correct? Suppose the corporation had used the cash to buy more inventory, subsequently sold the inventory for $1 million in cash, and then used this cash to repay equity to its shareholders. What funded the repayment—equity or borrowed money? Does it matter that after the repayment, the corporation's balance sheet shows equity of $4 million and debt of $1 million, all of which is apparently employed in the business? If it does, why is this not relevant in the first scenario?

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41 In *Shell Canada*, supra footnote 6, at 326, the Supreme Court stated, "Here, Shell borrowed NZ $150 million from the foreign lenders and immediately exchanged it for approximately US $100 million before applying it to its business. This exchange did not alter the basic character of the funds as 'borrowed' money. Money is fungible. The US $100 million was simply the NZ $150 million transformed into a different currency which, although it changed its legal form and its relative value, did not change its substance. It remained money. The value it represented simply changed from being denominated in New Zealand currency to being denominated in United States currency. Viewed thus, it is apparent that all of the NZ $150 million that Shell borrowed from the foreign lenders was borrowed money currently and directly used for the purpose of producing income from Shell's business."

42 Couzin, supra footnote 38, at 2:6.

Consider a second corporation in the money-lending business (ignoring for the moment the issue of whether such a business need rely on paragraph 20(1)(c) to deduct interest). Its business assets consist of cash of $1 million held in a single bank account, marketable securities of $1 million, and loan receivables of $14 million. The corporation's assets are funded by $6 million in equity and $10 million in debt. If the corporation borrows $1 million in cash, deposits this in its bank account so that it has $2 million in cash, and then reduces its equity by $1 million, has the corporation used the borrowed money in its business? Does it make a difference if the corporation puts the borrowed money in a separate bank account, pays back the equity using its existing cash, and then transfers the borrowed money to its main account? Conventional wisdom would say it does. But should it make a difference? Again, in both cases, after the repayment of equity the balance sheet of the corporation would show equity of $5 million and debt of $11 million, all of which is apparently used in its business.

One might argue that the direct use test mandates the conventional conclusion in these examples and that any alternative would require the adoption of an indirect use test. This argument confuses the question of how the borrowed money is used with the question of how the cash asset resulting from that borrowing is used. The former should be determined on the basis of a commonsense appreciation of the legal and practical effect of the taxpayer's actions, while the latter is merely evidence that may or may not be relevant to that determination. Failing to adopt the latter as indicative of how the borrowed money is used is not tantamount to adopting an indirect use test; it simply reflects an appropriate weighing of the evidence relevant to use.

If one accepts that the use of the borrowed money and the use of the cash asset acquired as a consequence of the borrowing are not necessarily coincident, this may explain the apparent inconsistency between the direct use requirement described in *Bronfman Trust* and the decision of the Exchequer Court in *Trans-Prairie Pipelines Ltd. v. MNR*.[43]

In *Trans-Prairie Pipelines*, the taxpayer borrowed to increase the capital of its business so that a portion of its total capital could be returned to its shareholders through a redemption of its preferred shares. In a business context, capital can be employed in all sorts of ways. Therefore, the court was entitled to take into account the full range of circumstances in determining how the borrowed money was used, including but not restricted to the use of the cash asset representing the borrowed money. A number of factors supported the use of the borrowed money in the business, including the fact that the total capital (debt and equity) committed to the business remained unchanged—only the mix of

43 [1970] CTC 537 (Ex. Ct.).

assets, liabilities, and equity changed. The court concluded that under the circumstances, it was reasonable to give more weight to factors other than the use of the cash in determining the use of the borrowed money.[44]

In *Bronfman Trust*, the court was quite right to limit its consideration to the use of the cash since the question was whether the borrowed money was used to earn income from property. The cash was not used to acquire income-producing property but to distribute cash to the beneficiaries. Accordingly, the use of the cash also established the use of the borrowed money since there were no other circumstances that pointed to an alternative determination of use.

The Federal Court of Appeal was recently called upon to consider the use test in *Singleton v. The Queen*.[45] In that case, the taxpayer withdrew capital from his law partnership and used the withdrawn funds to acquire a home. On the same day, the taxpayer borrowed funds from the bank and used the borrowed money to repay the capital he had just withdrawn from the partnership. The taxpayer then claimed a deduction for the interest on the borrowed money on the basis that the borrowed money was used to fund the business of his law partnership.

The minister disallowed the taxpayer's claim for the interest deduction on the basis that the taxpayer had used the borrowed funds to finance the purchase of his home and not to fund his law partnership. The Tax Court agreed with the minister and the taxpayer appealed to the Federal Court of Appeal.

Rothstein JA, for the majority, described the issue as being whether the transactions undertaken by the taxpayer were to be treated independently or as a series of connected transactions. He concluded that the transactions had to be viewed independently:

> There is no suggestion that the firm did not require the funds the appellant paid to the firm in replacement of the funds withdrawn from his capital account. Indeed, it is obvious that the withdrawn funds were required because they were replaced the same day. Nor is there any suggestion that the transactions were not *bona fide*, i.e. a sham contrived to make it appear that something was taking place that was not, in reality, occurring. The evidence is that the funds paid into the firm on October 27, 1988 were the funds borrowed from the Bank of British Columbia and with respect to which the appellant had a legal obligation to pay interest.

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44 I recognize that the approach I am advocating could be interpreted as suggesting that all money borrowed in a business context must necessarily be used in the business. That is not my intention. Rather, I am suggesting that the use question in a business context may be more complicated than simply following the use of the cash asset resulting from the borrowing. Resolving such difficult factual questions has always been the purview of the courts. The proof that it can be done in a rational way lies in the decision of President Jackett in *Trans-Prairie Pipelines*.

45 [1999] 3 CTC 446 (FCA). Leave to appeal to the Supreme Court of Canada was granted on April 20, 2000.

> If the transactions are viewed independently, therefore, it is clear that the funds the appellant used for the purpose of assisting in the acquisition of the home were his own funds that he withdrew from the law firm and the funds he used for the purpose of replenishing his capital account at the firm were funds borrowed from the Bank of British Columbia.[46]

Rothstein JA noted that the minister's position resulted in a logical inconsistency. In particular, a lawyer who initially financed the capital contribution to his law firm by borrowing would be entitled to an interest deduction while a lawyer who initially financed the contribution from his own funds but subsequently withdrew those funds and replaced them with borrowed money would not. If this logic is correct—and I suggest it is[47]—why should it make any difference whether the borrowed money is put into the business before or after the equity is withdrawn? In either case, the taxpayer has used borrowed money to replace existing capital, and therefore the borrowed money is clearly used in the business, even if the cash resulting from the borrowing is used for something else. An application of the use test that considered all the circumstances, and not just the use of the cash, would allow for such a finding while avoiding the artificial distinctions that result from considering the use of the cash only.

In support of his conclusion that the taxpayer was entitled to the interest deduction, Rothstein JA undertook a lengthy analysis of the decision in *Bronfman Trust*. In particular, he considered the comments of Dickson CJ that a court may disregard the apparent use of borrowed money where the transactions constitute a formality or a sham. He noted that one possible interpretation of these comments was that the appellant should be denied the interest deduction, presumably on the basis that his transactions amounted to a formality designed to attract the benefit of the interest deduction. He observed that such an interpretation appeared to contradict the very rationale of the decision in *Bronfman Trust*. That is, the question whether the purpose test has been satisfied must be determined by reference to the direct use of the borrowed money. He then concluded:

> In this appeal, the appellant's direct purpose satisfies paragraph 20(1)(c) but his indirect purpose does not. Applying the *obiter dicta* to the facts of this case fails

46 Ibid., at 454.

47 Joseph Frankovic, "Interest Deductibility and the Singleton Decision," *Tax Topics*, no. 1452 (North York, Ont.: CCH Canadian, January 6, 2000), 1-3, at 2, puts the argument as follows: "The actual use rule in subparagraph 20(1)(c)(i) simply encourages taxpayers to use their borrowings for business and investment purposes and to use their savings for personal consumption. There is no compelling reason why taxpayers should be prohibited from arranging their borrowings to ensure that the rule applies to their circumstances. Simply put, it doesn't make sense to have an actual use rule, only to turn around and assess borrowers based on what they would have done, or would not have done, but for the existence of the rule. Because an actual use rule forces taxpayers to 'do' rather than hypothesize what they 'could have done,' taxpayers must be given the opportunity to 'actually do' the right thing and borrow to invest."

> to recognize the direct use approach actually mandated by the Supreme Court in *Bronfman Trust*. Further, the application of the *obiter dicta* to this case would also be inconsistent with more recent pronouncements of the Supreme Court which suggests that in the absence of sham or an artificial transaction, a taxpayer should not be denied the benefit of provisions of the *Income Tax Act* with which he or she complies, even if the taxpayer's motivation is solely tax planning.[48]

Rothstein JA also adopted the comments of Krishna to the effect that the language of paragraph 20(1)(c) does not import a "series of transactions" approach found in other provisions of the Act. From this he concluded that it is not possible to extract from paragraph 20(1)(c) a legislative intent to import such a test in assessing how a taxpayer has used borrowed money.

The use test requires a court to determine the direct use of the borrowed money. The traditional interpretation of the test follows the use of the cash representing the borrowed money in order to determine the use of the borrowed money. This practice leads to artificial distinctions regarding use. The word "used," however, supports a broader interpretation that requires the courts to assess use on the basis of a common-sense appreciation of the legal and practical effect of the taxpayer's actions in employing the borrowed money. This, in turn, requires the courts to look to all the facts surrounding the borrowing, not just the use of the cash, and to assess which facts are the best determinants of direct use in the particular circumstances.

The Meaning of Purpose

Like paragraph 18(1)(a) and regulation 1102(1)(c), subparagraph 20(1)(c)(i) uses the word "purpose" as the basis for assessing whether a particular use of borrowed money qualifies the interest on that money for deduction. *Black's Law Dictionary*, 6th ed., defines "purpose" as follows:

> That which one sets before him to accomplish or attain; an end, intention, or aim, object, plan, project. Term is synonymous with ends sought, an object to be attained, an intention, etc.

The definition indicates that the aim or object of the use of the borrowed funds must be to earn income from a business or property. The question arises, however, whether this "purpose" is to be determined on the basis of the state of mind of the taxpayer (subjective) or the result achieved or likely to be achieved as a consequence of the use (objective).[49]

48 Supra footnote 45, at 458.

49 It is important to distinguish between the objective nature of the use test and the objective or subjective nature of the purpose test. As posited earlier, use can reasonably be determined only by reference to the objective actions of the taxpayer. On the other hand, purpose can be assessed on the basis of what the taxpayer believed the object or aim of the use to be (subjective) or on the basis of the actual or likely result of that use (objective). An objective

It is generally accepted that the word "purpose" can impose either an objective standard or a subjective standard. The distinction was aptly described by the Australian High Court in the following passage from *Magna Alloys & Research Pty. Ltd. v. FC of T*,[50] a case addressing the interpretation of the Australian version of paragraph 18(1)(a).[51]

> Motive means (to adapt terms which his Honour used) the reason why a taxpayer decides to incur the expenditure. Purpose may be either a subjective purpose—the taxpayer's purpose—where it means the object which the taxpayer intends to achieve by incurring the expenditure; or it may be an objective purpose, meaning the object which the incurring of the expenditure is apt to achieve. *Both motive and subjective purpose are states of mind and they are to be distinguished from objective purpose, which is an attribute of a transaction*. An objective purpose is attributed to a transaction by reference to all the known circumstances; whereas subjective purpose and motive, being states of mind, are susceptible of proof not by inference alone but also by direct evidence, for a state of mind may be proved by the testimony of him whose state of mind is relevant to a fact in issue [emphasis added].[52]

In other words, an objective purpose test would look to the result or expected result[53] of the use of the borrowed funds to determine purpose, while a subjective purpose test would look into the taxpayer's mind[54] to determine purpose. Although a subjective test looks to the state of mind of the taxpayer, it is rare for a court to rely on a taxpayer's statements alone in assessing subjective purpose.[55]

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use test does not dictate an objective purpose test, nor does it preclude a subjective purpose test. However, the very fact that the court must determine the use of the borrowed money does suggest that the objective circumstances (that is, how the money was used) will almost always be relevant to an assessment of purpose. For example, a taxpayer who uses borrowed money to acquire a vacation property cannot reasonably argue that his or her purpose was to earn income, given the objective use of the funds.

50 80 ATC 4542 (Full FC).

51 The Australian rule required that the expense be "incurred in gaining or producing the assessable income" and "necessarily incurred in carrying on a business for the purpose of gaining or producing such income." It is important to note that the court held, ibid., at 4545, that "[t]he purpose mentioned in the second limb is not a purpose imported by the phrase 'incurred in carrying on,' but the purpose of the business in the carrying on of which the deductible expenditure is incurred." Accordingly, the test being considered is different from that in paragraph 18(1)(a), which presupposes the existence of a business.

52 Ibid., at 4544.

53 Presumably, to be consistent, the expected result is what a reasonable person would expect to be the result, not what the taxpayer would expect.

54 In *Chandler v. DPP*, [1964] AC 763, at 804 (HL), Lord Devlin stated, "A purpose must exist in the mind. It cannot exist anywhere else."

55 Brooks, supra footnote 10, at 198, explains the reason for this in the context of paragraph 18(1)(a): "In determining the purpose for which an expenditure is incurred, the courts cannot rely simply upon the taxpayer's answer to the question of why he or she incurred the expense. Being bound by the answer to such a direct inquiry would be assuming a degree of honesty

The distinction between an objective test and a subjective test can be critical. This is particularly so when dealing with tax-avoidance provisions that look to the purpose of a transaction to determine whether the provision should apply. For example, subsection 55(2) asks whether the purpose of a transaction or series of transactions in which a corporate taxpayer receives a dividend was the reduction of a capital gain. If it was, the provision can apply to deny the intercorporate dividend deduction. The application of an objective purpose test would mean that the provision would apply whenever the receipt of a dividend resulted in the reduction of a gain, even if the taxpayer did not foresee or intend the reduction. The courts have found that such an interpretation is not appropriate and have instead adopted a subjective purpose test in subsection 55(2), albeit with full recognition of the onus placed on the taxpayer to dispel any assumption of purpose that the minister may draw from the result of the transaction.[56]

The degree to which the distinction between an objective and a subjective purpose test can affect the interpretation of subparagraph 20(1)(c)(i) depends, in part, on the manner in which the income-earning requirement in the test is interpreted. If the application of an objective purpose test requires that a particular use of borrowed money result or reasonably be expected to result in income as a direct consequence of that use, an objective purpose test is not appropriate. If, on the other hand, an objective purpose test requires only that on an objective assessment the use of the borrowed money contribute to or be sufficiently connected with the earning of income from a business or property, the distinction between an objective and a subjective purpose test may be illusory.[57]

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among taxpayers that the courts, in any other area, are unwilling to attribute to mortals. Therefore, like every other area of law where a legal consequence depends on a person's state of mind, the courts look at various objective facts from which to draw inferences about the individual's state of mind." A previous version of Brooks's article is cited with approval on several occasions in *Symes*, supra footnote 9.

56 *The Queen v. Placer Dome Inc.*, [1997] 1 CTC 72 (FCA). With respect to onus, Robertson JA states, ibid., at 80, "Practically speaking, it is evident that once it is established that a transaction has the effect of reducing significantly a capital gain it is proper for the Minister to infer that the taxpayer had such a purpose. To rebut that inference the taxpayer (or his advisors) must offer an explanation which reveals the purposes underlying the transaction. That explanation must be neither improbable nor unreasonable." Presumably, the determination of whether an explanation is improbable or unreasonable can be made only by considering the explanation within the context of the objective circumstances.

57 In *Robert G. Nall Ltd. v. Federal Commissioner of Taxation* (1937), 57 CLR 695, at 711 and 712 (HC), Dixon J applied a test of purpose that, although objective in nature, required only that the circumstances of the expenditure be consistent with an income-earning purpose, not that the expenditure actually result or reasonably be expected to result in income:

> But, in matters of income tax, purpose is an elusive and indefinite criterion. The purpose of a payment when a deduction is claimed for it becomes an attribute of the transaction rather than a state of mind in some actual person. . . .

In the context of paragraph (18)(1)(a), the Supreme Court of Canada has favoured a subjective test, albeit one that is not dependent upon the taxpayer's statements alone.[58] In other words, the purpose test adopted by the Supreme Court of Canada in the context of paragraph 18(1)(a) is an "objective circumstances" test.[59] This approach can be distinguished from an objective test on the basis that the court does not limit its consideration to the actual or expected result of the expenditure, but reviews all of the objective circumstances in assessing whether it is reasonable to conclude that the purpose is to gain or produce (earn) income. Conversely, in contrast to the application of a purely subjective test, the court is not bound to consider the taxpayer's state of mind or the motives the taxpayer may have had for the borrowing. Rather, purpose must be drawn from the objective circumstances.

The use of an "objective circumstances" test in interpreting subparagraph 20(1)(c)(i) is consistent with the earlier conclusion that the rationale of any income-earning purpose test is to ensure that a particular expenditure (or, in this case, use of borrowed money) has the requisite degree of connection with a business or income-producing property. It also meshes well with the two-prong nature of the test in subparagraph 20(1)(c)(i), which requires the court first to identify the direct use of the borrowed money (a determination that can properly be made only from a review of the objective circumstances) and then to determine purpose based on that use. The test avoids the need to consider motive, which is of dubious relevance to the issue of purpose, and frees the court to focus on the appropriate question whether the objective use of the borrowed money is consistent with an income-earning purpose. Finally, the test does not

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> [W]hen it is said that gaining or producing assessable income must be the purpose of the expenditure if its deduction is to be allowed, *no more can be meant than that the circumstances of the transaction must give it the complexion of money laid out in furtherance of a purpose of gaining income* [emphasis added].

This approach was referred to in *Magna Alloys*, supra footnote 50. If the purpose test in subparagraph 20(1)(c)(i) does not require income to be earned, the use of the borrowed money will almost invariably guide the court to an appropriate result, whether the purpose test is objective or subjective. In the former case the use will dictate purpose, while in the latter case the use will prevent the adoption of a subjective statement of purpose that is inconsistent with use.

58 In *Symes*, supra footnote 9, at 58-59, Iacobucci J states with respect to the purpose test in paragraph 18(1)(a), "As in other areas of law where purpose or intention behind actions is to be ascertained, it must not be supposed that in responding to this question, courts will be guided only by a taxpayer's statements, *ex post facto* or otherwise, as to the subjective purpose of a particular expenditure. *Courts will, instead, look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances*. For these reasons, it is not possible to set forth a fixed list of circumstances which will tend to prove objectively an income gaining or producing purpose [emphasis added]."

59 This is consistent with Brooks's comments, supra footnote 55.

impose upon the taxpayer the unreasonable burden of proving in hindsight that the use of the borrowed money was objectively capable of producing income—an approach that is consistent with the Supreme Court's interpretation of the purpose standard in paragraph 18(1)(a).

The Meaning of Income: What Income-Earning Standard Does Subparagraph 20(1)(c)(i) Impose?

From time to time, the debate about the purpose test in subparagraph 20(1)(c)(i) has revolved around whether the reference to income is a reference to net income or to gross income. In my view, this debate is not particularly helpful because it does not frame the issue in a manner that allows proper consideration of the rationale of the purpose test.

The structure of the Act relating to income from a business or property requires first that a business or income-producing property exist (often referred to as a source of income). This requirement is manifest in section 9 and the introductory language of subsections 18(1) and 20(1). If a source of income does not exist, the applicability of any deduction described in subsection 20(1), including the interest deduction, is not in issue. On the other hand, if a source of income does exist, the fact that no profit is realized should not be relevant to the availability of deductions or expenses incurred in respect of that source.

The objective of any commercial undertaking (whether the operation of a business or the holding of income-producing property) is *prima facie* to earn net income;[60] therefore, any expense incurred in furtherance of that objective is for the purpose of earning net income, whether or not net income is in fact earned. Once the court accepts that a particular undertaking is a business or a particular property is an income-producing property so that it constitutes a source of income,[61] the expenses properly associated with that business or property must

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60 The term "business" is defined in subsection 248(1) to include a profession, calling, trade, manufacture, or undertaking of any kind whatever. The definition is not exhaustive and therefore includes any activity that falls within the ordinary and accepted meaning of the term "business," even if the activity is not expressly set out in subsection 248(1). The common law definition most often quoted indicates that a "business" is something that occupies the time, attention, and labour of a person for the purpose of *profit*. Accordingly, a profit motivation is an implicit condition for the existence of a business. See also *Timmins v. The Queen*, [1999] 2 CTC 133, at 140 (FCA). The term "property" carries with it no particular connotation of profit. However, the source theory of income on which the Anglo-Canadian concept of income is based suggests three major categories of property: income-producing capital property, personal-use property, and trading property. The characterization of a particular property rests for the most part on the intention of the taxpayer in acquiring the property, as supported by the objective circumstances. It should be noted that an income-producing property need not produce income itself as long as it is tied to a commercial undertaking (for example, an office photocopier). See also *Friesen v. The Queen*, [1995] 2 CTC 369, at 378-79 (SCC).

61 The question of when a source of income exists is a topic unto itself. For a more detailed consideration of this issue in the context of a business, see John R. Owen, "The Reasonable

be assumed to be incurred to earn net income, or profit.[62] On this basis, the purpose test may be viewed as a net income test—that is to say, a test that requires the expense to be connected in some way to a business or property the purpose of which is to earn net income or profit.[63]

Expectation of Profit Test: Is There a Better Approach?" (1996), vol. 44, no. 4 *Canadian Tax Journal* 979-1015; and Cy Fien, "To Profit or Not To Profit: A Historical Review and Critical Analysis of the 'Reasonable Expectation of Profit' Test" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1287-1315. Although not often focused upon, similar considerations arise in distinguishing between an income-producing property and a personal-use property.

62 As noted by L'Heureux-Dubé J in *Hickman Motors Ltd. v. The Queen*, [1998] CTC 1 213, at 238-39 (SCC), it is vitally important to distinguish between determining the existence of a business and applying a purpose of producing income test:

> The Court of Appeal held at p. 5579 that the appropriate test to be applied in determining whether property has a purpose of producing income is "similar" to the test for determining the "analogous" question of whether a business has a reasonable expectation of profit. With respect, these two tests are not "similar," but "dissimilar."
>
> Both "revenue-producing" and "non-revenue-producing" assets can be acquired "for the purpose of producing income." A typical example would be an administrative photocopier (non-revenue producing) as opposed to a self-service pay-per-use photocopier (revenue-producing). Both kinds of assets can be used in the same business for the purpose of producing income. One asset directly produces income, the other is used for the objective purpose of producing income. *However, this is no guarantee that the business itself will make a profit. Both kinds of assets can be held by a business that shows a profit, or by one that does not show a profit. This is where the "purpose of producing income" test and the "reasonable expectation of profit" test must be clearly distinguished*.
>
> These two tests differ in terms of their general thrust. A business that has a profit does not need to demonstrate that it has a "reasonable expectation of profit." Where a business does not have a profit, however, it must have a "reasonable expectation of profit," to be determined by an application of the *Moldowan* test (see Krishna, *supra*, at p. 261). *In a nutshell, the "reasonable expectation of profit" test is principally directed at differentiating between a "business" and a "personal pursuit such as a hobby, etc.," whereas the "purpose of producing income" test is directed at determining whether an asset is appropriately used in the business*.
>
> The "reasonable expectation of profit" test questions whether there is a business, *whereas the "purpose of producing income" test presupposes a business and questions the usage of a piece of business-owned property*. The "reasonable expectation of profit" test looks at the historical and anticipated results of several years of operations, and asks: "will the revenue of this operation ever be greater than its expenses, such that a profit will occur?" The "purpose of producing income" test looks at an item of property and asks: "does it produce revenue, or is it at least used for that purpose?" These two tests address very different issues. Both tests could be applied separately to the same taxpayer at the same time [emphasis added].

63 In *Tonn v. The Queen*, [1996] 1 CTC 205, at 212 and 213-14 (FCA), Linden JA made the following observations about the purpose tests imposed by subsection 9(1) and paragraphs 18(1)(a) and 20(1)(c):

On the other hand, so long as the appropriate connection is made to a source of income, the expenditure need not itself generate any income since the purpose test is satisfied by reference to the inherent nature of a business or income-producing property and the connection of that expense with that business or property. On this interpretation, the test is a gross income test. Accordingly, the test can properly be viewed as either a net income test or a gross income test depending upon your point of view.

This analysis of the income-earning standard is consistent with the earlier conclusion that the rationale of the purpose test in subparagraph 20(1)(c)(i) is to ensure that a particular use of borrowed money has the requisite degree of connection with a business or income-producing property to justify the deduction of the interest paid or payable in respect of that borrowed money.[64] The purpose test is not on any reasonable construction intended to impose a requirement that net income be earned as a result of each particular use, but simply requires that a connection be made between the use and the business or income-producing property, which itself is by definition conducted or acquired to earn a profit.[65] If there is no business or income-producing property, no source of

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> As noted above, paragraph 18(1)(a) is to be read in light of subsection 9(1). The paragraph 18(1)(a) reference to income must therefore be read as a reference to net income, or profit. Taken as such, paragraph 18(1)(a) sets out a deductibility test quite similar to that implicit in subsection 9(1). . . . To be deductible according to paragraph 18(1)(a), an expense must have been incurred with the intention of producing profit. In other words, the expense must have been incurred within a business framework, bearing some relation to the income earning process. I might mention in this context that such intention, strictly speaking, is subjective; no requirement of objective reasonability is expressly imposed by the section. . . .
>
> Subparagraph 20(1)(c)(i), it can be seen, sets out yet another business purpose test, albeit of a rather narrow application, but in other respects much like the tests contemplated by subsection 9(1) and paragraph 18(1)(a).

It is noteworthy that Linden JA equates the reference to income in paragraphs 18(1)(a) and 20(1)(c) to the existence of a business. This position is consistent with the comments of the Supreme Court of Canada in *Hickman Motors*, supra footnote 62. Linden JA's subsequent comments regarding the objective nature of the reasonable expectation of profit test in assessing the existence of a source of income are not, however, consistent with the comments of L'Heureux-Dubé J in *Hickman Motors*.

64 In *74712 Alberta*, supra footnote 18, at 49, Robertson JA states, "At this point I wish to make three observations which will take on greater significance later in these reasons. First, the direct-use rule follows the principle set out in paragraph 18(1)(a) of the Act that expenses must be related to a source of income. Thus, for example, interest payments tied to consumption expenditures are not deductible because they yield no taxable income from a business or property." See also *Tonn*, supra footnote 63.

65 This general approach has been expressly adopted in the context of the purpose test in paragraph 18(1)(a). In *Symes*, supra footnote 9, at 55, Iacobucci J notes the following: "In order to be deductible as business expenses, the appellant's child care expenses must have been incurred 'for the purpose of gaining or producing income from the business' within the

income exists[66] and the question whether the purpose test has been satisfied does not arise.

There is, however, some authority for the proposition that the word "income" in subparagraph 20(1)(c)(i) refers to net income,[67] with the apparent consequence that, at least in the context of property, net income must be earned for the interest to be deductible. Generally, this view is premised on the argument that

meaning of paragraph 18(1)(a) of the Act. *This is not to say that the expenses must directly lead to the production of income*. Even with respect to the more restrictively worded ancestor of paragraph 18(1)(a), it was recognized in *Imperial Oil Ltd. v. M.N.R.*, [1947] C.T.C. 353, 3 D.T.C. 1090 (Ex. Ct.), at page 371 (D.T.C. 1098), that it is not necessary to prove a causative relationship between a particular expense and a particular receipt. *Indeed, provided that an expense otherwise satisfies paragraph 18(1)(a), an expense may be deductible even if it results in a loss* [emphasis added]." In *Hickman Motors*, supra footnote 62, at 238, L'Heureux-Dubé J adopts the same approach to the purpose test in regulation 1102(1)(c): "In my view, the above formulation of the rule in s. 20(1)(a) applies in the present circumstances and the first part of the test is: does the property produce income? In the affirmative, the deduction is allowable. The word 'income' is susceptible of two meanings: 'gross income' (revenue) or 'net income' (profit): see *Mark Resources Inc. v. R.*, (1993), 93 D.T.C. 1004 (T.C.C.); see also *Bellingham v. R.*, (1995), [1996] 1 F.C. 613 (Fed. C.A.), at pp. 627-28; *McLaren v. Minister of National Revenue*, (1990), [1991] 1 F.C. 468 (Fed. T.D.), at pp. 480-81. *While an item of property may produce revenue, it does not necessarily produce profit by itself, and it would be absurd to demand that each individual item of property actually yield 'net income' (profit) in and of itself* [emphasis added]." It is noteworthy that L'Heureux-Dubé J first identifies the inherent ambiguity in the word "income" and then implicitly adopts a "gross income" definition in the context of regulation 1102(1)(c). This approach is consistent with the reasoning noted above in that it recognizes that a property need not produce net income, or any income for that matter, provided that it is connected to an income-earning activity in a manner consistent with "reasonably acceptable principles of commerce and business practices." L'Heureux-Dubé J's approach is also consistent with the conclusion that the rationale of the purpose test is to connect outlays and expenses with a business or income-earning property, and not to impose a requirement that net income be earned in respect of each particular outlay or expense—that is, the test focuses on the purpose of the business or property to which the outlay or expense is connected, not the purpose of the outlay or expense. In *Interpretation Bulletin* IT-487, April 26, 1982, Revenue Canada also recognizes in the context of paragraph 18(1)(a) that an expense need not actually result in income to be deductible, even though Revenue Canada assumes that income in that paragraph means net income.

66 There is an ongoing debate as to the proper interpretation of the reasonable expectation of profit test in the context of whether a business source of income exists. The decisions in *Tonn*, supra footnote 63, and *Mastri v. The Queen*, [1997] 3 CTC 234 (FCA), which impose an objective standard on taxpayers to establish a reasonable expectation of profit in order to have a source of income, may be viewed as the high watermarks in this area. This is evident from the comments of the Supreme Court of Canada in *Hickman Motors*, supra footnote 62; the comments of Robertson JA in his dissenting judgment in *Spire Freezers Ltd. v. The Queen*, [1999] 3 CTC 476 (FCA); and the brief judgment of Robertson JA in *Walls and Buvyer v. The Queen*, 2000 DTC 6025 (FCA), which purports to adopt *Tonn* and *Mastri* but in substance does not.

67 See, for example, *Tonn*, supra footnote 63. The comments in *Symes* and *Hickman Motors* reproduced above, supra footnote 65, and the judgment in *Mark Resources Inc. v. The Queen*, [1993] 2 CTC 2259 (TCC), provide a more convincing argument to the contrary.

"income" in subsection 9(1) is defined as profit, and therefore income in subparagraph 20(1)(c)(i) must refer to a net concept of income for the Act to be internally consistent. I submit that this argument fails to recognize that the word "income" when used in the Act does not universally impart a meaning of profit as determined under subsection 9(1). In fact, I would argue that there are two parallel uses of the word "income" in sections 9, 12, 18, and 20, one of which refers to the computation of net income and the other to the identification of certain types of gross income as income from a particular source to be included in the computation of net income. A striking example is found in the introductory language of subsection 12(1), which states that in computing the income of a taxpayer, there shall be included as income from a business or property certain specified amounts. The first reference to income is a reference to the computation of net income, or profit; however, the second reference to income is a reference to gross income, being the amounts described in the subsection. Each of these gross receipts is described as income from a business or property to be included in computing net income (or loss) from the particular source. For example, the inclusion of dividends as income from a business or property mandated by paragraphs 12(1)(j) and (k) does not allow for the deduction of associated expenses such as interest in determining the amount of such income to be included in the computation of income from a business or property. It is therefore apparent that the argument that internal consistency requires that a reference to income always be a reference to net income is simply not correct, even within a single subsection of the Act.

The express statutory inclusion in the computation of income of certain sources of revenue as income from a business or property also argues against a narrow net income test in paragraph 20(1)(c). For example, for a taxpayer to obtain an interest deduction in computing income from a business or property, subparagraph 20(1)(c)(i) requires the borrowed money to be used for the purpose of earning income from a business or property. Conversely, in computing income from a business or property, paragraph 12(1)(j) requires dividends from domestic corporations to be included as income from a business or property. It seems more reasonable to tie the meaning of income in subparagraph 20(1)(c)(i) to the second reference to income in the introduction to paragraph 12(1)(j) since both refer to the source of the income, not the computation of income. This is particularly so given that the converse position results in the inclusion of the gross amount of the dividend in income without any deduction for interest, unless the dividend exceeds the interest. The adoption of such an imbalance in the Act should require a more explicit statement of intent by Parliament, particularly when subsection 9(2) expressly recognizes the potential for loss from either business or property.

In most cases, the general approach posited above to the relationship between the purpose test and the income-earning standard will yield the correct result. However, I recognize that difficult conceptual issues can arise where the purported source of income is either property or the use of the borrowed money itself. In the former case, the questions whether a particular property constitutes a source of income and whether the borrowed money used to acquire that property is used for the purpose of earning income from the property become very difficult to separate. For example, is borrowed money used to acquire common shares used for the purpose of earning income from property? One might argue that the fact that dividends are unlikely to exceed the interest expense supports the view that it is not. But on what basis is this argument made? Is it that the common shares are not a source of income, or that the common shares are not capable of producing net income after the deduction of interest expense on borrowed money used to acquire the shares?

The courts have generally taken the view that common shares do represent a source of income,[68] which is no doubt correct because they are capable of producing dividends, and dividends must be included in income as income from a business or property under either paragraph 12(1)(j) or (k).[69] If one accepts that common shares are a source of income, one is left with the question whether it is necessary to earn net income in order to deduct interest on money borrowed to acquire the shares. The analysis above suggests that it is not, on the basis that the borrowed money is used to acquire income-earning property (that is, the common shares) and therefore is used for the purpose of earning income. As noted above, the fact that the property may give rise to a loss is expressly recognized by subsection 9(2).

This somewhat simple analysis is sometimes obscured, however, by the fact that common shares may also yield a capital gain.[70] The logic is that if borrowed money is used to purchase common shares, and the shares are acquired with a view to realizing a capital gain rather than dividends, the shares are not acquired for the purpose of earning income because a capital gain is not income from property by virtue of subsection 9(3). This is tantamount to saying that the shares cease to be a source of income because the objective in acquiring the property is to realize a capital gain. The error in this logic lies in the fact that a property acquired to realize a gain on disposition is generally not a capital property, but

68 For example, see *Tennant,* supra footnote 6.

69 In some cases, such as interest-bearing debt and dividend-bearing shares, the Act essentially deems the property to be a source of income by expressly requiring inclusion of any interest or dividend in the computation of income as income from a business or property. Also, given the nature of dividend-bearing shares and interest-bearing debt, it is unlikely that such property would constitute personal-use property. However, in the case of a share or debt that is not capable of yielding dividends or interest because of its terms, the property may not constitute a source of income even though it is not personal-use property.

70 This problem is not limited to common shares. It can apply to any capital property that may appreciate in value.

an object of trade.[71] It should therefore be virtually impossible to have a common share that does not constitute a source of income either in the form of dividends (in which case the share is a productive capital asset) or in the form of proceeds from its sale (in which case the share is a trading asset).[72] The confusion raised in the context of applying the purpose test in subparagraph 20(1)(c)(i) originates from the apparent reluctance of the courts to classify common shares as objects of trade where otherwise appropriate.[73] This characterization would properly identify the commercial rationale for acquiring the shares, which is to earn income in the form of dividends and a net gain on sale. This, in turn, would avoid the need to adopt a distorted view of the purpose test as a means of addressing the perceived inequity of allowing an interest deduction where it far exceeds the potential for income because the capital gain also hoped for is not income from a source by virtue of subsection 9(3).

It might be argued, however, that this analysis fails to address the circumstance where interest on borrowed money used to acquire property exceeds the income received on the property, and the property either is indisputably income-producing capital property or is income-producing property that is not likely to appreciate in value (for example, a preferred share).[74] In my view, unless the property is not a source of income, in which case no computation of income is required,[75] the Act simply does not impose a general limit on the interest deduction

71 The source theory on which the distinction between income and capital gains is founded holds that income is a yield from a productive source. A common metaphor is the tree (capital) and the fruit (income). If the tree is acquired to yield income from its sale, its character as a source of income is replaced with its character as an object of trade. As noted in footnote 55, supra, the character of a particular property rests on the intention of the taxpayer in acquiring the property, as supported by the objective circumstances.

72 This does not hold true for all shares. If the share provisions do not allow for the payment of dividends and are such that the share cannot appreciate in value, the share will not constitute a source of income. This may represent a fourth category of property: non-productive capital property that is not personal-use property. Generally, such property will not constitute a source of income.

73 The real problem perhaps lies in the source concept of income itself, which has been referred to by one proponent of the much more comprehensive Haig-Simons theory of income as "narrow," "artificial," and "little less than absurd." See R.M. Haig, ed., *The Federal Income Tax* (New York: Columbia University Press, 1921), 54.

74 In most cases, the economic rationale for acquiring a preferred share is sound even though the interest deduction may exceed the dividend rate. For example, the holder might be entitled to a dividend tax credit or to receive the dividend tax-free so that the interest deduction can be applied to reduce another source of income. It is therefore a question of tax policy whether the interest deduction should be allowed in whole or in part, in such circumstances, not a question of how the purpose test should be applied.

75 Typically, this would be because the property is personal-use property. Such a determination would be made on the basis of the intention of the taxpayer in acquiring the property. This issue is similar to the question whether an undertaking is a business or a hobby. Alternatively,

in such circumstances. If Parliament wished to impose such a limit, it would be a relatively simple matter to amend the Act to that effect, as was done in the case of vacant land.[76] Whether the addition of such a limit is sound tax policy is an issue beyond the scope of this article.

The second conceptual difficulty typically arises where money is borrowed by a taxpayer that is not in the business of lending money and then used to fund a loan to a related person at a rate lower than the taxpayer's cost. Two views can be taken of this event. First, lending the borrowed money will result either in income from the loan (as dictated by paragraph 12(1)(c), if the loan bears interest), or in income from another source (for example, dividends on shares of the debtor), or a combination of the two. Accordingly, the borrowed money may be characterized as a source of income because it is used to earn income from a source—albeit, in the latter case, not from the borrowed money directly. The fact that the borrowed money does not itself produce net income would not preclude a deduction under subparagraph 20(1)(c)(i) because the use of the borrowed money is connected to a source of income—the borrowed money. If, on the other hand, one does not accept that the borrowed money is a source of income in its own right (which should be the case only if the loan does not bear interest and the earning of dividends is seen as too remote), it is impossible for the taxpayer to connect the use of the borrowed money to a source of income, and therefore the interest deduction is not available.

Whichever view is taken, it is important to note that the answer to this issue does not depend on the nature of the purpose test in subparagraph 20(1)(c)(i) or the income-earning standard imposed by that test, but on the status of the borrowed money as a source of income.

Is There Any Basis for Broadening the Purpose Test in Subparagraph 20(1)(c)(i)?

Notwithstanding the foregoing analysis, the courts have on occasion suggested a broader interpretation of the purpose test in the provision. Almost invariably, this interpretation is supported, at least in part, by the statements of Dickson CJ in *Bronfman Trust* reproduced above regarding the true commercial and practical nature of the taxpayer's transactions.

Two cases that departed from a straightforward interpretation of the purpose test in subparagraph 20(1)(c)(i) are *Mark Resources Inc. v. The Queen*[77] and

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the nature of the property may indicate that it is non-productive capital property that is not personal-use property, in which case it is not a source of income. Property in this category would be quite rare.

76 See subsection 18(2).

77 *Mark Resources*, supra footnote 67. A more recent case applying a similar analysis of the purpose test in paragraph 20(1)(c) is *C.R.B. Logging Co. v. The Queen*, [1999] 2 CTC 2279 (TCC).

Ludmer v. Ministre du Revenu national.[78] The rationale of these cases is subject to some skepticism, particularly in light of several Supreme Court of Canada decisions that were decided after *Mark Resources*.

Mark Resources

In 1979, Mark Resources Inc.[79] ("Mark Resources") incorporated Precision Drilling Inc. ("PDI") under the laws of Colorado to carry on a resource-related business in the United States. PDI's business did not succeed, and by April 30, 1984, it had accumulated business losses of US $707,350. These losses would expire in 1985 and 1986 under the loss carryforward provisions of the US Internal Revenue Code (the "IRC").

In October 1984, Mark Resources decided to liquidate PDI, and thereafter PDI ceased to carry on an active business. On February 22, 1985, Mark Resources borrowed US $7,815,468.11 from The Royal Bank of Canada ("the Royal Bank") for a term of 67 days at an interest rate of 9.625 percent per annum. The amount and term of the loan were calculated precisely to permit the borrowed funds to be used to generate enough income in PDI to absorb the US operating losses that were about to expire.

Mark Resources paid the borrowed funds into PDI's account, and the receipt was recorded as a capital contribution to PDI. On the same day, the funds were used by PDI to purchase a term deposit from the Royal Bank that carried interest at the rate of 8.75 percent per annum and matured in 67 days. PDI guaranteed Mark Resources' obligation to the Royal Bank and used its term deposit as security for that guarantee.

On April 30, 1985, Mark Resources and the Royal Bank extended the term of the loan to February 11, 1986 at LIBOR plus 0.875 percent. On the same day, PDI renewed its term deposit with the Royal Bank at an interest rate of 9.215 percent and with a maturity date of February 11, 1986. The exact rate of interest paid on the borrowing was not disclosed at trial, but it was agreed that the rate paid on the loan from the Royal Bank was higher than the rate paid by the Royal Bank on the term deposit. Accordingly, the borrowing costs of Mark Resources would necessarily exceed the income it could earn on the shares of PDI.

In its taxation year ending April 30, 1985, Mark Resources deducted $193,604 of interest on the loan from the Royal Bank in computing its income. In its

78 [1999] 3 CTC 601 (FCA). Leave to appeal to the Supreme Court of Canada was granted on April 20, 2000.

79 Mark Resources Inc. was a successor, through two amalgamations, to Precision Drilling Ltd. ("PDL"), an Alberta corporation that carried on a contract drilling and an oil and gas exploration and production business. This article refers to Mark Resources Inc. However, the judgment refers to PDL.

taxation year ending April 30, 1986, Mark Resources deducted a further $898,241 of interest on the loan.

Mark Resources received dividends from PDI in its 1985 and 1986 taxation years of $173,982 and $794,603, respectively. The dividends represented the full amount of the interest earned by PDI on its term deposits with the Royal Bank.

On April 30, 1986, PDI was liquidated and dissolved under the applicable corporate statute.

With respect to these transactions, Bowman J noted:

> The loan from the bank, the issuance of the term deposit and its deposit with the bank as security were all done through the London branch of the Royal Bank. No money was ever transferred to Canada or the United States or used in the operations of PDI or PDL [Mark Resources], except for the dividends that PDI paid to PDL [Mark Resources].[80]

Mark Resources included the gross amount of the dividends received from PDI in its income for its 1985 and 1986 taxation years and then deducted those amounts in computing its taxable income under subsection 113(1). The total interest paid by Mark Resources was $1,091,925 and the total dividends received by Mark Resources were $968,585, yielding a net loss on the transaction of $123,340.

Revenue Canada disallowed the deduction of the interest claimed by Mark Resources in its 1985 and 1986 taxation years.

Four arguments were put forward as to why the interest was not deductible. First, the interest was not interest on borrowed money used for a purpose described in either of subparagraph 20(1)(c)(i) or (ii). Second, the transactions had the effect of artificially or unduly reducing Mark Resources' income and therefore were subject to old subsection 245(1) of the Act. Third, the transactions or certain of them were shams or subterfuges. Finally, PDI was a mere nominee or conduit of Mark Resources. At trial, the last two positions were abandoned and the Crown's case was based on paragraph 20(1)(c) and old subsection 245(1).

Bowman J first addressed the application of old subsection 245(1). He concluded that the subsection did not apply because the transactions undertaken by Mark Resources were real commercial transactions that were properly documented and completed in accordance with those documents, and that the reduction in income resulting from the transactions was not artificial notwithstanding the prearranged nature of the plan.

Bowman J then considered Mark Resources' claim for the deduction of interest under paragraph 20(1)(c).[81] The respondent argued that the court should look

80 *Mark Resources*, supra footnote 67, at 2262.

81 Bowman J concluded that subparagraph 20(1)(c)(ii) had no application because the interest paid was not interest on an amount payable for property.

to the direct use of the borrowed funds to assess purpose as dictated by *Bronfman Trust*. The respondent's argument was essentially that the shares were not capable of producing income in excess of the interest expense and therefore the borrowed money could not be viewed as having been used for an income-producing purpose.[82] The appellant's argument was similar but suggested that the purpose test did not require that net income be earned in order for the test to be satisfied.

Bowman J rejected both positions and instead adopted a purpose test based on an economic analysis of the series of transactions:

> Both the appellant's and the respondent's characterizations of the purpose for which the funds were used have a certain superficial correctness, but I think they are both based on a logical fallacy in that they attribute to one event in the series a purpose based upon the immediately subsequent event. The true purpose is a broader one that subsumes all of the subordinate and incidental links in the chain. *The overriding ultimate economic purpose for which the borrowed funds were used was to permit the U.S. losses of PDI to be, in effect, imported into Canada and deducted in computing PDL's [Mark Resources'] income* [emphasis added].[83]

This statement set the tone for Bowman J's analysis of paragraph 20(1)(c), which looked to the economic result rather than the substantive legal result in interpreting and applying subparagraph 20(1)(c)(i).

In accordance with his introductory comment, Bowman J then addressed the "real" purpose for the borrowing. He concluded that the real purpose was the importation of the losses from the United States, and that the earning of interest income by PDI and the payment by it of dividends to Mark Resources were integral, but subservient and incidental, steps to the real objective that lay behind the implementation of the plan.

Although Bowman J identified the importation of losses from the United States as the ultimate economic objective of the transactions, he embarked upon a cautionary analysis of the meaning "income" for the purposes of paragraph 20(1)(c). Relying principally on the judgment of the Supreme Court of Canada in *Interprov. Pipe Line Co. v. MNR*,[84] he concluded that income in paragraph 20(1)(c) must refer to gross income and not net income. He also noted that the net income interpretation contended by the minister would lead to an absurdity (specifically, that in a circumstance where the borrowing cost slightly exceeded the income earned, the taxpayer could be denied the entire amount of the

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82 The respondent's argument confuses the issue of whether the purpose test in subparagraph 20(1)(c)(i) is satisfied with the issue of whether the shares of PDI constituted a source of income. Bowman J alluded to the distinction in the judgment, supra footnote 67, at 2274, footnote 4.

83 Ibid., at 2268.

84 [1959] CTC 339 (SCC).

borrowing cost and yet be taxed on the full amount of the income because there was no net income). Bowman J noted:

> Interest on money that is borrowed to invest in common shares, or property, or a business or corporation is deductible because it is laid out to earn amounts that must be included in the computation of income. Amounts of income such as dividends which must be included in income under paragraphs 12(1)(j) and (k) do not cease to be income merely because they are exceeded by the cost of their production.[85]

Having concluded that income in the context of paragraph 20(1)(c) refers to gross income, Bowman J observed that this approach would logically result in allowing the deduction of interest up to the amount of revenue earned with the excess being denied under the reasonableness limitation at the end of paragraph 20(1)(c).[86] Bowman J rejected this result, however, as not being in accordance with the scheme of the Act or its object and spirit. He concluded that since the ultimate economic purpose of the borrowing was the importation of losses from the United States,[87] no portion of the interest claimed by Mark Resources was deductible. In effect, he broadened the scope of the purpose test by applying a purposive or teleological interpretive approach to conclude that purpose in the context of subparagraph 20(1)(c)(i) can extend to the ultimate economic purpose of a borrowing, and that such purpose can be viewed as ineligible where it does not accord with the perceived scheme of the Act or its object and spirit.

As a preliminary but nevertheless important point, one might question Bowman J's conclusion that the scheme of the Act did not contemplate the "importation" of the active business losses of a controlled foreign affiliate. In fact, the foreign accrual property income (FAPI) scheme expressly allowed Mark Resources to use the active business losses of its controlled foreign affiliate to shelter it from FAPI that would otherwise be included in its income under subsection 91(1).

In simple terms, the FAPI regime in the Act requires a Canadian taxpayer to include directly in its income under part I its proportionate share of the FAPI of its controlled foreign affiliates. The definition of FAPI allows a foreign affiliate to deduct in the computation of its FAPI its deductible loss for the current and

85 *Mark Resources*, supra footnote 67, at 2274.

86 It is questionable whether the reasonableness test authorizes such a limitation. I submit that the reasonableness test is intended to ensure that the rate of interest is reasonable, on the basis of objective benchmarks such as commercial lending rates in similar circumstances, and is not intended to limit the deduction by reference to the income earned as a consequence of the use of the borrowed money. See *Mohammad v. The Queen*, [1997] 3 CTC 321 (FCA).

87 He did concede, however, that in the normal course, borrowed money that is used to acquire shares satisfies the purpose test because it is being used to earn income in the form of dividends.

five immediately preceding years. The amount of the deductible loss of a foreign affiliate is prescribed by regulation 5903(1). In 1984 and 1985, regulation 5903(1) defined "deductible loss" to include

- the excess of FAPI deductions over FAPI inclusions;
- active business losses of the foreign affiliate less any amounts that had been deducted in the preceding five years by the taxpayer or any related parties; and
- compensation received by the foreign affiliate for the use of its losses by another member of a corporate group.

For taxation years beginning after 1994, regulation 5903(1) was amended to provide that active business losses could no longer be included in the calculation of deductible loss and therefore could no longer be used to reduce the FAPI of a foreign affiliate.

Accordingly, in the taxation years in issue in *Mark Resources*, a controlled foreign affiliate was expressly allowed to deduct active business losses incurred in the current and the five preceding taxation years in computing its FAPI.[88] This provision allowed a Canadian taxpayer to reduce or eliminate the FAPI that would otherwise be attributed to it for a particular taxation year by deducting from the FAPI of its controlled foreign affiliate the active business losses incurred by the foreign affiliate in the current year or in any of the five preceding years. In effect, the Canadian taxpayer could "import" the active business losses of its controlled foreign affiliate into Canada to reduce or eliminate FAPI that would otherwise be included in the income of the taxpayer under subsection 91(1).

The business loss carryforward rule in regulation 5903(1) was stated in plain unambiguous language, and there was nothing in the rest of the Regulations or in the Act that suggested in any way that the active business losses of a foreign affiliate were to be applied only to reduce FAPI generated using capital from certain sources such as retained earnings. The ability of a foreign affiliate to apply active business losses to reduce FAPI that would otherwise be included in the income of its parent corporation under part I of the Act was completely unrestricted[89] and by its very nature encouraged controlled foreign affiliates to

88 Regulation 5903(1)(b).

89 The only restriction was the five-year limitation on carrying forward active business losses. The five-year restriction mirrored the domestic restriction in paragraph 111(1)(a) until the amendment of the latter provision for 1983 and subsequent taxation years to extend the carryforward to seven years. Even today (let alone in 1984 and 1985, before subsection 112(2.4) and other stop-loss rules were introduced), there is no rule in the Act that expressly stops the parent of a Canadian subsidiary with non-capital (that is, business) losses from contributing borrowed capital to earn tax-sheltered income in the subsidiary and receiving the income as tax-free intercorporate dividends. In 1984 and 1985, the same conclusion applied to foreign wholly owned subsidiaries with active business losses.

earn FAPI to use up active business losses realized from carrying on an active business in their jurisdiction of residence.

As noted above, regulation 5903(1) was amended for taxation years beginning after 1994 to eliminate the deduction of active business losses in computing FAPI. The technical notes accompanying the amendment stated:

> The proposed new subsections ensure that losses will be included in a deductible loss of a foreign affiliate of a taxpayer only where the affiliate is a controlled foreign affiliate of the taxpayer during the year the loss was incurred. As well, they provide that active business losses will not form part of a deductible loss of a foreign affiliate and will therefore no longer be available to reduce foreign accrual property income.[90]

The technical notes do nothing more than identify the fact that the government adopted a change in policy regarding the deduction of active business losses in computing the FAPI of a foreign affiliate for taxation years beginning after 1994. Before that change in policy, the Act and Regulations expressly allowed, and indeed encouraged, Canadian taxpayers to benefit from the ability of their controlled foreign affiliates to deduct active business losses from passive income that would otherwise constitute FAPI.

The result of the rules was to allow Mark Resources, which could not ordinarily earn FAPI in its controlled foreign affiliate without the attribution of such income to it under subsection 91(1), to earn investment income without any such attribution. Thus, the rules could only have the effect of encouraging Mark Resources to utilize losses to the extent that they were available. I suggest, therefore, that the premise of Bowman J's conclusion that the overriding economic purpose of the plan was not consistent with the scheme of the Act or its object and spirit was not correct. This misreading highlights the danger of adopting an approach to the interpretation of paragraph 20(1)(c) that requires the court to read in a legislative intent that is simply not manifest in the words of the provision or the statute read as a whole.[91]

Two more general comments can be made about Bowman J's judgment. First, he reached his conclusion that "purpose" in paragraph 20(1)(c) allowed the court to consider the ultimate economic purpose of a series of transactions based on the "object and spirit" of paragraph 20(1)(c) and the Act read as a whole. It is more than noteworthy that no case has ever suggested such an approach to the purpose test in paragraph 18(1)(a), which has been the subject of considerably more litigation than paragraph 20(1)(c). One might therefore question why the purpose test in subparagraph 20(1)(c)(i) warrants such a unique and expansive

90 Canada, Department of Finance, *Explanatory Notes to Revised Draft Amendments—Income Tax Regulations* (Ottawa: the department, January 23, 1995).

91 A similar approach taken by Linden JA in *The Queen v. Shell Canada Ltd.*, [1998] 2 CTC 207 (FCA), was soundly rejected by the Supreme Court of Canada.

interpretation. In any event, several Supreme Court of Canada decisions released after *Mark Resources* make it clear that such an interpretative approach is not acceptable in the context of subparagraph 20(1)(c)(i).[92] To be fair, however, Bowman J did not have the opportunity to review the rules of statutory interpretation and other comments regarding legitimate tax planning that are contained in those judgments.

Second, Bowman J's analysis of paragraph 20(1)(c) was generally correct except for his conclusion regarding the governance of the overriding economic purpose test in applying the provision. In particular, his conclusions that income in subparagraph 20(1)(c)(i) referred to gross income, and not net income, and that deductions in excess of gross income do not eliminate the source of income (even though it was apparently impossible for the preferred shares to earn net income after the deduction of the associated interest expense) are consistent with the analysis set out above. Accordingly, in the absence of his adoption of an economic analysis of the transactions taken as a whole, it is likely that Bowman J would have allowed the deductions in issue, at least to the extent of dividends received.

Ludmer

In *Ludmer*, the taxpayers borrowed $6.5 million in order to invest $7.5 million in the purchase of shares of two Panamanian companies, Justinian Corporation S.A. ("Justinian") and Augustus Corporation S.A. ("Augustus"). The objective of the companies was to invest the funds raised by the share issues in debt

92 In *Tennant*, supra footnote 6, at 298, Iacobucci J stated unequivocally that subparagraph 20(1)(c)(i) is not ambiguous. The Supreme Court of Canada has repeatedly stated that where a statutory provision is not ambiguous, its application must be determined by reference to the plain meaning of its words and the context in which those words are found: *Antosko*, supra footnote 27; *Friesen v. The Queen*, [1995] 2 CTC 369; *Alberta (Treasury Branches) v. MNR* (sub. nom. *Pigott Project Management v. Land-Rock Resources Ltd.*), [1996] 1 CTC 395; *Continental Bank*, supra footnote 32; and *Shell Canada*, supra footnote 6. Moreover, this approach applies even where the transactions are tax-motivated or the taxpayer obtains an apparent windfall. See the comments of Iacobucci J in *Antosko*, reproduced in footnote 27, supra. Also, in *Shell Canada*, supra footnote 6, at 330, McLachlin J said, "However, this Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. This issue is specifically addressed by this Court in *Duha Printers (Western) Ltd.* . . . See also *Neuman*. . . . *The courts' role is to interpret and apply the Act as it was adopted by Parliament. Obiter statements in earlier cases that might be said to support a broader and less certain interpretive principle have therefore been overtaken by our developing tax jurisprudence*. Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done [emphasis added]."

securities in Canada and the United States. The operations of the foreign companies were carried out in the Bahamas, where their income was not subject to tax.

The share capital of the foreign companies consisted of class A voting shares and class B non-voting shares. The offering was structured so that no shareholder could own more than 9.9 percent of either class of shares, and therefore neither of the foreign corporations would constitute a foreign affiliate of any particular shareholder.

Except for their voting and non-voting characteristics, it appears that the class A and class B shares were ordinary common shares and that dividends could be paid on these shares subject to the discretion of the companies' board of directors.[93] The initial offering document, dated April 26, 1977, indicated that the directors of each company would adopt a policy of reinvesting accumulated income but would declare dividends if they felt it would be in the best interest of the corporation and its shareholders to do so. In 1981, the dividend policy was amended to provide that if the corporation realized earnings, the shareholders could expect a declaration of dividends. As a result of this amendment, a dividend of $1 per share was declared for each of the fiscal years in issue.

The taxpayers acquired their shares through five different transactions between September 1977 and June 1979. The taxpayers disposed of their shares to the corporations in 1985. Over this period, the shares generated dividends of $600,000. As well, the taxpayers realized a capital gain of $9.2 million on the disposition in 1985.

The minister disallowed the deduction of interest claimed by the taxpayers for their 1981 through 1985 taxation years. The minister's position was that the amount borrowed had not been used for the purpose of earning income from property. Accordingly, the borrowing did not satisfy the purpose test in subparagraph 20(1)(c)(i).

The Federal Court—Trial Division dismissed the taxpayers' appeal, and the majority of the Federal Court of Appeal upheld that decision, but in separate judgments. Marceau JA concludes that the trial judge's finding of fact that the taxpayers' true purpose in investing in the two companies as structured was to defer tax and to transform the income into capital gains led to the necessary conclusion that the interest was not deductible. He goes on to say that this finding of fact distinguishes the case from the circumstances in cases such as *74712 Alberta Ltd.* and *Mark Resources*.

Marceau JA bases his conclusion on the motives of the taxpayers (which is essentially the purpose of the borrowing rather than the purpose of the use) for

93 Dividends on common shares are almost invariably paid at the discretion of the board of directors of the company that issued the shares.

the investment rather than on a consideration of whether the borrowed funds were used to acquire income-producing property. It was not suggested in any way that the common shares were not income-producing capital property for the purposes of section 9.[94] Accordingly, so long as the borrowed money was used to acquire those shares, the purpose test was satisfied. As noted by Robertson JA in *74712 Alberta*, the motive or intent underlying the purchase is irrelevant.

Desjardins JA renders a separate judgment, apparently in order to concur with one important aspect of the dissenting judgment of Létourneau JA. Specifically, Desjardins JA states that in order to satisfy the purpose test in subparagraph 20(1)(c)(i), a taxpayer need only have a reasonable expectation of income at the moment the investment is made, and that borrowed money need only be used to acquire property for the purpose of deriving gross, not net, income.

Desjardins JA concludes, however, that the evidence establishes beyond a shadow of a doubt that the real purpose the taxpayers had in mind when they borrowed the money was to acquire property (shares in Justinian and Augustus) that would produce a capital gain. Accordingly, the issue of gross versus net income is not relevant. Once again, the conclusion is based on a finding as to the motives or intentions of the taxpayers as opposed to the objective use of the borrowed money. Moreover, the conclusion is at odds with the apparent acceptance by the court that the shares were capital property and with the fact that the shares produced income effectively deemed by paragraph 12(1)(k) to be income from a source.

The majority adopts an approach that looks to the economic objective of the taxpayer in acquiring the property and uses this objective to conclude that the purpose of the taxpayer is inconsistent with the purpose of earning income requirement. In effect, the objective of the taxpayer vis-à-vis the income-producing property is favoured over the actual use of the borrowed money to acquire that property. This type of analysis may be appropriate in determining whether the shares are capital property or trading property, but it is not appropriate in assessing whether the purpose test is satisfied. Once it is determined that the gain motive is sufficiently remote to characterize the shares as capital property, the only issue should be whether the borrowed money is used to acquire the shares. If it is, the related interest should be deductible. If, on the other hand, the court is convinced that the principal objective of the taxpayer is to realize a gain,

94 As noted above, the question whether common shares should be considered a source of income is distinct from the question whether the purpose test in subparagraph 20(1)(c)(i) is satisfied. However, it is worth noting that if the overriding purpose for acquiring the shares was to dispose of them at a gain, one might question whether the shares were income-producing capital property at all. If they were instead property acquired in the course of an adventure or concern in the nature of trade, the taxpayer would still be entitled to the interest deduction because the shares were acquired for the purpose of realizing a trading gain and therefore still constituted a source of income for purposes of the Act.

the shares should be characterized as trading property and the interest deduction should be allowed, but the full amount of the gain should be included in the taxpayer's income.

Even if one accepts that the appreciation motive may not be sufficient to characterize the shares as trading property, the analysis adopted by the majority raises an obvious practical concern in that it could apply to virtually any investment in common shares that are held as capital property. This is simply because most, if not all, taxpayers acquire common shares with a view not only to receiving dividends, but also with a long-term view to realizing a gain in the appreciation of the shares.[95] In fact, one need only look to the stock market to realize that the real draw of equity investment is not dividends but gains. The direct implication of the test adopted in *Ludmer* is that where a taxpayer acquires common shares with the implicit objective of realizing appreciation in those shares, any interest on money borrowed to acquire the shares is not deductible. The paradox is that, in effect, such common shares are treated as non-income-producing capital property for the purposes of the interest deduction (through a manipulation of the purpose test in subparagraph 20(1)(c)(i)) even though dividends on the shares continue to be taxable under the express statutory inclusion in paragraph 12(1)(j) or (k).[96]

Létourneau JA recognizes the fallacy of adopting a purpose test that looks to the motives or intentions of the taxpayers vis-à-vis the income-producing property rather than the objective use of the borrowed money. He states:

> I am not in favour of importing a dominance test into the interpretation of subparagraph 20(1)(c)(i). *Not only is the respondent's argument in this respect unsupported by the text of the Act, it also goes against both business reality and the objective sought by that provision of the Act*. In addition, it leads to an undesirable tax uncertainty that might adversely and unjustifiably affect the business community and the Canadian economy. . . .
>
> As I have already mentioned, subparagraph 20(1)(c)(i) does not stipulate that the borrowed money has to be used "mainly" for the purpose of earning income from property. The interest deduction is intended to encourage and allow for the

95 The Supreme Court of Canada expressly recognized this in *Irrigation Industries Ltd. v. MNR*, [1962] CTC 215.

96 As noted above, the express statutory inclusion for dividends suggests that shares always constitute a source of income either because of this inclusion or because they are a trading property. Moreover, while there may be a policy argument for limiting the interest deduction available in respect of borrowed money used to acquire property that does not yield net income, for the reasons set out earlier, this result cannot be drawn from the current scheme of the Act or from the language in subparagraph 20(1)(c)(i). Any argument that the reasonableness limitation in paragraph 20(1)(c) or section 67 should apply to impose such a limitation ignores the fact that the reasonableness of an interest deduction (like any expense) relates to the amount of the deduction when compared to an objective benchmark, not to the amount of income earned as a consequence of the expense.

> acquisition of potentially income-generating capital. That is the conclusion to which the words "use for the purpose of earning income from property" lead us. It is therefore sufficient for the investor to have a reasonable expectation of income when investing borrowed money. It is not necessary for the investor to have an expectation of reasonable income [emphasis added].[97]

Létourneau JA goes on to state:

> In my view, it is reasonable to infer from that decision [*Hickman Motors*] that for the purposes of applying subparagraph 20(1)(c)(i), absent an artificial or sham transaction or exceptional circumstances, *there is a presumption that a taxpayer who purchases property that produces income, whatever the amount, probably intended to derive income from that property*. That is an objective benchmark for the intention of the person who acquires that property. In my opinion, disregarding this obvious fact would introduce a judicial assessment test as a condition of application of subparagraph 20(1)(c)(i) of the Act, which has no legislative basis and would be open to undesirable subjectivity, that is, the court's perception that the taxpayer took advantage of an improper tax benefit by deducting an overly high interest amount for income the Court considers insufficient in relation thereto. We must take care not to import into the text of section 20, as a condition of eligibility for interest deduction, the tests of section 245 of the Act regarding tax avoidance, *particularly because, as I have already mentioned, the amount of the interest deduction has to be assessed in relation to the amount borrowed, not the income earned* [emphasis added].[98]

Although perhaps expressed in somewhat different terms, the approach taken by Létourneau JA is consistent with the analysis of the purpose test in this article. In effect, he first concludes that a taxpayer who purchases income-producing property must be presumed to have intended to derive income from that property. Once that determination is made, interest paid on borrowed money used to acquire that property is, ipso facto, deductible because it is tied to an income-producing purpose. For the reasons discussed earlier, this is an appropriate interpretation of the purpose test in subparagraph 20(1)(c)(i).

Tying It All Together

The above analysis leads to the following conclusions:

1) Subparagraph 20(1)(c)(i) was added to the Act because of the uncertainty regarding the deductibility of interest expenses. As an express statutory deduction operating outside the general rules in the Act (that is, subsection 9(1) and paragraphs 18(1)(a) and (h)) governing the deduction of "ordinary" business expenses, it was necessary to include a purpose test in the provision.

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97 Supra footnote 78, at 631-32.

98 Ibid., at 635-36.

2) The general role of a purpose test, such as the tests found in paragraphs 18(1)(a), 20(1)(c), and regulation 1102(1)(c), is to reinforce the notion that only those expenses connected in some reasonable way with a source of income are deductible.

3) The purpose test in subparagraph 20(1)(c)(i) is an "objective circumstances" test in that the court must first ascertain the direct use of the borrowed funds and must then determine the taxpayer's purpose based on that use. In all cases, the purpose must be consistent with the use. The motives of the taxpayer are irrelevant.[99]

4) The method for determining the use of borrowed money is not limited to tracing the use of the cash resulting from the borrowing. Rather, the court must consider all of the circumstances surrounding the borrowing. The objective is to obtain a common-sense appreciation (based on the legal and practical effect of the taxpayer's actions) of how the taxpayer has employed the borrowed money.

5) The purpose test in subparagraph 20(1)(c)(i) parallels the tests in paragraph 18(1)(a) and regulation 1102(1)(c). Therefore, the courts' interpretation of the purpose tests in those provisions is relevant to the proper interpretation of the purpose test in subparagraph 20(1)(c)(i).

6) Consistent with the purpose tests in paragraph 18(1)(a) and regulation 1102(1)(c), the purpose test in subparagraph 20(1)(c)(i) does not require that each particular use of borrowed money result in income. Rather, it requires that the use of the borrowed money be sufficiently connected with a business or income-producing property that is, ipso facto, undertaken or held for the purpose of profit.

99 See also *74712 Alberta*, supra footnote 18, at 49-50, where Robertson JA states, "I see nothing in the jurisprudence, in particular the reasons of *Bronfman*, which requires a subjective appreciation of the motives or intent underlying the taxpayer's decision to borrow funds: see also *Symes v. R.*, . . . to the same effect in the context of paragraph 18(1)(a) of the Act. The words 'use' and 'purpose' are used in paragraph 20(1)(c) in an objective not subjective sense. It is important to recognize that terms such as "motive, intent, reason, purpose, object and effect" can be applied or interpreted differently, depending on the statutory context in which they are invoked: see generally *Placer Dome Inc. v. R.* . . . and J.F. Avery Jones, 'Nothing Either Good or Bad, But Thinking Makes It So—The Mental Element in Anti-Avoidance Legislation' (1983) *British Tax Review* 9." Although Robertson JA states that the words "use" and "purpose" are used in an objective, not a subjective, sense, I believe he means by this that the court will assess use and purpose on the basis of the objective circumstances, as is the case with paragraph 18(1)(a). Robertson JA takes a similar approach to assessing a taxpayer's intention in his dissenting judgment in *Spire Freezers*, supra footnote 66. This is an appropriate interpretation of the purpose test in subparagraph 20(1)(c)(i).