What Does Gifford Mean?

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PRÉCIS

Depuis des décennies, la question de savoir si un titre de créance est de la nature du revenu ou du capital semblait être déterminée par l'utilisation des fonds. Si les fonds servaient à acquérir des immobilisations, le titre de créance était considéré être de la nature du capital; si les fonds servaient à acquérir des actifs productifs de revenus, le titre de créance était considéré être de la nature du revenu. Pour de nombreuses personnes, il semblait que si un titre de créance était considéré être de la nature du capital, alors les intérêts et les autres frais associés au titre seraient également de la nature du capital. Cette dernière proposition a été directement contestée dans *Gifford v. The Queen*, culminant avec le jugement de la Cour suprême du Canada en 2004. Dans ce jugement, le tribunal en a étonné un grand nombre au sein de la communauté fiscale en établissant apparemment un nouveau critère permettant de déterminer si un titre de créance est de la nature du revenu ou du capital. Le critère était axé sur la nature du titre lui-même plutôt que sur l'utilisation des fonds.

La question de savoir si l'approche retenue par la Cour suprême du Canada est nouvelle suscite encore la discussion. L'auteur de cet article laisse entendre que cette approche peut en fait être le reflet exact de la jurisprudence antérieure. Toutefois, que l'approche soit nouvelle ou non, cette décision fait maintenant jurisprudence dans ce domaine et elle doit être appliquée par le gouvernement et les praticiens. L'arrêt *Gifford* ne fournit guère d'indications quant à l'application de ses principes. Il est fondé principalement sur une série de décisions du Royaume-Uni brièvement citées par le tribunal. Dans cet article, l'auteur tente de déterminer comment l'arrêt *Gifford* devrait être appliqué, analysant en détail à la fois la jurisprudence du Royaume-Uni et plusieurs courants jurisprudentiels au Canada. De plus, l'auteur s'interroge sur la distinction faite par le tribunal entre les institutions financières et d'autres contribuables.

ABSTRACT

For decades, whether a debt obligation was on capital account or on income account seemed to be determined by the use of the proceeds of the debt obligation. If the proceeds were used to acquire capital assets, the debt obligation was considered to be on capital account; if the proceeds were used to acquire income assets, the debt obligation was considered to be on income account. It seemed to many to be the case

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that if a debt obligation was considered to be on capital account, then interest, as well as other expenses, associated with the obligation would also be on capital account. The latter proposition was challenged directly in *Gifford v. The Queen*, culminating in a decision of the Supreme Court of Canada in 2004. In that decision, the court surprised many in the tax community by apparently setting out a new test to determine whether a debt obligation is on income or capital account. The test focused on the nature of the obligation itself, rather than on the use of the proceeds.

Whether the Supreme Court's approach is new is a matter of some debate; the author of this article suggests that the approach may, in fact, be an accurate reflection of early case law. However, whether or not the approach is new, the decision is now the governing law in this area, and it must be applied by the government and practitioners alike. The *Gifford* decision does not provide much help with the application of its principles. The primary authority is a line of British cases cited briefly by the court. In this article, the author attempts to determine how *Gifford* should be applied, reviewing in detail both the relevant British case law as well as several lines of Canadian case law. As well, the author reflects on the distinction drawn by the court between financial institutions and other taxpayers.

KEYWORDS: INTEREST DEDUCTIBILITY ■ DEBT ■ CAPITAL ■ INCOME ■ EXPENSES

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INTRODUCTION

That the Supreme Court of Canada in *Gifford v. The Queen*[1] held that interest can be an expense on income account was not a surprise to most members of the Canadian tax community; what was a surprise was the route by which the court reached that conclusion. The decision seemed to reverse mainstream Canadian jurisprudence, which appeared to hold that whether interest on a debt obligation is on income or capital account depends on whether the proceeds of the debt are used for capital or income purposes[2] or, possibly, that a debt obligation may never be on income account.[3] One commentator stated that the Supreme Court's position in *Gifford*

1 [2004] 1 SCR 411.

2 See Jinyan Li, "Interest is Not 'Always' a Capital Expense," Current Cases feature (2004) vol. 52, no. 3 *Canadian Tax Journal* 925-31, at 925 and 928.

3 See Vern Krishna, *The Fundamentals of Canadian Income Tax*, 7th ed. (Toronto: Carswell, 2002), 296.

"harks back to some early Canadian and UK jurisprudence that indeed indicated that 'on account of capital' could refer to a firm's capital structure—a view that many of us assumed had been superseded by modern case law and relegated to a footnote as a quaint historical anomaly in the annals of tax jurisprudence."[4] Even worse, the meaning of the decision, apart from apparently overturning previous case law, was far from clear to most readers.[5]

Whether indebtedness is on capital or income account is of critical importance in resolving a number of issues. Key among these issues is the deductibility of interest under the Income Tax Act.[6] Paragraph 20(1)(c) specifically permits the deduction of interest in respect of a borrowing or other debt where certain requirements are met. However, if interest expense is on income account, a taxpayer need not meet the requirements of paragraph 20(1)(c), because the interest would be deductible in calculating profit under section 9 and the limitation in paragraph 18(1)(b) (prohibiting the deduction of an outlay on account of capital) would not apply. Subparagraph 20(1)(c)(i) requires that the proceeds of a borrowing be used for the purpose of earning income from a business or property. Although a similar requirement (in paragraph 18(1)(a)) would seem to apply to the deductibility of interest under section 9, Canadian courts have developed specific tests in respect of the requirement in subparagraph 20(1)(c)(i) that would not need to be met were interest deductible under section 9. Moreover, paragraph 20(1)(c) begins with the requirement that the interest in question must be "paid in the year or payable in respect of the year"; different requirements could apply to a calculation of profit under section 9.

Whether a liability is on income or capital account is also relevant to other income tax issues; the tax treatment of financing and refinancing expenses under paragraph 20(1)(e) is one example. Another area where *Gifford* could have a significant impact is the treatment of foreign exchange gains and losses associated with the settlement or extinguishment of a liability (or perhaps a hedge of a liability), where the characterization of the foreign exchange gain or loss has traditionally been determined by the character of the underlying debt. The approach traditionally applied by the courts was described by McLachlin J in *Shell Canada* as follows:

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4 Joseph Frankovic, "Supreme Court's Decision on Interest Deductibility Defies Logic," *Tax Topics*, no. 1673 (Toronto: CCH Canadian, April 1, 2004), 1-4, at 2.

5 R. Ian Crosbie and Elinore J. Richardson, "Gifford: Back to the Drawing Board" (2004) vol. 12, no. 1 *Corporate Finance* 1146-50; Robert Jarman, "Supreme Court Leaves Unanswered Questions About Deductibility of Interest," *Dominion Tax Cases Newsletter* no. 94 (Toronto: CCH Canadian, March 15, 2004), 7-8, at 8; and Brian J. Arnold, "Canadian Supreme Court Analysis Muddies Characterization of Interest for Tax Purposes" (2004) vol. 34, no. 1 *Tax Notes International* 59-62. Arnold concludes, ibid., at 62, "Because the Supreme Court's analysis in the *Gifford* case is so flawed, I suspect that it will be largely ignored by the CRA and by taxpayers."

6 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.

> [t]he characterization of a foreign exchange gain or loss generally follows the characterization of the underlying transaction. . . . Thus, if the underlying transaction was entered into for the purpose of acquiring funds to be used for capital purposes, any foreign exchange gain or loss in respect of that transaction will also be on capital account.[7]

This statement was, of course, made prior to *Gifford*, when the test for determining whether indebtedness was on income or capital account was to look at the use of the proceeds of the indebtedness.[8]

Underlying the questioning of the *Gifford* approach by the tax community are perhaps fundamental policy questions. To what extent should financing expenses be matched (by character, not timing) with the income that they generate? To what extent are rules relating to capital expenditures merely timing rules, rather than absolute prohibitions on deductibility or perhaps even incentive provisions (as suggested by the Supreme Court of Canada in the past)? Why should interest expense be considered to be on capital account at all?[9]

The purpose of this article is not to explore these policy questions, but rather to try to determine what *Gifford* means. I will begin the discussion with a review of *Gifford*. I will then attempt a comprehensive review of the line of British cases to which the Supreme Court referred in *Gifford*, as well as a comprehensive review of the Canadian jurisprudence. Although lengthy, this review assists an evaluation of older Canadian case law in light of the *Gifford* approach. Finally, I will examine the

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7 *Shell*, infra note 18, at paragraph 68. See also *Neonex International Ltd. v. The Queen*, infra note 133 (FCA). Note that, consistent with McLachlin J's use of the word "generally," this approach may not always be the correct one; see, for example, *B. Netupsky v. The Queen*, [1992] 2 CTC 2531 (TCC).

8 Under the current Act, foreign exchange gains and losses could potentially be addressed in one of three ways: (1) gains and losses could be on income account and included or deducted under section 9; (2) losses could be addressed under paragraphs 18(1)(f) and 20(1)(f); or (3) gains and losses could be on capital account and treated as capital gains and losses under subsection 39(2). Foreign-currency fluctuations occurring after an obligation has been issued are generally ignored for debt forgiveness purposes; see paragraph 80(1)(k). At the time of writing, the position of the courts is that foreign exchange losses are to be addressed under paragraphs 18(1)(f) and 20(1)(f). (See *Imperial Oil Limited v. The Queen et al.*, 2004 DTC 6702 (FCA); rev'g. 2004 DTC 2377 (TCC); and *Inco Limited v. The Queen*, 2005 DTC 5109 (FCA); rev'g. 2004 DTC 3586 (TCC).) Paragraph 20(1)(f) does not provide any deduction unless interest is stipulated on the debt. In addition, the debt must be a "bond, debenture, note, mortgage, hypothecary claim or similar obligation" issued by the taxpayer after June 18, 1971. If paragraph 20(1)(f) is applicable to foreign exchange losses, the deduction will generally be at a rate of 100 percent in respect of "shallow" discounts and 50 percent in respect of "deep" discounts. In theory, paragraphs 18(1)(f) and 20(1)(f) apply whether the debt obligation is on income or capital account; accordingly, if these paragraphs continue to govern the treatment of foreign exchange losses, in theory *Gifford* will be relevant only for foreign exchange gains.

9 These issues are discussed in the articles cited infra note 107.

meaning of *Gifford*, particularly its implications for financial institutions. Generally, I conclude that applying *Gifford* will be a challenge, but that in fact most taxpayers should not be affected by this new approach to the characterization of indebtedness.

THE DECISION

The taxpayer in the *Gifford* case was Thomas Gifford, a financial adviser employed by a brokerage company, Midland Walwyn Capital Inc. Scott Bentley, another financial adviser employed by Midland Walwyn, was leaving the company. Mr. Gifford purchased Mr. Bentley's client list[10] for $100,000, subject to some adjustments. He borrowed funds in order to make the payment. At issue in the case were two points:

1. whether the $100,000 payment for the client list was deductible,[11] and
2. whether interest on the $100,000 borrowing was deductible.

In both respects, the key provision allegedly preventing deductibility was subparagraph 8(1)(f)(v) of the Act, which read (and still reads):

> 8(1) In computing a taxpayer's income for a taxation year from an office or employment, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto: . . .
>
> (f) where the taxpayer was employed in the year in connection with the selling of property or negotiating of contracts for the taxpayer's employer . . . amounts expended by the taxpayer in the year for the purpose of earning the income from the employment . . . to the extent that those amounts were not . . .
>
> (v) outlays, losses or replacements of capital or payments on account of capital, except as described in paragraph (j).

At the Tax Court of Canada, Bowman J found that both the payment made for the client list and the interest on the borrowed funds were deductible. With respect to the interest, Bowman J found that interest is not per se on capital account. He stated:

> In my opinion, whether interest is of a capital or a revenue nature depends on what the borrowed money is used for.[12]

10 This was a list of clients to whom the financial adviser sold securities. As part of the agreement between Mr. Gifford and Mr. Bentley, Mr. Bentley promised not to provide securities investment advice to the clients on the list for 30 months, and not to provide material information regarding the client list to other people without the consent of Mr. Gifford.

11 Mr. Gifford originally claimed an eligible capital expenditure deduction, but this was disallowed by the minister of national revenue on the basis that such a deduction is not available in respect of employment income.

12 *Gifford v. The Queen*, [2001] 2 CTC 2162, at paragraph 22 (TCC).

In support of this proposition, he cited an article by Brian Arnold[13] and Arnold's interpretation of *Bennett & White Const.*[14] and *Wharf Properties v. Comr. of Inland Revenue*,[15] both discussed below.

Bowman J's decision was overturned by the Federal Court of Appeal. Rothstein JA found that the payment for the client list was on capital account. Rothstein JA also found that interest is always on capital account and, in the absence of a specific provision in the Act permitting a deduction, is therefore not deductible. He stated:

> *Shell Canada*, *supra*, says that in the absence of the statutory provisions for deductibility, interest is, without exception, to be considered a capital expenditure. Even if one were inclined to the view that McLachlin J.'s comment should be interpreted as only characterizing interest as capital when the purpose of the loan is capital, *Bronfman Trust* would appear to suggest that even interest on loans for working capital, which would certainly include loans to cover current expenses, must be considered as a payment on account of capital.
>
> The learned Tax Court Judge appears to have interpreted McLachlin J.'s observation that the Supreme Court was not invited, in *Shell*, to revisit the characterization of interest being a capital expenditure, as an invitation for lower courts to do so. I am unable to interpret her words in the same way.
>
> In *Tennant v. R.* (1996), 96 D.T.C. 6121 (S.C.C.), at 6125, Iacobucci J. makes it clear that the Supreme Court is well aware that in academic and practice circles, commentators have suggested that *Canada Safeway*, *supra*, and implicitly, decisions that have followed it, were wrongly decided. In my respectful view, I think McLachlin J. was recognizing that it may be timely for the Supreme Court to revisit the question of the characterization of interest as a capital expenditure or as a current expense. However, I do not read her views in *Shell*, *supra*, to suggest that until such revisiting takes place, that the common law as developed by the Supreme Court to date is not to be respected by lower courts.[16]

Major J, writing for the Supreme Court of Canada, found that the payment for the client list was on account of capital. The basis for this finding was that the list significantly expanded Mr. Gifford's client network and reduced competition from other brokers. Under traditional tests in the Canadian tax jurisprudence, this finding would necessitate a finding that the interest paid on the $100,000 borrowing was also on capital account. However, this was not the route taken by Major J.

Major J stated definitively that interest is not always a capital expense:

> [T]he decisions of this Court have not held that interest is always a capital expense, but have consistently found that when the proceeds of the loan add to the financial

13 Brian J. Arnold, "Is Interest a Capital Expense?" (1992) vol. 40, no. 3 *Canadian Tax Journal* 533-53.

14 Infra note 76.

15 [1997] STC 351 (PC).

16 *The Queen v. Gifford*, [2002] 4 CTC 64, at paragraphs 37 to 39 (FCA).

> capital of the borrower any interest paid on that loan will be considered a payment 'on account of capital.'[17]

This statement came as a welcome confirmation of a view that was widely held in the tax community but was not without doubt, given some of the statements found in earlier Supreme Court of Canada cases.[18]

However, Major J used a seemingly new approach[19] to determine whether the borrowing in *Gifford* was on capital account. Although Major J acknowledged that, in determining whether interest is on income or capital account, an examination of the purpose of the proceeds of a loan is "in accordance with general accounting principles and logic,"[20] this was not the method selected by Major J in *Gifford*. Instead, Major J set out the following approach:

> Under our current Act it is not necessary to determine whether the payment is a capital expenditure but to determine whether the payment is being made "on account of capital." This distinction in terms is particularly important in relation to interest payments, because loan proceeds are seldom retained in the form they are received, unlike other capital assets. This distinction means that under our Act it is only necessary to consider what the proceeds of the loan are to the borrower when they are received, and does not require an examination of what those loan proceeds are spent on. If the money adds to the financial capital then the payment of interest on that loan will be considered to be a payment "on account of capital." If the loan proceeds constitute the inventory of the borrower, as is the case with moneylenders, then the payment of interest would be deductible. Lord Hoffmann in *Wharf Properties*, *supra*, discussed how loan proceeds can be different things to the borrower, at p. 339:
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>> This decision does not seem to their Lordships to help Mr. Gardiner at all. It is directed to a different question, namely whether the sum borrowed constitutes an addition to the company's capital or is a revenue *receipt*. <u>In other words, it looks at the nature of the *loan* in the hands of the recipient rather than the question of whether a payment of interest is a capital or revenue expense. It is unusual for a loan of money to constitute a revenue receipt but this can be the case if borrowing money is "part of the ordinary day to day</u>

17 *Gifford*, supra note 1, at paragraph 36.

18 See Rothstein JA's review of this jurisprudence in the Federal Court of Appeal's decision in *Gifford*. Indeed, in *Shell Canada Ltd. v. The Queen*, [1999] 4 CTC 313 (SCC), the Supreme Court of Canada seemed quite clear that interest was always on account of capital. See the discussion below around note 94. Major J, supra note 1, at paragraph 34, states that McLachlin J left the issue open; however, it is probably more correct to say that McLachlin J accepted that the current state of the law was that interest is always on capital account but suggested that the Supreme Court of Canada might take a different view if required to revisit the issue. See *Shell Canada*, supra, at paragraph 74.

19 As noted by Crosbie and Richardson, supra note 5, at 1148, "the Court draws a fine distinction, which observers might be pardoned for having overlooked."

20 *Gifford*, supra note 1, at paragraph 38.

> incidence of carrying on the business" (*per* Lord Templeman in the *Beauchamp* case, at p. 497) which may be the case in businesses of banking, financing or otherwise dealing in money: see *Farmer v. Scottish North American Trust Ltd.* [1912] A.C. 118. Ordinarily, however, a loan to a trading company, whatever the purpose for which it is intended to be used, will be an addition to that company's capital. Mr. Gardiner did submit that the shortness of the successive terms of the loans in this case was enough to make them revenue receipts, but their Lordships do not agree. The borrowing did not form part of the company's trading activities. While it or a replacement loan remained in place it was an addition to Wharf's capital: compare *European Investment Trust Co. Ltd. v. Jackson* (1932), 18 T.C. 1. [Italics in original, underlining added.]
>
> As earlier pointed out, loan proceeds are usually thought of as additions to the financial capital of the borrower. This view makes it necessary to deal briefly with the wording at the beginning of both s. 8(1)(f)(v) and s. 18(1)(b) that prohibits the deduction of "outlays . . . of capital." A literal reading of this phrase could render every expenditure that could not be directly traced to revenue non-deductible as an outlay of capital. This has not been the approach under these sections in the past, and the analysis should continue to look at what is acquired rather than examining where the money to make the payment originates.[21]

The general point made by Major J is that interest is not always on capital account, and that to determine whether interest is on income or capital account, one must look at the nature of the liability itself rather than the use of the proceeds of the liability. To illustrate his point, Major J cites the line of British cases ending most recently with *Woolworth*.[22] This is perhaps appropriate given that modern Canadian case law does not (or at least does not explicitly) seem to follow the principle set out by Major J. Accordingly, the next two sections of this article review, first, the *Woolworth* line of cases, to try to gain a better understanding of the *Gifford* approach, and then the relevant Canadian case law, to determine the extent to which Canadian cases reflect or diverge from this approach.

BRITISH JURISPRUDENCE

Given the reference to British case law in *Gifford*, this section of the article reviews that case law. Major J's reasons suggest that modern Canadian courts and most of the Canadian tax community have generally misunderstood the British case law on the characterization of financing expenses. As demonstrated below, although the beginnings of this case law are arguably somewhat confused, the concept that one determines the capital or income nature of a liability by analyzing capital structure rather than the use of proceeds is a reasonably clear theme, and one that has only strengthened with the passage of time.

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21 Ibid., at paragraphs 39 to 40.

22 Infra note 57 (cited in *Gifford* as *Beauchamp*).

One of the earliest British cases to consider this set of issues is *Anglo-Continental Guano Works v. Bell*.[23] The taxpayer in this case was a German company with an office in London. The company was in the business of buying and selling guano and manure. The purchases of inventory for the London office were financed by funds borrowed from the company's head office and from bankers. The amount of the borrowings fluctuated and the borrowings were repaid from time to time with available funds. Interest at a fixed rate (or a floating rate if the Bank of England rate exceeded a certain threshold) was charged on the daily balance of the borrowings. At issue was the deductibility of interest on the advances from both head office and the third-party lenders. The Crown argued that

> [y]ou cannot differentiate between the case where a man has the capital to employ and the case where he is obliged to borrow his capital.[24]

The court denied the deduction. Mathew J held that

> what are intended to be assessed are the profits of the particular business, and . . . those profits are to be ascertained in the ordinary way without reference to the consideration as to whether or not a particular partner or all the partners are trading with borrowed capital.[25]

Cave J stated that

> the gains of the trade are quite independent of the question of how the capital money is found, . . . the gains of the trade are those which are made by legitimate trading after paying the necessary expenses which you have necessarily to incur in order to get the profits; and . . . you cannot for that purpose take into consideration the fact that the firm or trader has to borrow some portion of the money which is employed in the business.[26]

The court seems to suggest (but does not state explicitly) that borrowed funds constitute part of the capital of the enterprise, and therefore interest would be on capital account. The court did not decide the case on the basis of any statutory provision.

Texas Land and Mortgage Co. v. Holtham[27] was decided in the same year as *Anglo-Continental*, by the same panel. The taxpayer in this case was a moneylender; it raised funds through debt issuances and deposits and on-loaned the funds to

23 (1894), 3 TC 239 (QB).

24 Ibid., at 243.

25 Ibid., at 244.

26 Ibid., at 245-46.

27 (1894), 3 TC 255 (QB).

purchase, or purchased directly, securities, land, and other property. The taxpayer issued debentures and debenture stock for the purpose of advancing funds by way of mortgages and other securities on Texas real property. The taxpayer wished to deduct commissions and fees paid to agents and brokers for placing the debentures and debenture stock, as well as the cost of stamps, postage, printing, advertising, and legal fees associated with the issuance of the debentures and the debenture stock.

Mathew J found against the taxpayer, stating:

> There is no doubt that in this case this Company raised money by shares with the intention of lending money on mortgage. To increase its capital it raised money on debentures. The argument is that the cost of raising the money ought to be deducted from the profits in a particular year. We are clearly of the opinion that that cannot be done. The amount paid in order to raise the money on debentures, comes off the amount advanced upon the debentures, and, therefore, is so much paid for the cost of getting it, but there cannot be one law for a company having sufficient money to carry on all its operations and another which is content to pay for the accommodation.[28]

The theme of these very early cases, then, is that, on the basis of general principles (as opposed to a specific statutory provision), expenses relating to borrowings would always be on capital account and therefore such expenses would not be deductible, because no expenses incurred to raise capital should be deductible.

Scottish North American Trust v. Farmer[29] carved out an important exception to this principle. In this case, the taxpayer carried on the business of buying and selling equities and debt of US railroads and other companies. The taxpayer company financed its operations in part through an overdraft account with its bankers in New York and, subsequently, through a six-month revolving loan that was granted for an amount up to £200,000 (which was the amount ultimately advanced), which loan was renewed for a further six-month period. At issue was the deductibility of the interest on the overdraft and the loan. The Crown contested the deduction on the basis that it contravened the statutory prohibition against deductions in relation to "sums employed or intended to be employed as capital," set out in rule 3, section 100 of the Income Tax Act of 1842.

Lord Atkinson of the House of Lords rejected the Crown's position. He stated:

> The profits and gains of any transaction in the nature of a sale must, in the ordinary sense, consist of the excess of the price which the vendor obtains on sale over what it cost him to procure and sell, or produce and sell, the article vended, and part of that cost may consist of the sum he pays for the hire of a machine, or the services of persons employed to produce, procure, or sell the article.
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> The second proposition established in the last-mentioned case [*Gresham Life Assurance v. Styles* (1892) (A.C. 309)] is that in these Acts, the words "profits and gains" are,

28 Ibid., at 260.

29 (1911), 5 TC 693 (HL).

> where the context does not otherwise require, to be construed in their ordinary signification. I can see no reason for suggesting that this last-mentioned principle should not apply to the word "capital" when used in these statutes, and that it too, where the context does not otherwise require, should be construed in its ordinary sense and meaning. If then one takes the case of an ordinary joint stock bank, whose business consists in the daily or hourly borrowing of money from the customer who lodges money with it either on deposit or current account, for which the bank becomes the debtor, or of lending money to those whose bills or notes it discounts, or whose securities it takes in pledge, and daily almost hourly, repaying in driblets by the cashing of the lender's cheques, the amount borrowed, then, according to the argument of the Attorney-General, the amount borrowed, fluctuating day by day, if not hour by hour, is to be treated as capital employed in the trade, adventure, or concern of the bank within the meaning of Rule 3, Section 100, of the Income Tax Act of 1842. No reduction, moreover, is to be made in respect of the sums lent by the bank on the discount side of its business. Indeed, the Attorney-General, as I understood, admitted, as he was by the necessities of his argument obliged to admit, that the result would be the same in the case of a joint stock bank, which by its charter or articles of association was absolutely prohibited from increasing its capital, that, it appears to me, simply, amounts to this that the word "capital" must, in this rule, be held to bear a wholly artificial meaning differing altogether from its ordinary signification, though there be no context in the clause requiring that there should be given to it a meaning different from that which it bears in ordinary commercial transactions.[30]

His Lordship then found that the term "capital" should have its ordinary commercial meaning. He relied on two cases, *Bryon v. Metropolitan Saloon Omnibus Co.*[31] and *General Auction Estate and Monetary Co. v. Smith*.[32] The issue in the former case was whether certain borrowings constituted an increase in capital that required the consent of the shareholders; the issue in the latter case was whether the defendant company had the power to borrow. Lord Atkinson stated:

> These authorities show that money borrowed by such a Company as the Appellant Company in this case in the fluctuating temporary manner in which it has been borrowed by them—the daily borrowing and lending of money being part of their trade and business—is not to be treated under the Joint Stock Companies Act as "capital." There is nothing to show that that word should bear a different meaning in the Income Tax Acts when applied to the proceedings of Joint Stock Companies. The interest is, in truth, money paid for the use or hire of an instrument of their trade as much as is the rent paid for their office or the hire paid for a typewriting machine. It is an outgoing by means of which the Company procures the use of the thing by which it makes a profit, and like any similar outgoing should be deducted from the receipts, to ascertain the taxable profits and gains which the Company earns.[33]

30 Ibid., at 705-6.

31 (1858), 44 ER 1215 (Ch. D.).

32 [1891] 3 Ch. 432 (KB).

33 Supra note 29, at 707.

Lord Atkinson distinguished the case in issue from the decision in *Anglo-Continental Guano Works*, stating:

> It does not appear to me that the reasoning on which this decision is based can apply to a bank whose business is the borrowing and lending of money; or to an investment company whose business is conducted as is that of the Respondents in the present case.[34]

Accordingly, at this point, the case law seemed to provide separate regimes for financial institutions and other taxpayers. The case law itself could also be divided into decisions based on a "common law" conception of capital and decisions based on the statutory prohibition of deductions of sums employed as capital.

Scottish North American Trust was arguably affirmed by *The European Investment Trust Co., Ltd. v. Jackson (HM Inspector of Taxes)*.[35] Again, the issue was the deductibility of interest. The taxpayer provided financing to persons intending to purchase cars on a "hire purchase" basis. The taxpayer would purchase the car and lease it to the customer; on expiry of the lease term, the lessee had the option to purchase the car for a nominal amount. The majority shareholder of the taxpayer was a US corporation. The US corporation had provided £900 of the taxpayer's £904 in paid-up capital and had also made an initial interest-bearing advance of approximately £10,300. Subsequently, the taxpayer received additional periodic advances from the US corporation to cover its financing transactions and cash requirements; the amount of these advances corresponded roughly to the amount paid by the taxpayer to purchase cars for lease. Interest on these subsequent advances was calculated daily on amounts outstanding. As customers paid their instalments, the taxpayer repaid the advances out of funds deposited into a dedicated account. The advances in question totalled £95,273, £347,575, and £447,965 in 1926, 1927, and 1928, respectively. At issue was the deductibility of the related interest.

In the decision of the Court of King's Bench, Finlay J denied the deduction. He cited several cases, including *Anglo-Continental Guano Works* and *Scottish North American Trust*, and stated the relevant principles as follows:

> [I]f you get a company dealing with money, buying or selling stocks or shares, Treasury bills, bonds, all sorts of things, and if you get that company getting, as such companies constantly do get, temporary loans from their bank—accommodation, I suppose, for sometimes twenty-four hours, or even less, sometimes for a good deal longer—if you get that sort of thing, then the interest on that money, the hire, so to speak, paid for that money, may properly be regarded as an expenditure of the business, an outgoing to earn the profits. On the other hand, if the truth of the thing is that by the payment of the interest the company does not obtain mere temporary accommodation, day to day accommodation of that sort, but does, in truth, add to its

34 Ibid., at 708.

35 (1932), 18 TC 1 (CA).

> capital and get sums which are used as capital and nothing else, then I think that in that case all the authorities show that that deduction cannot properly be made.[36]

Accordingly, Finlay J affirmed *Scottish North American Trust* to a certain extent. In his view, a moneylender or similar type of company could view a "temporary accommodation" as being on income account. Note that, in his view, a "temporary accommodation" could be "a good deal longer" than 24 hours.

The case seems to have been decided primarily on the basis of the statutory prohibition against deductions in respect of amounts employed or intended to be employed as capital. Finlay J emphasized that the taxpayer required a considerable amount of capital to carry on its business. Applying the principles set out above to the facts of the case, Finlay J stated:

> [J]ust as the sum referred to in paragraph 6 [the initial advance of approximately £10,300] was clearly an addition to the capital of the Company and nothing else, so also the sums referred to in paragraph 7 [the subsequent advances]—and certainly whatever else they were they were exceedingly large sums owing to the fortunately large business of the Company—were like the sums referred to in paragraph 6, not like mere temporary accommodation, borrowed by a company dealing in money, from its bankers, but were, in their nature, permanent additions, fluctuating, but none the less large, amounts, permanent additions to the capital of the Company.[37]

Thus, Finlay J left open the possibility that expenses relating to "mere temporary accommodation" could indeed be deductible.

The appeal of the decision was dismissed by all three members of the Court of Appeal panel. Hanworth MR held that there was an adequate factual basis for the findings. Slesser LJ stated that the sums advanced, having been remitted "to the credit of the Company's deposit account, in order to enable them to carry on their business, were capital moneys."[38] Romer LJ found that he could not reconcile a rejection of the appeal with *Scottish North American Trust*; however, as it was impossible, in his view, that the House of Lords in that case could be interpreted as suggesting that circulating capital was not "capital" within the meaning of that term in the statutory prohibition referenced above (subrule f), and as that case did not overrule *Anglo-Continental Guano Works*, the only conclusion that could be drawn was that each case must be decided as a question of fact. In fact, it could be suggested that while *European Investment Trust* affirms *Scottish North American Trust* with respect to financial institutions, it takes into account the severe undercapitalization of the particular taxpayer in determining the nature of borrowings. Therefore, at this point, *Anglo-Continental* arguably still stands as being applicable to taxpayers that are not financial institutions.

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36 Ibid., at 11-12.

37 Ibid., at 12.

38 Ibid., at 15-16.

In *Ward (HM Inspector of Taxes) v. Anglo American Oil Co., Ltd.*,[39] the taxpayer was in the business of importing petroleum products from the United States for sale in the United Kingdom. The taxpayer financed the acquisition of a company with the issuance of one-year notes. The taxpayer had expected to be sufficiently profitable to repay these notes in full at maturity; however, these expectations did not fully materialize, and one year later the taxpayer financed the repayment of the notes by issuing three further series of notes. At issue was the deductibility of interest and other financing expenses (including foreign exchange losses) relating to the initial series of notes and a separate issuance of notes. The Court of King's Bench found that the interest was "annual interest" and therefore not deductible pursuant to a specific statutory provision relating to interest.[40] However, the court went on to consider whether the borrowings were on capital account for purposes of the statutory prohibition of deductions of sums employed as capital under rule 3(f) of schedule D of the Income Tax Act, 1918. Singleton J stated:

> It seems to me, when I look at what was done and the reason which prompted the Company to issue the Notes, that they were not within the category of short loans or ordinary trading facilities, but that they were rather of the nature of moneys obtained for, and employed or intended to be employed for, capital purposes. If, then, interest on them is a payment in respect of them within the meaning of Rule 3, I am driven to the conclusion that it is a deduction which cannot be made in computing the amounts of profits or gains, having regard to the terms of Rule 3(f).[41]

However, Singleton J went on to state:

> I conceive the scheme of that part of the Act and of Schedule D, which deals with profits or gains from trade and deductions which can be made therefrom, to be this: that one must arrive at profits or gains in the ordinary commercial or business sense. Interest on ordinary bankers' overdrafts which has arisen for ordinary trading purposes is a legitimate deduction, because it is money wholly and exclusively laid out or expended for the purpose of trade. On the other hand, interest on an issue of notes, whether for one year or for a longer period, may fall, and in the circumstances of this case does fall, into an entirely different category. It seems to me to savour much more of a capital nature or of some fund employed or intended to be employed as capital, and I do not think the issue of notes on which interest accrued would be regarded by business men as of the same nature as facilities obtained for ordinary trading purposes.[42]

39 (1934), 19 TC 94 (KB).

40 Rule 3(l) of the rules applicable to cases I and II of schedule D of the Income Tax Act, 1918 precluded the deduction of "any annual interest or any annuity or other annual payment payable out of the profits or gains" in computing profits under case I.

41 Supra note 39, at 108.

42 Ibid., at 108-9.

Here again, we see an affirmation of the proposition in *Scottish North American Trust* in respect not only of "short loans" but also of "trading facilities." Interestingly, the court seems to have determined that the notes were on capital account by looking to the intended use of the borrowed funds, rather than the terms of the notes or the capital structure of the company (although the court did note that the principal shareholders had rejected an issuance of preferred shares in the past). Also interesting is the absence of any discussion of the distinction between financial institutions and other taxpayers.

In *Ascot Gas Water Heaters, Ltd. v. Duff (HM Inspector of Taxes)*,[43] the taxpayer manufactured heating appliances. At issue was the deductibility of commissions paid to the parent corporation of the taxpayer for guaranteeing certain trade debts of the taxpayer owing to a related party. Also at issue was the deductibility of further commissions paid to the grandparent corporation of the taxpayer, but this time in relation to guarantees of borrowings made to finance expansion of the taxpayer's business. The deductibility of the commissions was challenged under a number of provisions, including rule 3(f) of cases I and II of schedule D. Citing *European Investment Trust* as the leading case on point (and also, by implication, relying on *Scottish North American Trust*), Lawrence J stated:

> The principle, therefore, which the Commissioners ought to have applied in each of these cases was whether the sums in respect of which the commission dealt with in these two cases was payable, were sums which, although capital, were temporary in their nature and might be regarded as an ordinary incident of carrying on the business of the Company.[44]

With respect to the guarantee of the borrowing to fund the expansion of the business, Lawrence J held that

> the money was lent in payment for first mortgage debenture capital (which cannot, in my opinion, be in any sense regarded as within the sort of temporary accommodation of which Finlay, J., spoke), and also because . . . the parties to the transaction said . . . "Further expansion is only possible if an adequate long-term credit is obtainable and sufficiently large liquid assets in the form of reserves are formed."[45]

With respect to the guarantee of the trade debts, the court upheld the deductibility of the commission, citing reliance on

> the fact that the commission was payable in respect of a sum of money which was raised in respect of the guarantee of the amount of an existing trade debt, and the fact that that trade debt was very largely reduced in the two years after the guarantee had

43 (1942), 24 TC 171 (KB).

44 Ibid., at 176.

45 Ibid.

> been given, and the fact that the parties were, according, to the evidence, anxious that this loan should be repaid as quickly as possible.[46]

Again, *Scottish North American Trust* and *European Investment Trust* are relied upon by the court; again, the emphasis seems to be on the characterization of the underlying loans as being "temporary" or not; and again, there seems to be no separate treatment of financial institutions.

In *Pattison v. Marine Midland Ltd.*,[47] the taxpayer—a UK subsidiary of a US bank—carried on an international commercial banking business, primarily by making short-term and medium-term loans. Before the taxpayer began its operations, it issued US $15 million of loan stock from related companies on a subordinated, unsecured basis. The borrowing was redeemable by the taxpayer after 10 years. The taxpayer intended to use, and did use, the funds to make US dollar deposits and loans, earning a profit on the spread. The loan was consistent with the taxpayer's policy of maintaining matched foreign-currency assets and liabilities. The loans were redeemed after 5 years. At issue was the deductibility of the foreign exchange loss on the redemption. The taxpayer's ordinary and preferred share capital was invested in gilt-edged securities and certificates of deposit, and not employed in the business. The Crown's primary argument was that the foreign exchange loss was not deductible pursuant to section 130(f) of the Income and Corporation Taxes Act 1970 (ICTA) (the indirect successor of rule 3(f) of the Income Tax Act, 1918), which stated:

> In estimating the balance of profits and gains chargeable under Schedule D, or for the purpose of assessing the duty thereon, no sum shall be deducted from or allowed to be set against or deducted from such profits or gains . . . on account of any capital withdrawn from . . . nor for any sum employed or intended to be employed as capital in such trade, manufacture, adventure or concern.

Vinelott J denied the deduction on the basis that the loan stock was "part of the capital structure of the company."[48] He stated that

> the loan stock had all the characteristics of preference share capital. It represented a long-term obligation entered into to raise moneys which the company could employ to enable it to commence trading."[49]

Vinelott J rejected the contention that the use of the proceeds to acquire current assets was relevant, citing *European Investment Trust* and *Scottish North American Trust*. However, Vinelott J did state that

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46 Ibid., at 177.

47 (1981), 57 TC 219 (Ch. D.).

48 Ibid., at 236.

49 Ibid., at 237.

> in a doubtful case the use made by a company of moneys borrowed—whether the moneys are embarked in the trade in the acquisition of current assets or otherwise, on the one hand, or are retained on deposit or invested or used in the acquisition of fixed assets, on the other hand—may throw some light on the character of the borrowing. But if a borrowing is clearly stamped as a borrowing on capital account . . . the fact that the moneys borrowed are embarked in the trade in the purchase of current assets becomes irrelevant.[50]

Vinelott J's decision was ultimately overturned by the Court of Appeal and the House of Lords on a different point.[51]

Overseas Containers (Finance) Ltd. v. Stoker[52] was an anti-avoidance case relating to the shifting of expected foreign exchange losses (which ultimately materialized) to a UK corporate member of a multinational shipping group. The losses arose in respect of short-term and medium-term loans by German shipyards to a company related to the taxpayer, which were assumed by the taxpayer, as well as further short-term and medium-term loans relating to the construction of ships by others in the taxpayer's corporate group. The taxpayer—a newly formed company with share capital of £1,000—had assumed the existing loans and entered into the new loans in order to isolate the expected foreign exchange losses. Had the losses been realized by the original borrowers or other operating companies in the corporate group, the losses would not have been considered to have been incurred in the course of trading transactions and therefore would not have been deductible.

The court considered whether, had the taxpayer carried on a trade, the losses would have been in respect of capital. Vinelott J stated:

> I think that in directing their attention to the question whether the borrowings by [the taxpayer] were mere temporary accommodations the Commissioners failed to direct their minds to the real question. It is quite plain that in the case of a company which carried on a trade other than that of dealing in money borrowing on the terms on which [the taxpayer] borrowed from sources outside [the taxpayer's corporate] group would almost inevitably be a borrowing on capital account; it would be irrelevant to enquire whether the monies borrowed had been utilised on capital account or embarked in its trade as (in the language used in the older cases) circulating capital. While the use made of borrowed money may throw some light on the character of the borrowing in a doubtful case, if the borrowing is clearly stamped as a borrowing on capital account it is not relevant to enquire whether the monies borrowed were used for a capital or a revenue purpose. . . .
>
> However the whole question in this case is whether a borrowing in these terms by a company whose business is dealing in money is similarly to be treated as a borrowing on capital account or whether the borrowing should not be treated as analogous to the acquisition of stock in trade. . . .

50 Ibid., at 245.

51 [1983] STC 269 (CA); aff'd. [1984] STC 10 (HL).

52 (1987), 61 TC 473 (Ch. D.).

> There is *prima facie* a distinction between monies borrowed in order to put the borrower in a position to carry on the business of dealing in money (which was I think the way in which the borrowing by the taxpayer company was treated by Finlay J. and by the Court of Appeal in *European Investment Trust Company, Ltd. v. Jackson*) and money borrowed in the course of carrying on that business; and in the case of money borrowed from the parent of the taxpayer company it may be easier to draw the inference that the borrowing was made to enable the taxpayer company to embark on or to expand or continue its trade, and was not a borrowing made in the course of that trade. I am not therefore persuaded that *European Investment Trust Company, Ltd. v. Jackson* concludes this question in favour of the Crown. In *Pattison v. Marine Midland Ltd.* the borrowing was clearly stamped as capital introduced by the parent in order to enable the taxpayer company to trade.[53]

Vinelott J then discussed the High Court of Australia decision in *AVCO Financial Services Ltd v. FC of T*, citing the following passage (among others):

> Where a taxpayer carries on the business of borrowing and lending money, the moneys used for that purpose are analogous to trading stock—the taxpayer in effect deals in the money. Exchange gains and losses, regularly and frequently made and incurred, in the course of making repayments of borrowed money which is used by a taxpayer in making loans in the course of its finance business are outgoings made in the day to day conduct of the business and for the purpose of carrying on the business as a going concern. The first matter to be considered, in deciding whether a payment is of a capital or of a revenue nature, is what was the character of the advantage sought by the payment. . . . The question has to be considered from a practical and business point of view. . . . From that point of view, the additional moneys paid as a result of the unfavourable exchange variations—the exchange losses—were part of the price by which the appellant obtained the money which it used to make a profit—part of the process by which the appellant obtained regular returns. The payments were recurrent and frequent, although irregular, and they involve the exercise of judgment by the officers of the appellant who put its borrowing policy into effect as part of the conduct of the business. The exchange losses were in my opinion losses on revenue account, and of course the gains have the same character. The view which I expressed in *Commercial and General Acceptance Ltd v. FC of T* . . . that an exchange gain or loss on the repayment of moneys lent will always be a capital gain or loss, must, on reconsideration, be rejected. In a case such as the present the gains and losses do not have the same character as the repayments that produced them, and, considered separately, but in the light of all the circumstances, are seen to be revenue in character.[54]

Vinelott J did not consider the application of these principles to the case at hand on the basis that the taxpayer was not truly in the business of borrowing and lending money. The appeal to the Court of Appeal was dismissed without analysis on this point.[55] However, the Court of Appeal stated that Vinelott J had been

53 Ibid., at 528-29.

54 82 ATC 4246, at 4251 (Full HC).

55 [1989] STC 364 (CA).

"inclined to, but did not, decide that the losses, if trading losses, were losses on revenue account."[56]

Beauchamp v. F.W. Woolworth plc[57] is the most recent and now the leading decision in this line of cases. In *Woolworth*, the taxpayer operated department stores. The taxpayer borrowed SFr 50 million and borrowed another SFr 50 million a year later. Each borrowing carried a fixed interest rate, and each had a five-year term (a Bank of England requirement). Both borrowings were immediately converted into pounds sterling. The loans were shown on the taxpayer's financial statements as "non-current liabilities" until they were repayable within one year. The first loan was repayable early with a premium at the issuer's option. It was repaid six months early, and the second loan was repaid at maturity. Under regulatory requirements regarding foreign financing, early repayment required the consent of the Bank of England; such consent was forthcoming on condition that the financing be replaced with new foreign loans, which did in fact occur.

At various board meetings leading up to the borrowings, it was stated that the loans were needed to resolve short-term cash flow problems. These problems stemmed largely from poor inventory control, which was expected to improve over a relatively short period of time. At the time of the second borrowing (which was approved at a special meeting of the board convened about eight months after the first borrowing), inventory levels were still high. The evidence showed that each borrowing, worth approximately £5 million at the time it was incurred, represented only about one week's turnover of inventory. However, a further reason for the cash shortfall relating to both borrowings was a modernization program being undertaken by the taxpayer for its various physical outlets.

Owing to depreciation of the pound sterling relative to the Swiss franc, both loans were repaid at a loss with respect to foreign-currency fluctuations. The taxpayer sought to deduct the losses under the ICTA.

The Special Commissioners held that the losses were deductible on the basis that the purpose of the loans was to provide the taxpayer with short-term liquidity:

> [W]e find the loans to have been loans arranged to tide the taxpayer company over a short-term problem namely the failure of the taxpayer company's trading activities to generate a sufficient cash flow to cover the taxpayer company's commitments and day to day needs. We find that the more efficient stock control and better trading results were expected within a short time to solve the problem.
>
> On that basis we hold the loans represented temporary facilities rather than permanent capital and we attach significance to the following circumstances: (1) that the 5 year term was a Bank of England requirement; (2) that the formalities associated with the loans appear to have been dealt with as simply and accepted as readily by the board of the taxpayer company as might be the documentation required to secure a bank overdraft; (3) that for accounting purposes the loans appear to have been placed in

56 Ibid., at 368.

57 [1987] STC 279 (Ch. D.); rev'd. [1988] STC 714 (CA); rev'd. [1989] STC 510 (HL).

the same category as the 5 year £5m loan from National Westminster Bank; (4) that proposals for raising "permanent capital" were not pursued but the loans were regarded as adequate to meet the taxpayer company's needs; (5) that the evident intention of the taxpayer company was to repay the loans out of profits generated in the course of the taxpayer company's trade; (6) that the loans were no part of the shareholder's funds and were not intended to provide additional funds with which to trade.[58]

At the Chancery Division, Hoffmann J reversed the judgment of the Special Commissioners, stating:

> I think that these loans cannot reasonably be regarded as anything other than accretions to the taxpayer company's capital. No one can describe a loan for a fixed term of five years as a mere temporary accommodation. The amount and the term were fixed, and the loan was for a substantial period. I do not think it matters that the taxpayer company was entitled to make earlier repayment if it was willing to pay a capital premium. In practice it was not contemplated that the Bank of England would allow payment to be made much earlier than the five-year term of the loan.[59]

Hoffmann J then considered whether accounting treatment had any significance:

> The view that the loans formed an addition to the taxpayer company's capital is confirmed by the way the taxpayer company's auditors dealt with them in the accounts. . . . The Swiss franc loans were listed in the balance sheet as part of the "Total Capital Employed." The auditors therefore treated them as accretions to capital. Only when they were repayable within a year of the balance sheet date were they removed from capital and included in current liabilities. . . .
>
> I do not of course suggest that the conventional period of one year used by accountants to distinguish between current liabilities and capital employed is an infallible yardstick for the purposes of corporation tax. However, since the purpose of the accounts is to give a true and fair view of the company's position, it is a useful point of departure; and when the loan is for a fixed period of as long as five years, it seems to me that one would need fairly powerful reasons for differing from the accountants and not treating it as part of the capital employed by the company.[60]

Hoffmann J then stated:

> It seems to me that in attaching importance to what the taxpayer company was seeking to do, rather than to what it actually did, the commissioners misdirected themselves. The fact that the object of the borrowings was to deal with a temporary shortage of cash is irrelevant if the solution actually adopted was to make an addition

58 Decision of the Special Commissioners, reported with the decision of the Chancery Division, ibid., at 292.

59 Ibid., at 293.

60 Ibid., at 294.

to the taxpayer company's liquid resources sufficiently permanent to be regarded as an accretion to its capital. . . .

In cases where there is no fixed term for repayment, or where the term is of a borderline nature, the use to which the money was put may throw some light on whether or not it was an accretion to capital. . . .

But this is not a doubtful case. The terms of the loans are in my judgment sufficient to make it clear that they constitute additions to the capital employed by the taxpayer company, and it does not matter whether they were intended to be employed in the making of payments of a revenue or of a capital nature.[61]

The Court of Appeal reversed the Chancery Division's decision. Nourse LJ found that section 130(f) of the ICTA should be interpreted narrowly such that it does not apply to foreign exchange losses but only to the repayment of the loans themselves; accordingly, the decision should rest solely on general principles.[62] On this basis, Nourse LJ found that

[t]he basic principle in regard to loans is that if they are a means of fluctuating and temporary accommodation, they are to be regarded as revenue transactions and not accretions to capital.[63]

Applying general principles, Nourse LJ stated that in arriving at the initial decision in *Woolworth*, the Special Commissioners

61 Ibid., at 295.

62 Specifically, Nourse LJ surmised that the taxpayer had probably inappropriately conceded that the deductibility of the interest was governed by the status of the advances themselves. However, Nourse LJ found that a concession was not the equivalent of a binding decision, and therefore *European Investment Trust* was not binding in so far as it related to interest. Howard Kellough and Joel Nitikman have argued that any Canadian case law relying on *European Investment Trust* (Nitikman cites *Montreal Coke*, infra note 69, discussed in the text that follows) should be read as lacking binding authority on the basis that *European Investment Trust* was overturned by the decision of the Court of Appeal in *Woolworth*. See Howard J. Kellough, "Emerging Income Tax Issues: Section 231.2 Requirement Letters, Uses and Abuses of Trusts, and Interest Deductibility," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 2:1-33, at 2:32-33; and Joel Nitikman, "Is Interest a Current Expense?" Current Cases feature (2000) vol. 48, no. 1 *Canadian Tax Journal* 133-42, at 136. See also the discussion in Richard Bramwell, "Interpreting Consolidation Acts: The Influence of History" [1992], no. 2 *British Tax Review* 69-74, at 71-72. However, the Court of Appeal decision in *Woolworth* (even if it were upheld by the House of Lords) would not be binding on Canadian courts. Also, the House of Lords in *Woolworth*, as discussed below, considered *European Investment Trust* a valid precedent with respect to the broader issue of whether a borrowing is on income or capital account. Nourse LJ himself said, "I think we are free to disregard that case so far as it related to interest, although its authority would no doubt be unimpeachable in regard to the advances themselves" (*Woolworth*, supra note 57, at 718 (CA)). Accordingly, even if *European Investment Trust* was not a binding precedent for British courts addressing the treatment of interest, it should continue to be relevant to the extent that this line of cases is used by Canadian courts to decide between income and capital treatment.

63 *Woolworth*, supra note 57, at 719 (CA).

> weighed one relevant consideration against another and found that the taxpayers' purpose in raising the loans outweighed the terms of the loans pure and simple. In concluding that the arrangements for providing cash for the general purposes of the taxpayers' trade over the five-year periods were within the ordinary activities of running the business, the commissioners were not only echoing the words of Lord Reid, but also the test stated by Lawrence J in *Ascot Gas Water Heaters* . . . , "an ordinary incident of carrying on the business of the Company."[64]

The primary judgment of the House of Lords, written by Lord Templeman, overturned the Court of Appeal and concluded—also on general principles rather than on the basis of section 130(f) of the ICTA—that because the capital of the taxpayer was enlarged, the loans were on capital account and therefore the foreign-currency losses were not deductible.

Lord Templeman reviewed the distinction between income and capital expenditures as follows:

> The most common form of provision is by means of a current account which may be in credit when earnings are received and in debit when expenses are paid out. The bank charges for providing the facilities afforded by the current account and for the sums involved in accepting cheques drawn on the account when it is overdrawn. The temporary and fluctuating borrowings incurred in transacting business are revenue transactions. On the other hand, a trading company which borrows unconditionally a fixed amount for a definitive period may use the money generally for the purposes of its business or for any other purpose authorised by its constitution, and even when the money is employed in the business, the money may be laid out on income expenditure or capital expenditure.[65]

Applying these principles to the facts in issue, Lord Templeman stated:

> The taxpayer company could do as it pleased with [the] 100m borrowed Swiss francs, provided that the application of the money was intra vires the objects of the taxpayer company. The commissioners found as a fact that the taxpayer company intended to use the 100m Swiss francs to overcome a difficulty which was hoped to be of short duration and which was caused by the fact that stocks were high and trade depressed. But there was nothing to stop the taxpayer company spending the whole or part of the money on capital items, and indeed part was spent on capital items. For my part, I do not attach any importance in the present circumstances to the intentions of the taxpayer company or to the actual use made of the money in the present circumstances. The 100m Swiss francs, worth some £10m, were available to the taxpayer company as additional capital. . . .
>
> The authorities do not support the proposition that a borrowing of a definite sum for a fixed term of five years can be an income transaction. . . .

64 Ibid., at 721.

65 *Woolworth*, supra note 57, at 514 (HL).

> [T]he borrowing itself did not form part of the day to day activities of the taxpayer in earning profits. . . .
>
> [T]he taxpayer company's trade was furthered over a five-year period by an increase of capital during that period and not by fluctuating and temporary accommodation.[66]

As an aside, I note that in the Supreme Court of Canada's decision in *Gifford*, Major J refers to *Wharf Properties* in his discussion of the British line of cases dealing with the characterization of indebtedness as being on income or capital account. However, as is evident from the quotation that Major J took from *Wharf Properties*,[67] *Wharf Properties* is not itself part of that line of cases. As stated in the quotation, *Wharf Properties* did not deal with the characterization of indebtedness as being on income or capital account. Rather, in *Wharf Properties*, the issue was whether interest payments were deductible under section 16(1) of the Inland Revenue Ordinance (Hong Kong) ("the Ordinance") (notwithstanding section 17(1)(c)). Section 16(1) allows a deduction in respect of (generally) "interest upon any money borrowed by [the taxpayer] for the purpose of producing such profits." Section 17(1)(c) prohibits a deduction of "any expenditure of a capital nature." The House of Lords found that section 17(1)(c) required an examination of the use of the borrowed funds:

> [W]hile the question of whether money is intended to be used for a capital or revenue purpose is inconclusive as to whether its receipt is a revenue receipt or an addition to the company's capital, the purpose of the loan during the period for which the interest payment was made is critical to whether it counts as a capital or revenue expense.[68]

Major J uses *Wharf Properties* to illustrate the difference between his approach (a review of the terms of the borrowing itself) and the approach advocated by others (a review of the use of the proceeds of the borrowing), which is consistent with the fact that *Woolworth* and *Wharf Properties* address two entirely separate British tax concepts.

CANADIAN JURISPRUDENCE

The foregoing review of the line of British case law referenced by the Supreme Court in *Gifford* demonstrates clearly that for purposes of the relevant UK statutory provisions and/or under general principles, whether a loan is on income or capital account is generally determined by reference to the terms of the loan and the capital structure of the debtor, rather than the use to which the borrowed funds were put. But does this approach reflect Canadian case law prior to *Gifford*? Arguably, early Canadian case law on interest deductibility, and generally Canadian case law on debt forgiveness, are consistent with the British approach. The more recent high-level Canadian court decisions on interest deductibility have, perhaps, simply summarized incorrectly the preceding case law on the issue.

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66 Ibid., at 514-15 and 518-19.

67 Supra note 21 and the accompanying extract.

68 *Wharf Properties*, supra note 15, at 356.

Montreal Light, Heat & Power Consolidated[69] was one of the earliest cases in which a high-level Canadian court considered whether debt is on capital or income account. The taxpayer had issued new Canadian dollar bonds for a 15-year term and used the proceeds (as well as the proceeds from the sale of some investments) to repay outstanding US dollar bonds carrying a higher interest rate. The taxpayer sought to deduct a premium and expenses in connection with the retirement of the old bonds and the discount on the issuance of the new bonds. At the Supreme Court of Canada, Duff CJ found that the expenses were not incurred for the purpose of earning income as required by paragraph 6(a) under the Income War Tax Act (Canada), but also found that the expenses were on capital account and therefore could not be deducted as a result of paragraph 6(b).[70] Referring to British case law, Duff CJ stated:

> [T]hese disbursements were made for a purpose which falls within the principle enunciated by Lord Cave in *The British Insulated and Helsby Cables Ltd. v. Atherton* . . . ; that is to say, the expenditures were made with a view to securing an enduring benefit, the reduction of the cost of borrowed capital over a period of at least fifteen years. . . .
>
> I have no doubt that the sums borrowed by means of the original issue of debentures were capital, as distinguished from income, or that the sums borrowed by the second issue of debentures for the purpose of retiring the earlier issue were also capital. The sums which the appellant company seeks to deduct are sums paid in respect of capital, and on the principle of the decisions in the *Arizona Copper Company's* case . . . and the *Texas Land and Mortgage Company's* case they are not expenses incurred in the process of earning income in respect of which the appellant company is assessable.[71]

Kerwin J also referred to the classic UK case of *British Insulated and Helsby Cables v. Atherton*,[72] stating that deduction of the expenditures was prohibited by paragraph 6(b) on the basis that the expenditures were made with a view to bringing into existence an advantage for the taxpayer's enduring benefit as set out in that case.[73]

The decision was upheld by the Privy Council, which agreed in obiter with the holding of the Supreme Court on the capital issue, without substantial reasoning.[74]

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69 Sub nom. *Montreal L, H & P Con. and Montreal Coke & Mfg. Co. v. Minister of Nat'l. Rev.*, [1942] CTC 1 (SCC). The Supreme Court applied the same reasoning to the appeal in *Montreal Coke & Mfg. Co.*, which was decided at the same time.

70 Income War Tax Act, RSC 1927, c. 97. At the relevant time, section 6 disallowed a deduction in respect of "(a) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" and "(b) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act."

71 *Montreal L, H & P*, supra note 69, at 6 and 8.

72 [1926] AC 205 (HL).

73 *Montreal L, H & P*, supra note 69, at 11.

74 [1944] CTC 94 (PC).

Montreal Light, Heat & Power acknowledged the *Scottish North American Trust* line of cases[75] but did not rely on it, possibly because the debts in question seemed self-evidently to be on capital account, but also possibly because the use of the proceeds of the borrowing—namely, the retirement of the older, more expensive debt—would be considered to be on capital account.

In *Bennett & White Const. Ltd. v. MNR*,[76] the Supreme Court of Canada considered the deductibility of a guarantee fee with respect to bank loans and overdrafts. The company's borrowings were substantial and fluctuated daily by amounts as high as $200,000. Three individuals provided guarantees for all sums advanced to the company up to a total of $370,000 with interest at 6 percent. The company used the borrowed money to meet payrolls and to purchase materials and equipment for the business. The evidence showed that if the company had not borrowed from the bank, it could have accomplished only 25 percent of the work done in each of the years in question.[77] There was little outstanding equity in the taxpayer. The interest deductions were allowed by the minister of national revenue under paragraph 5(1)(b) of the Income War Tax Act (Canada), which at that time provided for a deduction for "[s]uch reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow." The court found that the fees were not deductible on the basis that they were prohibited by paragraph 6(1)(b) (the equivalent of paragraph 18(1)(b) of the current Act). Rand J stated:

> In the absence of statute, it seems to be settled that to bring interest paid on temporary financing within deductible expenses requires that the financing be an integral part of the business carried on. That is clearly exemplified where the transactions are those of daily buying and selling of securities: *Farmer v. Scottish Trust* . . . or conversely lending money as part of a brewery business: *Reid's Brewery v. Mail*. . . .

75 Counsel for the taxpayer argued that whether the expenses were deductible was a question of fact and that *Texas Land and Mortgage* (on which the Crown's case was apparently based) relied on *Anglo-Continental Guano Works*, which was subject to negative commentary in *Scottish North American Trust*. In finding that the taxpayer's expenses were not deductible, Duff CJ held, supra note 69, at 7-8, "From all this it will be seen that the comments upon the *Anglo-Continental Guano Works Company's* case in the House of Lords in *Farmer's* case [*Scottish North American Trust*] were directed to a point which has no bearing whatever on the decision in the *Texas Land Company's* case and has no relevancy to any question which arises in this case. In *The European Investment Trust Company's* case there was no dispute that the sum of £10,000 borrowed by the taxpayer as a fixed loan with fixed interest running for a considerable period was borrowed capital. The point with which the House of Lords in *Farmer's* case and the Court of Appeal and Mr. Justice Finlay in *The European Investment Trust Company's* case were concerned was whether, the business of the taxpayer being that of dealing in investments, temporary loans of fluctuating amount borrowed for the purpose of financing individual transactions from time to time, out of which the taxpayer made its profit, could be classed as capital used in the taxpayer's business, or as so connected with the process of earning profits that the interest paid could be treated as an expenditure in the process of earning profits."

76 [1949] CTC 1 (SCC).

77 *Bennett & White Const. Co. v. MNR*, [1947] CTC 252, at 253-54 (Ex. Ct.).

Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (b). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue. The lender might insist on being furnished with premises near the scene of the works; it might exact any other accommodation as the price of its willingness to provide funds; but all that would be outside the circumference of the transactions from which the income arises. Within the meaning of the Act, the premiums create part of the capital structure and are a capital payment: *Watney v. Mustgrove*. . . . They furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business.[78]

Estey J stated:

This was not a borrowing of money on a temporary or short-term basis such as is necessary and incidental to the ordinary and usual transactions in the course of the appellant's business. In effect this line of credit made available to the appellant for an indefinite period the ability to borrow funds for the purpose of accepting contracts beyond the volume its paid-up capital and surplus would permit. The provision for the cancellation of the guarantee, having regard to the relation of the guarantors to the company, and the practice since 1934, does not detract from the conclusion that this line of credit provided a long-term basis upon which the company might obtain the funds it required.

In *Scottish North American Trust v. Farmer* . . . Lord Johnston stated at p. 698:

> It may be well said that if money is borrowed on a permanent footing, as from year to year, the capital of the concern is in a commercial sense enlarged thereby, and the business extended, whereas no commercial man would consider that his banking facilities were part of his capital, or the consideration he paid for them anything but an expense of his business.

. . . The appellant's position is similar to that of the taxpayer in *The European Investment Trust Co. Ltd. v. Jackson* . . . where it was engaged in the business of financing the purchase of automobiles. Its paid-up capital was relatively small and when that and the proceeds of a loan, admittedly capital, from the Finance Corporation of America, were exhausted, in order to finance further purchases it was arranged that the Finance Corporation of America would make further advances. It was contended that the interest on these further advances should be deducted in computing the profits. These advances were made as required by the taxpayer and were repaid by amounts as received from the purchasers. They were described by the taxpayer as short loans and the interest was computed upon monthly statements. The commissioners found as a fact that the proceeds of these additional advances were "employed or intended to be employed as capital in the trade" and that therefore the interest paid

78 Supra note 76, at 7.

could not be deducted in computing profits. On appeal this decision was affirmed. The taxpayer in that case, as the appellant here, when its capital was exhausted found it necessary to borrow in order that further contracts or a larger volume of business might be accepted.

The *Jackson* case was decided since that of *Scottish North American Trust v. Farmer* . . . so much relied upon by the appellant. The taxpayer in that case was engaged in the buying and selling of securities. In the course of its business it purchased securities in New York in amounts beyond its available cash. Arrangements were made with a New York banker for an overdraft (for a period a line of credit was arranged). The interest paid on this overdraft was held to be a deductible expense. In the Court of Sessions their lordships stressed that these were short-term loans, or as stated by the Lord President:

> I cannot see how a temporary accommodation in the course of business ever is or ever can be capital.

Then in the House of Lords Lord Atkinson pointed out that the money was borrowed in a "fluctuating temporary manner" and the daily borrowing and lending of money being part of their business is not to be treated as capital. Moreover, in discussing this case in the *Jackson* case, Romer, L.J., pointed out that in the *Farmer* case the money was found by the commissioners not to be capital and after reviewing that decision and others in relation thereto, concluded that in each case:

> . . . It is a question of fact whether the capital money borrowed is or is not capital employed in the trade within the meaning of this sub-paragraph, and if the Commissioners have decided, as a question of fact, that it is, then this Court cannot interfere.

. . . The disbursements of the guarantors here in question were made not as interest on the money borrowed but as the purchase price for the guarantee that made borrowing under the line of credit possible. The appellant upon obtaining this line of credit was enabled to complete its financial arrangements at the bank, which enabled it to undertake the larger volume of business. Sums borrowed under such circumstances are capital and the sums paid are not deductible under the provisions of 6(1)(a).[79]

Accordingly, both Rand J and Estey J take the *Scottish North American Trust* approach to the characterization of the fees as being on capital or on income account: they both emphasize the nature of the borrowing, rather than use of the proceeds.

The Supreme Court of Canada considered the deductibility of interest in *Canada Safeway Ltd. v. MNR*.[80] The taxpayer, which operated grocery stores, had issued debentures and used the proceeds in financing the acquisition of a corporation that supplied the taxpayer with groceries and other products for sale to the public. The acquisition price was also financed in part by the redemption of preferred shares of the taxpayer held by the vendor. Kerwin CJ and Taschereau, Rand, and Cartwright JJ found that the interest paid on the debentures was not deductible because it was

79 Ibid., at 9-12.

80 [1957] CTC 335 (SCC).

incurred to earn non-taxable income (that is, dividends on the shares). While Locke J agreed that part of the purpose of the acquisition of the shares was to earn tax-free dividends, he found that the interest was incurred in part to earn taxable income, on the basis that the acquisition of the subsidiary allowed the taxpayer to save on costs and acquire products that otherwise would not have been available. However, Locke J then found that the interest was not deductible owing to the prohibition in paragraph 6(1)(b). He stated:

> As to Section 6(1)(b) there is no doubt that the interest paid on the debentures was a payment on account of capital within the meaning of that subsection since I think the words "on account" must be construed as including an outlay such as interest paid on an obligation incurred to purchase a capital asset such as shares. This was the interpretation assigned to the expression in *Montreal Light, Heat and Power Company v. MNR* by Sir Lyman Duff with which I respectfully agree.[81]

Therefore, Locke J looked to the use of the borrowed funds to determine whether the borrowing was on income or capital account. (He ultimately found that part of the interest should be deductible under the predecessor of paragraph 20(1)(c) of the current Act.)

Kerwin CJ did mention that there were good arguments to support a finding that the deductions were prohibited because they were on capital account.[82] Rand J also stated the following in respect of interest being on capital account:

> It is important to remember that in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense. If a company has not the money capital to commence business, why should it be allowed to deduct the interest on borrowed money? The company setting up with its own contributed capital would, on such a principle, be entitled to interest on its capital before taxable income was reached, but the income statutes give no countenance to such a deduction.[83]

However, neither Kerwin CJ nor Rand J decided the case on this point or provided much guidance as to the scope of the provision in the context of interest deductions.

In *Tip Top Tailors Ltd. v. MNR*,[84] the taxpayer, a clothing manufacturer and retailer, paid for purchases of cloth in pounds sterling. Anticipating a devaluation of the pound, the taxpayer deliberately accumulated an overdraft with its bankers in respect of the purchases. At issue was the nature of the resulting foreign exchange gain. At the Supreme Court, Rand and Locke JJ stated that if the debt was on capital account,

81 Ibid., at 351.

82 Ibid., at 340.

83 Ibid., at 344-45.

84 [1957] CTC 309 (SCC).

the foreign exchange gain would also be on capital account. However, both justices found, with little substantive analysis, that the gain was on income account, on the basis that the debt was incurred solely in the course of trade. Rand J found that each dollar of accumulated debt was used to discharge the purchase price of the goods, and that the sterling had no other use. The argument that the overdraft represented a type of investment was rejected by the court. As noted by Cartwright J, in dissent, the decision seemed to overturn previous jurisprudence supporting the view that borrowings from a financial intermediary, even if used to finance purchases of inventory, should be on capital account.

In *Aluminum Union Ltd. v. MNR*,[85] the Exchequer Court considered whether foreign exchange losses on the repayment of debt were deductible to the taxpayer. The debt was incurred in respect of an overdraft account of the taxpayer with a Japanese branch of an American bank. The account balance was used to finance the taxpayer's current expenses; it fluctuated and was recorded as a current liability for accounting purposes. However, the balance was not ultimately repaid until approximately 10 years later (as a result of the Second World War). The court found that the foreign exchange losses were deductible notwithstanding that the debt had been outstanding for such a long period. The precise basis for the court's conclusion is unclear. The court found the use of the funds relevant, but also noted the accounting treatment (as a current liability). The court also seemed to conclude that trading in foreign currency was a secondary activity of the taxpayer. Finally, the unique circumstances of the case suggest that the decision may have been somewhat result-driven.

The deductibility of foreign exchange losses on the repayment of debt was also considered by the Federal Court Trial Division in *Columbia Records of Canada Ltd. v. MNR*.[86] The taxpayer had borrowed US dollars from its parent company through a series of loans between 1955 and 1961; apparently, the loans were due between 1970 and 1972 but were documented by demand notes. The court found that the foreign exchange losses were on capital account:

> Firstly, the borrowings of funds from the parent company by the appellant were for the purpose of obtaining working capital, because the appellant's issued capital of $50,000 was inadequate for such purpose. The repayment of those borrowings by the appellant was [done] at a convenient time as and when by reason of retained earnings the appellant had monies surplus to working capital requirements and therefore was able to do so.
>
> As a consequence, these financial transactions between the parent company and the appellant were quite distinct from the activities by which the appellant earned its income and therefore were not transactions in the ordinary course of the trading operations of the appellant.

85 [1960] CTC 206 (Ex. Ct.).

86 [1971] CTC 839 (FCTD).

> Secondly, these financial transactions were entered into and the expenditures made (occasioned by foreign exchange losses in connection with these financial transactions), with a view of bringing into existence an advantage for the enduring benefit of the appellant's business. Such advantage was a substantial factor that enabled the appellant to get into its trading business and to maintain its trading activities over the said period and in such a way that the appellant was able successively in each fiscal year to earn substantial earnings.[87]

Again, the court in *Columbia Records* seems to apply both methods to determine whether the debt was on capital account: the characteristics of the debt itself and the use of proceeds of the debt. Thin capitalization was specifically noted by the court.

In the same year, the Federal Court Trial Division decided *Can. Perm. Mort. Corp. v. MNR*[88] (*Canada Permanent Mortgage Corp.*), which is generally regarded as the leading case on the characterization of liabilities of financial institutions. The taxpayer was in the business of borrowing money from depositors and purchasers of debentures and lending it under mortgages. The court was required to consider whether profits from sales of securities were on income or capital account, and whether certain commissions or finders' fees paid to third parties were deductible. The commissions were paid to persons who found prospective purchasers of the taxpayer's debentures.

Heald J noted that the minister had allowed the taxpayer to deduct commissions paid for finding prospective mortgagors, and then stated:

> I think it strange that the respondent allowed commissions on loans as an expense but disallowed commissions on the sale of debentures.
>
> It is clear from the evidence that the appellant's business is borrowing money from the public and then lending it out on the security of real estate mortgages. In this business, the appellant's stock in trade is borrowed money. Surely any expense involved in acquiring the company's stock in trade is properly deductible. The company, in the years under review, concluded that it was necessary to pay such finders' fees in order to ensure an adequate flow of borrowed funds. One side of the appellant's business is to obtain borrowed funds. The other side is to lend out these borrowed funds on the security of mortgages.
>
> The debenture commissions are necessary expenses on the one side. The loan commissions are necessary expenses on the other side—that is—necessary, in the judgment of the company to ensure that all of the borrowed funds which the company has acquired can be lent out on mortgage security. And yet, the respondent disallows the debenture commissions on the one side while at the same time, allowing the loan commissions on the other side. . . .
>
> I am . . . of the opinion that the said finders' fees are not capital outlays within the meaning of Section 12(1)(b) of the Act.[89]

87 Ibid., at 845-46.

88 [1971] CTC 694 (FCTD).

89 Ibid., at 697-98.

Heald J did not reference any particular case law, nor did he describe the terms of the borrowings or the capital structure of the taxpayer.

In *The Queen v. P.B. Bronfman Trust*,[90] the Supreme Court of Canada simply assumed that the outlay of interest in question was on capital account. The trust had tried to deduct interest on funds borrowed from a bank to make distributions to its beneficiary. The Supreme Court actually characterized the borrowings as "temporary":

> [T]he trustees considered it advantageous to retain the trust investments temporarily and finance the allocations by borrowing funds from a bank.[91]

However, the court did not examine the terms of the loan or even question whether the borrowings were truly on capital account; it merely made a passing reference to the use of proceeds as determining the nature of the borrowing:

> It is perhaps otiose to note at the outset that in the absence of a provision such as paragraph 20(1)(c) specifically authorizing the deduction from income of interest payments in certain circumstances, no such deductions could generally be taken by the taxpayer. Interest expenses on loans to augment fixed assets or working capital would fall within the prohibition against the deduction of a "payment on account of capital" under paragraph 18(1)(b): *Canada Safeway Ltd. v. MNR*, [1957] S.C.R. 717; [1957] C.T.C. 335, at 722-23 (C.T.C. 339-40) *per* Kerwin, C.J. and at 727 (C.T.C. 344) *per* Rand, J.[92]

A similar absence of examination of the point is evident in *Shell Canada Ltd. v. The Queen*.[93] Writing for the majority and relying on *Canada Safeway* and *Bronfman Trust*, McLachlin J (as she then was) stated:

> [Subparagraph 20(1)(c)(i)] is an exception to s. 9 and s. 18(1)(b), which would otherwise prohibit the deduction of amounts expended on account of capital, i.e., interest on borrowed funds used to produce income.[94]

In both *Bronfman Trust* and *Shell Canada*, it is likely that the taxpayers did not make a section 9 argument, and therefore the possibility that interest could be an expense on income account was not noted for the court. Nevertheless, both cases, apparently merely summarizing previous case law, suggest that interest is an expense that is always on capital account.

90 [1987] CTC 117 (SCC).

91 Ibid., at 118-19. The decisions in this case give virtually no information regarding the terms of the loans.

92 Ibid., at 124.

93 Supra note 18.

94 Ibid., at paragraph 28.

The foregoing review of the Canadian jurisprudence relating to the deductibility of interest and other financing expenses reveals a distinct lack of analysis of the topic. *Bennett & White*, which provides more analysis than most of the Canadian case law, relies on the *Scottish North American Trust* line of cases; subsequent cases, such as *Bronfman Trust*, implicitly acknowledge that interest could be on income account but provide very little analysis as to when this would be the case. Indeed, courts in cases such as *Bronfman Trust* and *Shell* seem to assume that interest is typically on capital account and look primarily to the use of the proceeds of the borrowing to make that determination. The exception, *Canada Permanent Mortgage Corp.*, does explicitly state that indebtedness can be on income account, but it refers to no case law and provides very little principled analysis. The Supreme Court in *Shell Canada* seems to be quite clear that interest is not deductible except as permitted by paragraph 20(1)(c), yet its analysis on this point is limited to citing *Canada Safeway* and *Bronfman Trust*.

However, the Canadian tax courts have not entirely ignored the concept that debt may be on income or capital account, regardless of the use of the proceeds thereof. One area in which this is evident is the treatment of debt forgiveness.[95] The Act provides a detailed regime dealing with the realization of debt forgiveness in sections 80 to 80.04, but whether debt forgiveness is included in income or is subject to the regime in sections 80 to 80.04 is a matter of general principle.[96]

Early cases addressing the characterization of forgiven debt as being on income or capital account were not very clear in respect of the distinction. In *G.T. Davie & Sons Ltd. v. MNR*,[97] the taxpayer was a ship manufacturer that had borrowed funds from a bank to enable it to complete its shipbuilding contracts. The bank forgave part of the debt. The court determined that the debt forgiveness was on capital account—a point already conceded by the Crown—and merely stated:

> It is quite clear that the advances by C.C.C. to the appellant were on capital account. They are described as "capital" in the mortgage . . . and as working capital in Vote No. 638.[98]

95 For a more detailed review of these cases, see Stephen S. Ruby, "Section 80 and Unincorporated Entities," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 19:1-37.

96 Paragraph (j) of the definition of "forgiven amount" in subsection 80(1) carves out from the amount of the obligation the principal amount of an "excluded obligation." An "excluded obligation" is defined in subsection 80(1) to include "an obligation issued by a debtor where . . . (d) the principal amount of the obligation would, if this Act were read without reference to sections 79 and 80 and the obligation were settled without any amount being paid in satisfaction of its principal amount, be included in computing the debtor's income because of the settlement of the obligation."

97 [1954] CTC 124 (Ex. Ct.).

98 Ibid., at 132.

However, the court did dwell on the fact that the lender was not the purchaser of the ships, implying that the result might have been different had the debt been more closely tied to the taxpayer's trading operations.

In *Oxford Motors Ltd. v. MNR*,[99] the court was required to determine whether manufacturer's rebates on cars sold to the taxpayer by the manufacturer were capital gains or income. Without examining the nature of the indebtedness, the court found that the rebates were on income account; indeed, the court stated that the fact that the rebates were in the form of debt forgiveness did not alter their character as trading profits.[100]

More recent cases have analyzed this point somewhat more carefully. In *Molstad Development Co. v. The Queen*,[101] the taxpayer owed a mortgage in respect of land that was held as inventory. The lender was a bank, not the vendor of the property. The debt was partially forgiven; at issue was whether the forgiven amount was to be included in income or subject to the debt forgiveness rules in subsection 80(1) of the Act. Notwithstanding that the financing was used to acquire inventory, Rip J found that the debt was on capital account. He stated:

> When a person subscribes for share capital in a corporation the transaction is a capital transaction regardless of the use [to which] the corporation applies the money. The corporation may use the funds to purchase a plant or use the funds to purchase its inventory; in both cases the money obtained from shareholders is capital. Similarly when a corporation borrows money from its banker to finance [an] acquisition of assets, including inventory, for example, the transaction between the lender and borrower is a capital transaction. The debt is on capital account.
>
> I fail to see how the use to which the borrowed funds is put by the debtor affects the character of the borrowed money.[102]

The court did not discuss the terms of the mortgage.

The same issue arose in *Queenswood Land Associates Ltd. v. The Queen*.[103] The taxpayer was in the land development business and owed a participating debt to a bank. One of the terms of the debt was that the use of the borrowed funds had to be approved by the lender. Noël J noted that the taxpayer was "heavily financed."[104] The bank forgave the debt, and the forgiveness was included in income for accounting purposes. At issue was whether the debt forgiveness gave rise to an income inclusion under section 9 of the Act. The Federal Court of Appeal found that no

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99 [1959] CTC 195 (SCC).

100 Other decisions in this line of cases include *E. Galipeau v. MNR*, [1962] CTC 289 (Ex. Ct.), and *Golden Horseshoe Turkey Farms v. MNR*, [1968] CTC 294 (Ex. Ct.). These decisions emphasize the distinction between unpaid purchase price and borrowed funds, elaborated upon below.

101 [1997] 2 CTC 2360 (TCC).

102 Ibid., at paragraphs 50 to 51.

103 [2000] 1 CTC 352 (FCA).

104 Ibid., at paragraph 5.

such inclusion was required because the debt was on capital account. The court approved the reasoning in *Molstad*. It also distinguished *Tip Top Tailors* as a decision that turned on its facts (implying that the case was about currency speculation). The court accepted *Oxford Motors* on the basis that, in that case, the rebates were intricately linked to the taxpayer's trading operations, and stated:

> Nothing of the sort took place here. The Tax Court Judge found as a fact that the loans were used to provide the appellant with the working capital necessary to conduct its land development operations."[105]

This line of cases suggests that the unpaid purchase price for inventory will be considered to be on income account and that longer-term loans from parties other than a vendor of inventory will be considered to be on capital account, notwithstanding that the proceeds of such loans may be used to fund inventory. Also to be noted is *Alco Dispensing Canada Ltd. v. The Queen*,[106] which treated debts for unpaid management bonuses as being on income account. Unfortunately, this line of cases does not provide more substantial guidance on distinguishing between loans on income account and loans on capital account.

APPLICATION OF THE GIFFORD TEST

Given that the only Supreme Court of Canada decision that deals squarely with the characterization of indebtedness as being on income or capital account (namely, *Bennett & White*) follows UK case law on this point, and given the conspicuous lack of analysis by Canadian courts subsequent to *Bennett & White*, it is probably not surprising—if only in hindsight—that the Supreme Court of Canada appears to have overturned accepted wisdom and returned to UK case law. The potential for such a reversal was anticipated by a number of commentators, most notably Brian Arnold.[107] However, as stated above, most commentators were surprised by the Supreme Court's approach in *Gifford*.

The general approach in *Gifford*—to examine the nature of the indebtedness rather than its use—had seemed to many people to be not only unsubstantiated by any relevant authority, but illogical and possibly even nonsensical. However, a closer look at the judgment demonstrates that sometimes the Supreme Court of Canada understands Canadian tax cases better than Canadian tax lawyers (although it is probably also fair to say that the Supreme Court does not always communicate that understanding in a useful or clear fashion, *Gifford* itself being a case in point). While it is not evident that the court's decision was based on a consideration of the

105 Ibid., at paragraph 35.

106 [1996] 1 CTC 2662 (TCC).

107 See Arnold, supra note 13. See also Brian J. Arnold and Tim Edgar, "Deductibility of Interest Expense" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1216-44; Kellough, supra note 62; Nitikman, supra note 62; and Joseph Frankovic, "Why Interest Should Be Considered a Current Expense" (2001) vol. 49, no. 4 *Canadian Tax Journal* 859-78.

relevant tax policy issues, the case was clearly decided on the basis of relevant authority, and Major J's judgment provides more rigorous analysis than most previous Supreme Court of Canada jurisprudence in this area.[108] *Gifford* cannot be ignored or dismissed.

However, applying the *Gifford* approach will be a challenge. There is very little case law, and virtually no Canadian case law, on point.

Major J states that debt that adds to the financial capital of a taxpayer is on capital account, whereas debt that is inventory is considered to be on income account. While this statement clearly has its roots in the case law reviewed in this article, Major J's choice of the term "inventory" is somewhat confusing. "Inventory" is defined in subsection 248(1) of the Act to mean (in part) "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year."[109] A liability is not property.[110] However, Major J is characterizing the proceeds of the borrowing (before they have been used for some purpose), rather than the liability itself.[111]

Major J then refers to the line of British cases reviewed above to determine when the proceeds of a borrowing will be considered to be inventory and when they will be considered to add to the taxpayer's financial capital. More specifically,

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108 It is ironic that Major J's approach to the characterization of interest as being on income or capital account seems to contradict Nourse LJ's analysis in *Woolworth*. Nourse LJ affirmed the taxpayer's position that foreign exchange losses (or interest for that matter) should not be disallowed under section 130(f) of the ICTA. He reviewed the language of section 130(f) ("in computing the amount of the profits or gains to be changed . . . no sum shall be deducted in respect of . . . (f) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade") and its origins in the schedule D rules in the Income Tax Act 1842 ("no sum shall be set against or deducted from . . . such profits or gains . . . nor on account of any capital withdrawn therefrom . . . nor for any sum employed or intended to be employed as capital in such trade") and concluded that this provision only applied to disallow deductions for the repayment of loans themselves. The House of Lords did not discuss this point, instead deciding the case on general principles. However, given that Canadian courts must rely on the interpretation of statutory provisions such as the preamble to subsection 20(1) and paragraph 18(1)(b), it is probably appropriate to look to the principles in the *Woolworth* line of cases for guidance, notwithstanding the entirely different approach (at least in the Court of Appeal) to statutory provisions that are so similar to the corresponding provisions of the Act.

109 The definition is proposed to be amended to exclude property to which proposed subsection 94.1(4) or 94.2(3) applies. See Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005), clause 44(4).

110 See, for example, CRA document no. 2004-0098141I7, January 14, 2005; CRA document no. 9815215, August 10, 1998; and CRA document no. 9316065, June 17, 1993.

111 Loans made by a moneylender may or may not be on capital account. However, as stated above, it is difficult to see how a liability could be inventory. Joseph Frankovic, supra note 4, at 4, comments that "the idea that money constitutes inventory of a moneylender because it is in the business of lending money is nonsensical. Lent money is no more inventory to a moneylender than a leased computer is inventory to a computer leasing company." The emphasis here seems to be on the distinction between an asset that is used to generate income and an asset that generates business income only in the form of proceeds of disposition.

Major J refers to *Wharf Properties*, which, as discussed above, actually addresses a different issue, and which in turn refers to the *Woolworth* line of cases.

So, what does the *Woolworth* line of cases, and the relatively sparse Canadian jurisprudence, tell us?

Leaving aside financial institutions, which will be discussed below, *Woolworth* itself is the leading case. *Woolworth* suggests that there are two key factors to consider. The first factor seems to be the term of the borrowing. As set out above, Lord Templeman in the House of Lords contrasts "a current account which may be in credit when earnings are received and in debit when expenses are paid out" and "temporary and fluctuating borrowings incurred in transacting business" with an unconditional borrowing of a fixed amount for a definite period. However, a debt that was initially on income account should not become a debt on capital account merely because the debt ultimately remained outstanding for a significant length of time.[112] A borrowing with no fixed terms of repayment may be a "borderline case," at least in the view of Hoffmann J in the Chancery Division. The intention of a borrower to repay a loan within a short time is not relevant, as stated quite clearly in *Woolworth*.

The *Woolworth* line of cases does not offer much guidance with respect to the length of term of a borrowing that will lead to the loan being considered to be on income rather than on capital account. *Woolworth* itself tells us that a five-year borrowing is clearly on capital account. In *Anglo American Oil Co.*, one-year notes were considered to be on capital account.[113] One might look to other lines of cases to seek some guidance on this point; however, given the variability of the case law on these kinds of issues, lines of cases that are unrelated to the character of a borrowing may not be of much use.[114]

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112 *DWS Corp. v. MNR*, [1968] CTC 65 (Ex. Ct.).

113 Supra note 39. *H. Silverman v. MNR*, [1960] CTC 262 (Ex. Ct.), may also be of some interest. In this case, the taxpayer flipped real estate, funding the purchases with five-year mortgages. The taxpayer was required to pay a "bonus" to the mortgage lender in respect of two transactions; at issue was the deductibility of the bonuses. With respect to one bonus, the court emphasized that although the mortgage had a five-year term, given that the taxpayer clearly expected to sell the property in short order, the loan should be considered to be "temporary"; the court used this fact in support of its conclusion that the bonus should be deductible. However, the court seemed to place more emphasis on the fact that the proceeds of the borrowing were clearly used to purchase the real estate, in contrast to the other transaction in which the use of the proceeds of the borrowing was not clear. Given that this latter point was the means by which the court concluded that the bonus on the first transaction was deductible but the bonus on the second transaction was not, the court's comments with respect to the temporary nature of the loan are likely of little assistance.

114 For example, notwithstanding that a five-year term was of crucial importance in *Woolworth*, in *BP Australia v. Comr. of Taxation etc.*, [1965] 3 All ER 209 (PC), a five-year term of supply contracts that were subsequently cancelled was a neutral feature in determining whether lump-sum cancellation payments made by the taxpayer were on income or capital account. (Indeed, the Privy Council ultimately found that the payments were deductible.)

The second factor is whether there are any constraints on the use of the proceeds of the borrowing. As set out above, Lord Templeman emphasized that the taxpayer could have spent the proceeds of the borrowings on anything. That the taxpayer actually chose to spend the proceeds on items that themselves might be seen to be on income account was not relevant; the relevant point was the ability of the taxpayer to choose. Therefore, debt that could be used only for specific purposes would typically be on income account. The clearest example of this would be the unpaid purchase price for inventory; this seems clear from the *Oxford Motors/ Molstad/Queenswood* line of cases.

It is unclear how far this principle extends. For example, presumably the unpaid purchase price of inventory would always be on income account even if the purchase price need not be paid for several years; the same would be true of unpaid remuneration of employees. However, would the unpaid purchase price of a capital item (such as a building or a significant piece of equipment) still be on income account? The fact that the debt relates to an item on capital account should be largely irrelevant, if we take Major J at his word. The relevant point would presumably be that the taxpayer's use of the funds was clearly restricted to the purchase of the item in question. Could such debt be said to add to the financial capital of the debtor? What of a long-term borrowing where the lender required the borrower to use the proceeds for a specific purpose (for example, where the lender could call the loan if the proceeds were not so used)? Again, would this truly be an addition to the borrower's financial capital? Such debt may not have anything to do with the taxpayer's day-to-day business.

The courts also frequently refer to the "fluctuating" nature of a loan as an indication that the loan may be on income account.[115] Theoretically, this suggests that a revolving credit facility—even one with a 10-year term, for example—could be on income account. However, in most cases, this will be an unlikely conclusion given that such a facility could effectively be used as a term facility. There may be some circumstances (perhaps where the facility places restrictions on the term of each draw) where a case might be made for income treatment. Presumably the references by the courts to fluctuating balances mean fluctuations beyond the borrower's control, such as fluctuations in a bank account to which trade receivables are deposited and from which trade payables are paid.[116]

115 Lord Templeman in *Woolworth*, supra note 57, at 514 (HL).

116 In *General Foods, Ltd. v. MNR*, [1967] Tax ABC 527, the board found that foreign exchange losses on the repayment of a borrowing were not deductible notwithstanding that the debt arose as part of an "open account" (effectively, an open credit facility) established by the parent corporation for the taxpayer. The amount owing under the open account fluctuated regularly. However, the indebtedness was closely related to the acquisition of capital assets (although this was not considered by the board to be determinative); the loan was documented with a five-year promissory note; the loan was accounted for separately from the taxpayer's current liabilities; and the loan itself was granted and maintained for the parent's convenience.

The capital structure of the taxpayer may also be relevant. As Vinelott J stated in *Overseas Containers* (referencing *European Investment Trust*),

> [t]here is *prima facie* a distinction between monies borrowed in order to put the borrower in a position to carry on the business of dealing in money . . . and money borrowed in the course of carrying on that business.[117]

Vinelott J was speaking of a financial institution, but the concept should apply equally to taxpayers that are not financial institutions. Rand J and Estey J in *Bennett & White*, as well as Gibson J in *Columbia Records*, also emphasized the distinction between activities that permit a taxpayer to carry on the business and activities that are part of the business. Therefore, where a company was clearly undercapitalized prior to the borrowing, the borrowing would likely be considered to be on capital account.[118] In *Overseas Containers*, Vinelott J also commented that it might be easier to infer that a borrowing from a parent (or, presumably, another related party) is being made for the purpose of enabling the taxpayer to commence or expand its business.

Is the amount of the debt relevant? As shown in *Woolworth*, the fact that the debt might be very small in comparison with the taxpayer's volume of business is of no relevance. However, amounts that are very large in comparison with the taxpayer's volume of business are very likely to be on capital account (see, for example, the comments of Finlay J above in *Scottish North American Trust*).

In the Chancery Division decision in *Woolworth*, Hoffmann J suggests that accounting treatment could be relevant. It is questionable whether accounting can offer much guidance. Hoffmann J himself concedes that accounting treatment may not be terribly helpful given that accounting principles generally require that liabilities with a term of more than one year cannot be classified as current liabilities.[119] Indeed, once a long-term liability has a term of less than one year, it becomes a current liability. This type of logic is very different from the logic employed under the Act, which requires an initial judgment as to the character of a liability, which character does not change as the liability approaches maturity. However, Canadian courts have found accounting treatment to be relevant in some circumstances.[120]

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117 *Overseas Containers*, supra note 52, at 529; see also *Marine Midland*, supra note 47, at 237, and *Ascot Gas*, supra note 43, at 176.

118 In paragraph 3 of *Interpretation Bulletin* IT-95R, "Foreign Exchange Gains and Losses," December 16, 1980, the Canada Revenue Agency states that undercapitalization does not automatically result in capital treatment with respect to foreign-currency gains or losses on the repayment of a liability.

119 On this point, see Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), section 1510.

120 See, for example, *Aluminum Union Ltd.*, supra note 85, in which the court found accounting treatment relevant in determining that foreign exchange losses on the repayment of debt were deductible to the taxpayer.

Several courts suggest that the use of the proceeds of the indebtedness may be relevant in "borderline cases."[121] Generally, however, the use of the proceeds appears to be irrelevant.

In summary, in determining when the debt of a taxpayer that is not a financial institution is on income or capital account, the courts would likely consider the following (the first two items being the most important):

- length of the term
- restrictions (or the lack thereof) on the use of the proceeds of the indebtedness (including whether the proceeds could only be used to finance the purchase of specific items because the indebtedness is unpaid purchase price or unpaid remuneration)
- whether the balance fluctuates
- whether the taxpayer was adequately capitalized before the debt was incurred
- the identity of the lender (that is, a related company or third party) (perhaps)
- the amount of the debt (in some cases only)
- use of proceeds (in "borderline cases" only)
- accounting treatment (perhaps).

Although this approach is new (or at least reverses the accepted wisdom of the past few decades), as a practical matter this approach should not have much effect on most taxpayers other than financial institutions. One would expect that many of these taxpayers already treat medium-term and long-term financing on capital account, and very short-term financing (such as bank account overdrafts and interest on the unpaid purchase price of inventory) on income account. Problematic situations, such as the use of long-term debt to finance purchases of inventory (as in *Woolworth*), probably do not arise frequently.

In addition, query whether any of these conclusions are relevant to the character of foreign exchange gains and losses on the disposition of debt. Historically, the case law on that point has developed separately from the interest deductibility and financing expenses cases. Does *Gifford* bring the two lines of cases together? Given that *Woolworth* was a foreign exchange case, one suspects that *Gifford* may do exactly that. If so, now two lines of cases[122] suggest that financing expenses should not necessarily be matched, in character, with the income they generate.

Finally, there has been some speculation as to the meaning of the language toward the end of the Supreme Court's judgment in *Gifford*, namely:

> As earlier pointed out, loan proceeds are usually thought of as additions to the financial capital of the borrower. This view makes it necessary to deal briefly with the wording

121 See Hoffmann J's decision in *Woolworth*, supra note 57 (Ch. D.), and Vinelott J's decisions in *Marine Midland*, supra note 47, and *Overseas Containers*, supra note 52. Given the lack of authority to help determine whether a liability is on income or capital account, "borderline cases" might be a large category.

122 Subject to the resolution of the case law referred to in note 8, supra.

> at the beginning of both s. 8(1)(f)(v) and s. 18(1)(b) that prohibits the deduction of "outlays . . . of capital." A literal reading of this phrase could render every expenditure that could not be directly traced to revenue non-deductible as an outlay of capital. This has not been the approach under these sections in the past, and the analysis should continue to look at what is acquired rather than examining where the money to make the payment originates.[123]

At first glance, it might seem that Major J is suggesting that paragraph 18(1)(b) has three tests—whether the outlay is "an outlay, loss or replacement of capital," "a payment on account of capital," or "an allowance in respect of depreciation, obsolescence or depletion"—and that the test in *Gifford* only addresses the second point. Indeed, this is probably correct, although of limited significance since each category addresses a distinct type of outlay. The passage quoted above likely means that when an expense is paid out of the proceeds of a borrowing on capital account, that expense should not be considered to be "an outlay of capital" even though the expense could, quite literally, be described as "an outlay of capital." Rather, deductibility of the expense should be examined according to the use to which the expenditure was put.[124]

IMPLICATIONS FOR FINANCIAL INSTITUTIONS

Determining whether a debt is on income or capital account is a very different question when the debtor is a financial institution.[125] Oddly, the Act recognizes this difference on the asset side but not on the liability side. The specified debt obligation and mark-to-market regime in sections 142.2 to 142.6 effectively makes significant assumptions regarding the nature of shares and debt held by financial institutions. All shares are mark-to-market property (and therefore effectively on income account) unless (generally) the taxpayer has a "significant interest" in the issuer.[126] Most debt obligations[127] will be specified debt obligations (and therefore effectively on income account whether or not they are also classified as mark-to-market property) unless (generally) the taxpayer is related to the issuer, the taxpayer does

123 *Gifford*, supra note 1, at paragraph 40.

124 Thanks to Blake Murray for suggesting this interpretation.

125 For a broader discussion of this and related issues, see Tim Edgar, "Deduction of Loan Losses and Financing Expenses by Moneylenders," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 16:1-52.

126 Generally, a taxpayer has a significant interest in the issuer where the taxpayer is related to the issuer (otherwise than by virtue of a paragraph 251(5)(b) right) or the taxpayer holds shares of the issuer representing at least 10 percent of the shareholdings of the issuer by votes and value. See subsection 142.2(2).

127 Namely, an interest in a loan, bond, debenture, mortgage, hypothecary claim, note, agreement of sale, or any other similar indebtedness or an interest in a debt obligation where the taxpayer purchased the interest, but not an income bond, an income debenture, a small business development bond, a small business bond, or a prescribed property. See the definition of "specified debt obligation" in subsection 142.2(1).

not deal at arm's length with the issuer, or the taxpayer has a significant interest in the issuer.[128]

As seen above, under the regime for determining the character of a liability prior to *Gifford*, the character of a liability of a financial institution would typically be determined by reference to the assets acquired with the proceeds of the liability. Generally, then, where a liability was used to acquire a mark-to-market property or a specified debt obligation (other than a mark-to-market property), the liability should be considered to be on income account, thereby allowing a matching of character (although not necessarily of timing) as between the asset and the liability.

In *Gifford*, Major J states:

> If the loan proceeds constitute the inventory of the borrower, as is the case with moneylenders, then the payment of interest would be deductible.[129]

The most important point of this statement is the confirmation that financial institutions are to be treated differently than other taxpayers in respect of financing expenses. This is a welcome confirmation in the face of rather sparse case law.

However, the impact of *Gifford* on financial institutions is not entirely clear. This lack of clarity could be attributable, in part, to a similar lack of clarity in the Supreme Court's approach to the tax policy underlying paragraph 18(1)(b) in respect of interest and paragraph 20(1)(c). Are these provisions intended to address timing, or matching of character? Are they intended to be tax expenditure provisions, encouraging taxpayers to accumulate capital where otherwise the deduction of financing expenses would be inappropriate (as suggested by the Supreme Court in the past)? An understanding of the policy driving these provisions would facilitate an understanding of their application to financial institutions.

Scottish North American Trust and *Canada Permanent Mortgage Corp.* seem to support the position that any liabilities incurred by a financial institution that fund corresponding lending activities (presumably regardless of the term of the liability) should be on income account, on the basis that the liabilities allow the financial institution to earn the profits of its ordinary business. In *European Investment Trust*, Finlay J regarded the indebtedness of a moneylender as being on capital account but imagined that a "temporary accommodation," the interest on which would be deductible, could be "a good deal longer" than 24 hours. As reviewed above, *European Investment Trust* can be viewed as authority for the proposition that interest paid by a taxpayer will be on capital account where the associated funding is necessary to provide a financial institution with adequate capitalization to function. Beyond that, presumably under *European Investment Trust* a financial institution can deduct interest even if it is in respect of relatively long-term indebtedness, on the basis that even such long-term indebtedness is still "temporary" in that it is not

128 Ibid.

129 *Gifford*, supra note 1, at paragraph 39.

part of the "permanent" capitalization of the financial institution. *Marine Midland* affirms this perspective, drawing a distinction between borrowings that enable a corporation to commence trading and other borrowings. Presumably borrowings that enable a financial institution to significantly expand its business would also be considered to be on capital account. This concept is repeated in *Overseas Containers*, which specifically contrasts financial institutions with other taxpayers.

But how does one distinguish between such long-term, yet "temporary," indebtedness and "permanent" indebtedness of a financial institution? In some cases, the distinction will be obvious—for example, deposits with a bank are clearly temporary indebtedness. However, many liabilities of a financial institution are not so easily categorized. One source of guidance could be regulatory capital requirements.[130] For example, under the "Capital Adequacy Requirements" guidelines published by the Office of the Superintendent of Financial Institutions, Canadian banks must have sufficient "Tier 1 Capital" and "Tier 2 Capital."[131] One could argue that any debt instruments incurred at a time where the issuer has already met its Tier 2 Capital requirements could be considered to be on income account. This may turn out to be a persuasive, although not determinative, factor to the courts or the Canada Revenue Agency (CRA), particularly in cases where a financial institution is required to issue more debt to comply with its regulatory capital requirements.

Another source of guidance could be national or global averages or trends in the industry. After all, one industry's thin capitalization is another industry's efficient capitalization. However, comparisons with industry standards would not provide much in the way of certainty for either taxpayers or the CRA since the benchmarks (for example, the particular sector or geographic comparison) may be unclear.

It may be the case, however, that the most helpful method to determine whether a liability is "inventory" to a taxpayer is the method that is currently used. Both the CRA[132] and the courts (through *Canada Permanent Mortgage Corp.*)[133] already ask

130 Thanks to Andy McGuffin for this suggestion.

131 Canada, Office of the Superintendent of Financial Institutions, "Capital Adequacy Requirements," *Guideline* no. A—Part I, January 2001. "Tier 1 Capital" consists of items such as common shares, contributed surplus, retained earnings, and certain non-cumulative preferred shares; "Tier 2 Capital" consists of items such as subordinated debt instruments with a term that exceeds five years.

132 In paragraph 4 of *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues," October 31, 2003, which was published before the Supreme Court of Canada's decision in *Gifford* was issued, the CRA stated that it accepts that "taxpayers in certain financing businesses (e.g. moneylenders) may consider interest expense for borrowed money that constitutes stock-in-trade to be on income account, and deductible under section 9."

133 See also *Neonex International Ltd. v. The Queen*, [1977] CTC 472 (FCTD); rev'd. in part [1978] CTCD 485 (FCA). In this case, the taxpayer claimed a deduction on a bonus paid to a third-party lender. The taxpayer habitually borrowed and on-loaned to various affiliates in the group; this borrowing followed the same pattern. The Federal Court Trial Division permitted the deduction on the basis that financing affiliates was part of the taxpayer's business. There was very little examination of this point, however. The Court of Appeal found that the particular

whether a liability is the inventory or stock-in-trade of the financial institution. As Rand J stated in *Bennett & White*, the question is whether the financing is "an integral part of the business carried on."[134] This inquiry should encompass a number of different aspects of the issuance of the liability, including the process by which the liability was issued, whether the type of liability recurs, and the amount of the liability. The reference to *AVCO Financial Services* in *Overseas Containers* is helpful here. The court in *AVCO* mentions the regularity and frequency of the loans in question, as well as the process by which the loans were put into place. For example, again, deposits with a bank are clearly part of the bank's business. However, almost by definition, where the liability in question has a long term, this inquiry will often focus to a large extent on the use or intended use of the proceeds of the liability, because a review of the terms of the liability itself would, in many cases, be fruitless.[135] Two long-term liabilities incurred by a financial institution may have exactly the same terms, but one could properly be considered to be part of the financial institution's business and the other could properly be considered to be on capital account. The term of the liability itself may therefore be of little use in this context; if a financial institution carries on a business of granting loans with 20-year terms, it is only reasonable to conclude that 20-year term liabilities incurred by the financial institution to fund those loans should be considered to be part of the stock-in-trade of the financial institution as well. That a financial institution may very well take on liabilities of quite long duration in order to carry on its ordinary business was acknowledged by Finlay J in *European Investment Trust*. The absence of restrictions on the use of the liability will likely be of little use in this context, given that it is not unusual for financial institutions to fund their inventory assets with debts that have no significant restrictions on the use of proceeds. If one were to limit a financial institution's income account liabilities to short-term liabilities and liabilities with tight restrictions on the use of the proceeds, the financial institution's asset inventory would be very much larger than its liabilities on income account, resulting in a sharply skewed view of the taxpayer's income.

Indeed, although the point is illustrated more dramatically in the context of shorter-term borrowings, it holds in respect of short-term borrowings other than

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loan in question was not part of the taxpayer's business, but rather was advanced in order to finance (or refinance) the purchase by the related borrower of an acquisition of a controlling interest of another company and therefore was on capital account.

134 Supra note 76, at 7.

135 In *AVCO*, supra note 54, at 4259, Mason, Aickin, and Wilson JJ state, "A distinction is to be drawn between moneys borrowed by a finance company in the ordinary course of its business and moneys borrowed for some special purpose which excludes the use of the money in the ordinary course of the finance company's business, e.g., for on-lending or the repayment of a loan the proceeds of which have been employed in the ordinary course of its business. *CAGA* [(1977), 137 CLR 373 (Full HC)] was an instance of a borrowing for a special purpose, the company undertaking not to use the funds for on-lending and to employ them in such a way that they could be regarded as part of the permanent capital structure of the business."

bank deposits (which clearly should be considered to be on income account for a bank, because they constitute the core of a bank's business). One would have thought that shorter-term borrowings (say, for a term of two years) would be considered to be on income account, but the *Gifford* approach renders this treatment uncertain.

Accordingly, notwithstanding the apparent conclusion in *Gifford* that one is not permitted to look to the use of the proceeds of a liability to determine whether it is on income or capital account, it is submitted that in the case of a financial institution, this question must remain a critical component of the inquiry. If the use of the proceeds of a liability is found to be irrelevant to the characterization of that liability as being on income or capital account to a debtor financial institution, then it is likely that *Gifford* will have the greatest impact on financial institutions.

CONCLUSION

Contrary to the general feeling in the Canadian tax community, *Gifford* is neither shocking nor nonsensical. It follows relatively established case law in the United Kingdom, and reflects some key Canadian case law decided in the middle of the last century. It could even be argued that the generally held view of the tax community (and of the Canadian tax courts, to a large extent) was due to an unduly loose reading of the relevant jurisprudence. However, whether *Gifford* is correctly decided or not, it is the law. The challenge now is to determine its meaning. Indeed, it is disappointing that, when given the opportunity to address squarely an issue so fundamental to Canadian tax law, the Supreme Court of Canada seems to have offered confusion rather than clarification.