PRACTITIONERS' CORNER

Interest Deductibility in Canada: The *TDL Group Co.* Decisions

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Interest deductibility is no simple matter in Canada, as illustrated by the recent Federal Court of Appeal decision in *TDL Group Co.*, which concerned interest expense in a Canada-U.S. cross-border matter. While the decision provides some important statements regarding the deductibility of interest expense, perhaps more significant is what the court did *not* say. This article examines the conclusions reached by both the Tax Court of Canada — denying an interest deduction — and by the Federal Court of Appeal — subsequently allowing the deduction — in an effort to identify a more unified theory on the proper approach to interest deductibility in Canada.

Last summer, one of the writers and two colleagues examined[1] the then-recently issued decision of the Tax Court of Canada (TCC) in *TDL Group Co. v. The Queen*.[2] That article was part of a broader discussion of Canada's controversial approach to the deductibility of interest expense related to the financing of business or investment opportunities. That approach — which is not seen in the U.S. or other countries — is framed by two important elements:

- a 1957 Supreme Court of Canada (SCC) decision[3] that generally prohibits such deductibility; and
- subsequent legislation intended to override that judgment; namely, paragraph 20(1)(c) of the Income Tax Act (Canada).[4]

However, there has been constant disagreement between taxpayers and the government over the scope and effect of this legislation.

The occasion for last summer's article was the publication of a revised statement[5] by the government of its views concerning how paragraph 20(1)(c) has been shaped by the case law. Fortuitously, during the same week of that publication, the TCC released its decision in *TDL Group Co.*, which amply illustrated the difficulties arising in the application of paragraph 20(1)(c).

Now a year later, the government has added guidelines to its revised statement[6] and the Federal Court of Appeal (FCA) has reversed[7] the TCC's decision. This

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[1]Nathan Boidman, Héléna Gagné, and Michael N. Kandev, ''Interest Deductibility in Canada: What's the Fuss?'' *Tax Notes Int'l*, July 13, 2015, p. 161.

[2]2015 TCC 60.

[3]*Canada Safeway Ltd. v. Minister of National Revenue*, [1957] SCR 717, 57 DTC 1239.

[4]RSC, 1985, c 1 (5th Supp.). Unless otherwise indicated, all statutory references herein are to the ITA.

[5]Canada Revenue Agency, Income Tax Folio S3-F6-C1, ''Interest Deductibility.''

[6]*See infra* note 17.

[7]*TDL Group Co. v. The Queen*, 2016 FCA 67.

article briefly reviews the facts of the case and the conclusions of both the TCC and the FCA. The two decisions underscore the challenge of interpreting a legislative provision that is very brief and vaguely worded.

The Canadian Legislation in a Nutshell

In Canada, interest expense is considered to be a capital expenditure and is not deductible unless it meets the specific requirements of the ITA. Paragraph 18(1)(a) limits the right to deduct expenditures to those made or incurred for the purpose of gaining or producing income from a business or property. Paragraph 18(1)(b) provides that no deduction may be made for ''capital'' expenditures unless they are expressly permitted under other provisions of the ITA. Paragraph 20(1)(c) is the specific provision that allows a deduction for interest despite the prohibition in paragraph 18(1)(b). It applies to interest regarding borrowings and assumed obligations, and requires that (i) the subject amount be paid in the year or be payable in respect of the year, (ii) under a legal obligation to pay interest, and (iii) that the subject amount be reasonable.

When money is borrowed, the use of the money must be established and the purpose of that use must be to earn business or property income.[8] This fairly vague statutory requirement of an income-earning purpose has resulted in a massive body of case law. *TDL Group Co.* is the most recent example of the confusion surrounding that test.

Principles Found in Canadian Jurisprudence

The interpretation of the word ''purpose'' was addressed by the SCC in *Ludco Enterprises Ltd. v. The Queen*,[9] as follows:

> [T]he requisite test to determine the purpose for interest deductibility under s. 20(1)(c)(i) is whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made.

With regard to purpose, the court also stated:

> Absent a sham or window dressing or other vitiating circumstances, a taxpayer's ancillary purpose may be nonetheless a bona fide, actual, real and true objective of his or her investment, equally capable of providing the requisite purpose for interest deductibility in comparison with any more important or significant primary purpose.[10]

The interpretation of the word ''used'' has also been addressed by the SCC; in particular whether it refers to direct or indirect use, as well as whether it connotes first or current use. In *The Queen v. Bronfman Trust*,[11] the SCC stated that, ''[t]he text of the Act requires tracing the use of borrowed funds to a specific eligible use.''[12] In *Shell Canada Limited v. The Queen*,[13] the SCC described the test by saying that ''[i]f a direct link can be drawn between the borrowed money and an eligible use,'' then the money was used for the purpose of earning income from a business or property.

The SCC also noted therein that ''[i]nterest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use.'' The SCC's commentary in these two cases establishes that the test to be applied is the direct use of the borrowed money. In some circumstances, however, the courts have stated that an indirect use will be accepted as an exception to the direct use test.

Despite the extensive SCC guidance on the interpretation of section 20(1)(c), this short provision remains a significant source of tax disputes, including in cross-border contexts, such as the interest deduction that was denied in *TDL Group Co*. by the TCC but subsequently allowed by the FCA.

The Decision of the TCC

In *TDL Group Co*., the taxpayer appealed a reassessment denying interest deductions on the basis that the funds borrowed were not used for the purpose of earning income from a business or property, even though borrowing to buy common shares is generally considered to meet that test.

Wendy's International Inc., the ultimate U.S. parent of the group, lent to its U.S. subsidiary, Delcan Inc., at an interest rate not to exceed 7 percent. Delcan in turn loaned the full amount to its direct subsidiary, TDL Group Co., at a rate of 7.125 percent. Delcan subsequently assigned this loan receivable to another U.S. affiliate in the group. TDL Group then used the full amount of the loan from Delcan to purchase additional common shares in its wholly owned U.S. subsidiary, Tim Donut U.S. Limited Inc. Tim's U.S. in turn used the full amount received from TDL Group to make an interest-free loan back to Wendy's, which was evidenced by a promissory note (''the note'').

Originally, the loan to Wendy's was intended to be interest bearing. However, there were concerns that such an arrangement would have adverse tax consequences, specifically regarding U.S. state taxes and the thin capitalization and foreign accrual property income rules under the ITA. To avoid the potential problems, it was decided that the loan would proceed on a non-interest basis until the matter was sorted out.

8 Borrowed money used to acquire a life insurance policy or property the income from which would be exempt, will not qualify.

9 2001 SCC 62.

10 *Id.*

11 87 DTC 5059 (SCC).

12 *Id.*

13 1999 3 SCR 622.

Thereafter, Tim's U.S. incorporated a new U.S. subsidiary, Buzz Co. Tim's U.S. assigned the note to Buzz Co. as payment for its shares of Buzz Co. Buzz Co. then issued a demand for payment on the note to Wendy's, which repaid the note in full by issuing a new promissory note to Buzz Co. The new note was for the full amount of the previous note and also bore interest at a rate of 4.75 percent. Thus, the non-interest-bearing loan was effectively replaced by a new interest-bearing loan.

The interest-bearing loan from Delcan to TDL Group was made on March 18, 2002. The interest-free loan from Tim's U.S. to Wendy's was made on March 27, 2002. The new interest-bearing loan between Wendy's and Buzz Co. was effected on November 4, 2002.

The government denied the deduction of interest paid on TDL Group's loan from Delcan during the seven-month period in which the loan from Buzz Co. to Wendy's was on an interest-free basis. As of November 4, 2002, when the loan to Wendy's was effectively repaid and replaced with an interest-bearing loan, the government allowed interest deductibility from that date onward. Thus, the issue before the TCC was the interest payable over the initial seven-month period, namely, from March to November 2002.

TDL Group argued that the purchase of common shares of Tim's U.S., which was the direct use of the proceeds of its borrowings from Delcan, satisfied the income-earning purpose test in subparagraph 20(1)(c)(i), and that only the direct use of borrowed funds should be considered. The subsequent use of those funds by Tim's U.S. was therefore irrelevant. In essence, TDL Group's position was that the purchase of shares had capitalized its subsidiary, thereby enabling that subsidiary to acquire capital assets and to operate its business for TDL Group's ultimate benefit, in the form of payment of future dividends. Therefore, it was irrelevant whether Tim's U.S. actually earned income immediately after the new capital injection.

TDL Group noted that Tim's U.S. had a 10-year plan to significantly expand its U.S. operations that in fact ultimately did result in substantial dividends eventually being paid to TDL Group. According to TDL Group, this was clear evidence that the purchase of the common shares had an income-earning purpose.

The government's position was that the transactions undertaken were nothing more than a series of predetermined steps of a tax plan to create a deductible interest expense in TDL Group. The government argued that TDL Group's investing in Tim's U.S. had no income-earning purpose when Tim's U.S. made the first loan to Wendy's.

In its decision, the TCC stated that:

> some types of income, such as capital gains or even dividend income, may often be derived from indirect uses of the money invested in shares of a corporation that owns subsidiaries or has investments in other corporations like the case at hand. . . . These arguments clearly support an argument that monies borrowed for the purposes of creating wealth indirectly would fall within the purpose of the section.[14]

However, the TCC dismissed the appeal on the ground that TDL Group did not have ''any reasonable expectation of earning nonexempt income of any kind'' from its common share investment. This conclusion considered Tim's U.S.'s history of losses, its policy of applying cash flow to capital expenditures rather than to dividends, as well as its 10-year projection that in fact showed no dividends.

The TCC added that:

> The evidence clearly and unambiguously only points to the sole purpose of the borrowed funds as being to facilitate an interest free loan to Wendy's while creating an interest deduction for the Appellant.[15]

The TCC disregarded the fact that the long-term plan had always been for the loan to Wendy's to eventually be interest bearing and that the plan was only delayed by business exigencies.

In other words, the TCC looked at the indirect use of the borrowed funds, namely, the direct use by Tim's U.S., to disallow the contested interest deduction. This seems be an inversion of the principle that the indirect use of borrowed funds may be considered in some circumstances as an exception to the direct use requirement, specifically in order to *allow* interest deductibility. The TCC referred to the indirect use in order to find that the borrowed money was used by the taxpayer solely to facilitate an interest-free loan to the taxpayer's parent corporation, while creating an interest deduction for the taxpayer. Consequently, the taxpayer's appeal was dismissed.

The Decision of the FCA

The principal issues raised before the FCA were:

- whether the money borrowed by TDL Group was ''used for the purpose of earning income'' within the meaning of subparagraph 20(1)(c)(i); and
- whether the amount of interest paid on the borrowed money was reasonable.

The FCA concluded that the TCC erred in law in its application of subparagraph 20(1)(c)(i) and that the interest paid during the period at issue was reasonable. Consequently, the FCA allowed the appeal and vacated the reassessment at issue.

In determining the purpose, the FCA referred to the principle settled in *Ludco* that the taxpayer's purpose of using borrowed monies is to be assessed when the monies are used. Thus, when assessing the purpose of

[14] *Supra* note 2 at para. 27.

[15] *Id.* at para. 32.

TDL Group, the appropriate time for the determination was when it subscribed for the additional common shares of Tim's U.S. The FCA rejected the premise that a second point in time should also be considered, that is, when — several months after the purchase of the shares — the loan to Wendy's was repaid and replaced with an interest-bearing loan.

The FCA considered that an unanswered paradox was reflected in the outcome of the TCC's decision: that there was no income-earning purpose of the loan for the first seven months but there was an income-earning purpose for the rest of the term of the loan. The FCA concluded that the paradox resulted from two legal errors made by the TCC in its application of subparagraph 20(1)(c)(i) to the facts.

The FCA understood that the first error was to import into subparagraph 20(1)(c)(i) a requirement that TDL Group have a reasonable expectation of receiving income on account of the newly acquired shares within the first seven months of ownership of those shares. According to the FCA, the TCC had applied the test at two different moments in time: It had identified no income-earning purposes during the first seven months of TDL Group's ownership of the additional common shares but found such a purpose for the period thereafter.

Although the TCC did not draw that distinction between the two periods per se, distinct periods were created as a result of the government's reassessment of TDL Group. The FCA assumed that the only explanation of how the TCC had considered the shares to have carried an income-earning purpose for the period thereafter was that the TCC had imported a requirement of receiving income from the newly acquired shares within the period. Canadian jurisprudence has clearly rejected this proposition: The analysis should not be driven by whether the taxpayer actually received income but rather by the presence or lack of a reasonable expectation of income when an investment is made.

Interestingly, the FCA did not address the importation of an ''indirect use test'' by the TCC. However, the TCC should only have considered the use by TDL Group as borrower and not the use made by a party in which the borrower had invested. In so doing, the TCC effectively put in doubt the business decisions behind the purchase of the common shares. The use test should have been applied without regard to the use by Tim's U.S. of the new capital injection.

The bona fide business judgments and decisions that take place when monies are borrowed should not be substituted — by the government or by the courts — with what may appear to be a more sound decision or a more believable motive. The second-guessing of a bona fide business decision of a taxpayer is somewhat symptomatic of a results-driven analysis, which for TDL Group, in the FCA's view, translated into a focus on tax avoidance by the TCC.

The second error noted by the FCA was the emphasis on tax avoidance, which was specifically cautioned against in *Shell*. According to the TCC, the ''sole purpose of the borrowed funds [was] to facilitate an interest free loan to Wendy's while creating an interest deduction for the Appellant.''[16]

Interestingly, without straightforwardly stating it, the FCA critiqued the TCC for rendering a rather results-oriented conclusion. The TCC did second-guess the business decision behind the purchase of the additional common shares as having no possible business explanation other than tax avoidance and therefore concluded that there could not have been any reasonable expectation of income when the investment was made. That emphasis colored the analysis and resulted in an erroneous conclusion.

Ironically, the FCA seems to have fallen into the same trap. In its review of the facts, the FCA considered relevant the fact that the loan to Wendy's was originally intended to be on an interest-bearing basis although no rate was specified. However, the intention to make an interest-bearing loan is simply not germane. The only relevant intention is the purchase of the common shares as a bona fide business decision, and it is this intention that should suffice to determine the analysis.

The TCC did not need to address the reasonability of the interest payments, given its conclusion about the purpose of the borrowed monies. The government had argued that the interest was not reasonable in view of the fact that the same amount was immediately lent back to Wendy's without interest. The FCA did not agree with the argument made by the government and referred to the *Shell* decision in which the SCC concluded that the reasonableness of an amount paid must be assessed by reference to the terms on which the monies were lent and the purpose for which the borrower used the money. This means that no consideration should be given to the use of the monies by the entity in which the borrower invested.

As a result, the FCA found that the interest was inherently reasonable given that the government itself had found the interest reasonable once the loan to Wendy's was effectively repaid and replaced with an interest-bearing loan.

Final Thoughts

Perhaps the most important concern that arises as a result of the TCC decision is the appropriate standard by which bona fide business decisions should be reviewed by the government or by the courts. The income-earning purpose test requires only a *reasonable* expectation of profit. It does not require a correct expectation of profit.

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[16] *Id.*

Accordingly, a measure of deference should be the norm. In this case, the TCC apparently did not hesitate to substitute its business judgment for that of the taxpayer. Ironically, the FCA did not directly criticize that approach. Moreover, the government's recently revised statement on interest deductibility contains no guidance on this issue.[17] Thus the question of what level of scrutiny taxpayers can expect their business decisions to be subjected to remains largely unanswered. ◆

[17]In its revised Income Tax Folio S3-F6-C1, ''Interest Deductibility,'' dated March 18, 2016, the government stated that following a winding up or amalgamation, assumed debt can be allocated for interest deduction purposes to eligible assets. Where a corporation acquires the shares of another corporation in exchange for an assumption of debt or a note payable to the vendor, the government would consider the shares that were initially acquired (and have disappeared) to have been substituted for assets formerly held by the acquired corporation that has been wound up or amalgamated. These assets would then be tested for an eligible purpose. Where the debt represents only partial consideration for the share acquisition, if some assets do not meet the purpose test, the taxpayer may adopt a flexible approach in linking the debt to the eligible assets formerly held by the acquired corporation. Similarly, if some of those eligible assets are subsequently distributed as a dividend or a return of capital, taxpayers would be entitled to link the debt to any remaining eligible assets.