

4 DÉCEMBRE 2024

Federal Court of Appeal Confirms CRA Can Collect Arrears Interest Despite Absence of a Tax Debt

Auteurs : [Élisabeth Robichaud](#), [Anne-Sophie Villeneuve](#) et [Cédric Primeau](#)

Traduction en cours.

The Federal Court of Appeal (FCA) recently dismissed the Bank of Nova Scotia's (BNS) [appeal](#) and upheld the Canada Revenue Agency's (CRA) practice of charging arrears interest on a non-existent tax debt where audit adjustments increase taxable income that is offset by the carryback of a loss incurred in a subsequent year. This approach can result in significant interest, potentially exceeding the amount of tax due, accruing on a tax liability for a period in which the liability has been reduced or extinguished.

The Dispute

In 2015, pursuant to a tax audit, BNS was reassessed to include additional amounts in its income for the 2006 taxation year. As is typically the case when the CRA reassesses a taxpayer that has an available balance of losses, BNS asked to carry back its non-capital losses from a subsequent taxation year, in this case 2008, to offset the increased income for 2006.

The CRA implemented the requested carryback, but charged BNS interest on the full notional 2006 tax liability up to 30 days after the date of the carryback request made on March 12, 2015 – instead of up to 30 days after April 28, 2009, i.e., the date on which BNS's tax return for the 2008 loss year was filed – resulting in nearly six years of “arrears interest” on a liability that had been extinguished, since the offsetting loss was recognized in 2009. This resulted in BNS being assessed interest of \$7.9 million for an increase in taxable income of \$1 million for the 2006 year.

BNS challenged the reassessment in the Tax Court of Canada (TCC), which sided with the CRA and rejected BNS's contention, amongst others, that the rule under the *Income Tax Act* (ITA) providing for interest on a tax debt to run until a loss carryback is made does not apply in its case, since the reassessment for 2006 was made to process audit adjustments, not a carryback request ([read our take on this decision](#)). The TCC thereby dismissed the argument that Parliament did not intend for a taxpayer to be subject to interest when its carryback request could not be made until taxable income is increased as a result of an audit.

The FCA confirmed the TCC's decision and found that while the text of the ITA leaves ambiguous whether the reassessment implementing the loss carryback needs to result from the taxpayer's carryback request, as opposed to the CRA's implementation of the audit adjustments, the context and purpose favour the CRA's interpretation that so long as a loss carryback request is made, the context in which it is made has no bearing on the calculation of interest.

Legislative Background

The provision relied on by the CRA, subsection 161(7) ITA, was first enacted in 1954. Up until 1985, as the ensuing iterations of the provision were silent on the calculation of interest in scenarios such as the one at issue, there was a common understanding that the “interest clock” stopped running in the year in which the loss carryback became available – i.e., in the case of BNS, 2008.

In 1985, subsection 161(7) was amended to include paragraph 161(7)(b), which stipulates that interest on a tax debt that is offset by a loss carryback accrues until 30 days after the latest of four specified dates, including the day on which the return for the subsequent loss year

is filed (under subparagraph 161(7)(b)(iii)) and the day on which a request to carry back a loss is made, where the carryback is made as a consequence of a “request in writing” (under subparagraph 161(7)(b)(iv)).

At the time, the Department of Finance presented the amendment to Parliament as being “not of a controversial nature,”¹ but rather aimed “to deal with the technical problems that had arisen in the administration and application”² of the ITA. Parliament therefore enacted the amendment on the understanding that it was not a significant change or departure from the prior law.

Following the 1985 amendments, the CRA initially applied subparagraph 161(7)(b)(ii) rather than subparagraph 161(7)(b)(iv) in situations where taxpayers requested a loss carryback as a result of an audit adjustment, since, in the CRA’s words, it is “as a result of an audit” that “the taxpayer learned that the income for the preceding year was higher than originally reported.”³ The CRA appears to have since reneged on this interpretation, taking the position – as it did in BNS’s case – that interest should accrue until 30 days after the date of the carryback request where the request is filed as a result of an audit that increased a prior year’s tax liability.

The FCA’s Analysis

The FCA performed a textual, contextual and purposive interpretation of subparagraph 161(7)(b)(iv). It found the text to be ambiguous as it was unclear whether the provision applied if the CRA reassessed, not only to implement the loss carryback requested but also to make other adjustments of its own initiative. However, the FCA concluded that the contextual and purposive analysis supported the CRA’s position as it aligned with the legislative intent to ensure certainty, predictability and fairness in tax legislation, even if it resulted in a harsh outcome.

The FCA considered various factors raised by BNS in support of its position, but found that each one favoured the CRA’s interpretation. First, the fact that subparagraph 161(7)(b)(iv) does not explicitly carve out from its application a situation where a carryback is requested as a result of an audit supports that the interest should accrue until the loss carryback request. Second, BNS’s interpretation could lead to inconsistent interest calculations, depending on whether the CRA implements the audit adjustments and the loss carryback in one or two reassessments. Third, there is no reason to believe Parliament did not foresee that subparagraph 161(7)(b)(iv) could function like a penalty. Fourth, by enacting a specific provision related to loss carrybacks, Parliament intended for the interest calculation to be different from interest calculations related to other discretionary deductions. Lastly, the 1985 Technical Notes do not support the interpretation that the cause of the carryback request should determine whether the provision applies. However, the FCA did not discuss the comments quoted above made to the Senate when the 1985 amendments were enacted, finding instead that the original iteration of subsection 161(7), which dates back to 1954, was irrelevant.

A Questionable Tax Policy

While there is no clear finding on the specific policy of paragraph 161(7)(b), the FCA decision refers to the general policy underlying the ITA, namely the principles of certainty, predictability and fairness. At first glance, however, and in our respectful view, these principles appear difficult to reconcile with the FCA’s conclusion that there was no reason to believe that Parliament did not foresee that subparagraph 161(7)(b)(iv) could function like a penalty.

This is so because taxpayers regularly find themselves in the position where they reported their income for a given year based on their interpretation of the (notoriously complex) tax legislation, and paid tax accordingly, with no deliberate intention to avoid taxes owing, and their taxable income is subsequently increased as a result of an audit. In such circumstances, it is difficult to see how subparagraph 161(7)(b)(iv) can serve as an effective deterrent, given that the taxpayer is not aware of the increased tax liability until the end of the audit.

The notion that Parliament intended such a punitive result is even more difficult to justify, considering that loss carryforwards made in the exact same context do not lead to the same outcome. Indeed, paragraph 161(7)(b) does not apply to loss carryforwards, with the result that where, as a consequence of audit adjustments, the taxpayer requests that the CRA offset its increased tax liability by carrying forward losses available from prior years, no arrears interest will accrue on this increased liability.⁴

A Looming Due Diligence Defence?

It is trite law that interest is the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to – in a colloquial sense – or owed to, another; and that “there can be no such thing as interest on principal which is non-existent.”⁵ The CRA itself also defines interest, for interest deductibility purposes, as requiring that it be “referable to a principal sum.”

The accrual of interest on an amount corresponding to a tax debt that no longer exists, by virtue of a legal fiction, is at odds with basic commercial and accounting principles. It also results in a form of windfall for the CRA, which, as a result of this legal fiction, is allowed to collect potentially significant sums of money against a notional tax debt to which it was no longer entitled once the loss was incurred.

In our view, the reassessment of amounts that go beyond what can be considered “interest” start to resemble more of an administrative penalty under the guise of interest, in which case a due diligence defence should allow taxpayers to present evidence that they were not negligent; namely, that they believed on reasonable grounds in a non-existent state of facts that, if it had existed, would have made their act or omission innocent, or that they took all reasonable steps to prevent the act or omission from occurring. It remains to be seen whether a due diligence defence is available to taxpayers where subparagraph 161(7)(b)(iv) applies – an issue that was not discussed by FCA nor the TCC below.

¹ *Standing Senate Committee on Banking, Trade and Commerce*, 33-1, No 18 (17 October 1984) at 10 (Mr. Timothy Morris).

² *Standing Committee on Finance, Trade and Economic Affairs*, 33-1, No 37 (4 June 1985) at 5 (Mr. David C. Weyman).

³ CRA Technical Interpretation 2011-042070117.

⁴ “Revenue Canada Round Table,” in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 58:1-76, question 49, at 58:29-30.

⁵ See the Supreme Court of Canada’s *Reference as to the Validity of Section 6 of the Farm Security Act, 1944 of Saskatchewan*, affirmed by the Privy Council.

Personnes-ressources : [Élisabeth Robichaud](#) et [Anne-Sophie Villeneuve](#)