INTEREST DEDUCTIBILITY: NAVIGATING THE PURPOSE TEST

TDL Group Co. v. The Queen
2015 TCC 60

KEYWORDS: INTEREST ■ INTEREST DEDUCTIBILITY

INTRODUCTION

The Tax Court of Canada decision in *TDL Group Co.*[52] addressed the question of the deductibility of interest paid on borrowed money that is first used to purchase the common shares of a corporation and is then used by that corporation to make an interest-free loan. Pizzitelli J's decision to deny TDL Group Co. ("the taxpayer") more than $10 million in interest deductions in these circumstances suggests that it may be insufficient to merely look to the direct use of borrowed funds in assessing whether a borrower has a reasonable expectation of earning income as required under paragraph 20(1)(c) of the Income Tax Act. In *TDL*, the court felt obliged to evaluate whether the borrower had a reasonable expectation of earning income in light of its wholly owned subsidiary's indirect use of the borrowed funds.

In considering whether the taxpayer was eligible to deduct interest in connection with borrowed amounts used to acquire common shares, the *TDL* decision addressed a question that had recently been considered in *Swirsky*[53] and *Income Tax Folio* S3-F6-C1, "Interest Deductibility."[54] However, in evaluating whether the borrower had a reasonable expectation of earning income, in *TDL*—in contrast to the *Swirsky* decision and the folio—the Tax Court gave material consideration to the use of the share subscription proceeds by the corporation issuing the shares.

The *TDL* decision raises several questions about the scope and timing of the evaluation of a taxpayer's indirect uses of borrowed funds and whether the taxpayer has a reasonable expectation of earning income in light of these indirect uses. The decision also, somewhat surprisingly, raises the possibility that capital gains may be a form of income for the purpose of paragraph 20(1)(c), though it does not elaborate on this possibility.

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move LNG. An "eligible liquefaction facility" is defined in regulation 1104(2) as a self-contained system located in Canada (including buildings, structures, and equipment) that is used or intended to be used by the taxpayer for the purpose of liquefying natural gas. Generally, the additional allowances in respect of a facility that liquefies natural gas in Canada will be allowed to be claimed only against income of the taxpayer that is attributable to the liquefaction of natural gas at that facility (see regulation 1104(18)).

52 *TDL Group Co. v. The Queen*, 2015 TCC 60.

53 *Swirsky v. Canada*, 2014 FCA 36.

54 *Income Tax Folio* S3-F6-C1, "Interest Deductibility" (which replaced *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues," October 31, 2003).

Facts

The dispute arose in respect of a series of transactions that occurred in March 2002 ("the series of transactions"). On March 18, 2002, the taxpayer's ultimate parent, Wendy's International Inc. ("the parent"), loaned $234 million to its US subsidiary, Delcan Inc. ("Delcan") at an interest rate not to exceed 7 percent. On the same date, Delcan loaned the full amount to the taxpayer at an interest rate of 7.125 percent ("the loan") and subsequently assigned the loan to another affiliate in the corporate group. On March 26, 2002, the taxpayer used the proceeds from the loan to subscribe for additional common shares in its wholly owned US subsidiary, Tim Donut US Limited, Inc. ("TDL US"). TDL US made an interest-free loan to the parent the following day, as evidenced by a promissory note ("the note").

In effect, the result of the above series of transactions was that an amount that was loaned by the parent on March 18, 2002 on an interest-bearing basis was loaned back to the parent on March 27, 2002 on an interest-free basis. Planning documentation adduced at trial indicated that the note was originally intended to bear interest; however, concerns about the potential consequences of such interest with respect to US state taxes and the Canadian thin capitalization and foreign accrual property income (FAPI) regimes caused the parties to temporarily loan the funds on an interest-free basis.

In the months following the series of transactions, the taxpayer's corporate group confirmed that the loan from TDL US to the parent should be interest-bearing, and it undertook certain reorganization steps to effect this change. As part of the reorganization, TDL US incorporated a new US company, Buzz Co. ("Buzz"), subsequently renamed TD US Finance Co. ("the reorganization"), and transferred the note to Buzz as consideration for the issuance of shares. Buzz issued a demand for payment on the note to the parent, which repaid the note in full by issuing a new promissory note to Buzz on November 4, 2002 ("the new note") for the full amount of the loan. The interest rate on the new note was 4.75 percent. The net effect of the series of transactions and the reorganization was that the parent loaned funds on an interest-bearing basis and borrowed back those funds on an interest-bearing basis.

The Canada Revenue Agency (CRA) denied the taxpayer's interest deduction on the loan during the period commencing on the day after the note was issued to the parent (that is, March 28, 2002) and extending to the day before the new note was issued to the parent (that is, November 3, 2002). The CRA reassessed the taxpayer on the basis that the amounts borrowed from Delcan under the loan were not used for the purposes of earning income from a business or property as required by paragraph 20(1)(c). The CRA also advanced the alternative argument that the interest deducted by the taxpayer in respect of the loan was not, in the circumstances, a reasonable expense under paragraph 20(1)(c).

Interestingly, the CRA allowed the taxpayer to deduct interest paid in respect of the loan on and after November 4, 2002, which was the date on which the non-interest-bearing note was replaced with the interest-bearing new note. Although it is not expressly stated in the judgment, the court's description of the reassessment suggests that the CRA also permitted the taxpayer to deduct interest paid on the loan

from the date of the loan from Delcan (March 18, 2002) to the date the funds were loaned back to the parent on an interest-free basis (March 27, 2002).

The Decision

The court cited the Supreme Court of Canada's four-part test from *Shell Canada* ("the *Shell* test") for determining whether interest was deductible under subparagraph 20(1)(c)(i):[55]

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

In TDL, it was conceded that the first two criteria of the *Shell* test were satisfied. The loan from Delcan was made pursuant to a loan agreement and the impugned interest was payable to Delcan under that agreement in 2002. Instead, the dispute between the parties focused on the *Shell* test's third criterion: whether the proceeds from the loan were used for the purpose of earning income from a business or property. Although the CRA also disputed the application of the fourth criterion of the *Shell* test, the court, in light of its finding that the loan was not used for the purpose of earning income from a business or property, declined to rule on whether the amount of interest charged under the loan was reasonable.

In analyzing whether the third criterion of the *Shell* test had been satisfied, the court noted that one must first determine the "use" of borrowed money, and then determine the "purpose" for which the money was borrowed. The court contrasted the companion decisions of the Supreme Court of Canada in *Singleton*[56] and *Ludco Enterprises*[57] as cases that examined, respectively, the question of "use" and the question of "purpose." *Singleton* was principally concerned with whether loaned amounts had been "used" to fund a taxpayer's legal practice, notwithstanding that as a result of the series of transactions, the taxpayer had indirectly used the borrowed funds to purchase a personal residence. In contrast, the *Ludco* decision was concerned, in part, with determining whether the borrowing had an income-earning purpose, though it was generally conceded that the direct "use" of the funds had been an investment in certain foreign corporations.

The court noted in TDL that there was no dispute about the direct use of the funds transferred pursuant to the loan. The parties agreed that such amounts were

55 *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622, at paragraph 28.

56 *Singleton v. Canada*, 2001 SCC 61.

57 *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62.

used to subscribe for additional common shares in the taxpayer's wholly owned subsidiary (TDL US). There was, however, a dispute between the parties as to whether the additional common shares of TDL US were acquired for the purpose of earning income. The court also reiterated the Supreme Court's finding in *Ludco* that there was no requirement that the sole purpose of the borrowing be the earning of income. Rather, interest payments could qualify for the deduction under paragraph 20(1)(c) even if the earning of income was an ancillary purpose.

The Supreme Court found in *Ludco* that courts should objectively determine the nature of the purpose of a borrowing, guided by both subjective and objective manifestations of purpose. Accordingly, the test for determining the purpose for interest deductibility under subparagraph 20(1)(c)(i) was stated to be "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made."[58] The Supreme Court went on to state that "[r]easonable expectation accords with the language of purpose in the section and provides an objective standard, apart from the taxpayer's subjective intention, which by itself is relevant but not conclusive."[59] On the basis of the Supreme Court's finding, the Tax Court concluded that the purpose test must be applied at the time the taxpayer subscribed for additional shares in TDL US and that "all the circumstances must be considered."[60]

The Tax Court observed that the words "all the circumstances must be considered" gave courts wide latitude to review both the direct and the indirect use of funds to determine the purpose of the borrowing. The court viewed the Supreme Court's decision in *Singleton* as prohibiting a review of a series of transactions to determine the use of a borrowing; rather, the courts were to review the direct use of the borrowing to determine whether that borrowing had satisfied the use criteria. However, the Tax Court did not feel similarly bound to limit the scope of inquiry in determining the purpose of a borrowing. The court interpreted the phrase "all the circumstances must be considered" as permitting a court to consider the indirect uses of the funds when assessing the purpose of a borrowing. Accordingly, the court held that the indirect use of the subscription proceeds in the hands of TDL US was a relevant factor to consider in assessing the purpose of the taxpayer's borrowing from Delcan under the loan.

Interestingly, the court seemed to imply that the potential to earn capital gains could qualify as an income-earning purpose under paragraph 20(1)(c). For example, the court indicated that "some types of income, such as capital gains or even dividend income, may often be derived from indirect uses of money invested in shares of a corporation that owns subsidiaries or has investments in other corporations like the case at hand."[61] The court summarized as follows the question to be asked in determining

58 Ibid., at paragraph 54.

59 Ibid., at paragraph 55.

60 *TDL Group Co.*, supra note 52, at paragraph 25.

61 Ibid., at paragraph 27.

the appeal: Could it be said that "the [taxpayer] had the reasonable expectation to earn income; either immediate or future dividend income or even increased capital gains as a result of the purchase of shares at the time of such purchase?"[62] The court did not further elaborate on the role of capital gains in satisfying the purpose test. However, it is difficult to reconcile these statements with the Supreme Court's observation in *Ludco* that "[i]nterest on borrowings used for non-income earning purposes, such as personal consumption or the making of capital gains is similarly not deductible."[63] It is also difficult to reconcile that observation with subsection 9(3), which states that "'income from a property' does not include any capital gain from the disposition of that property."

The court found that, considering all the circumstances, there was insufficient evidence to conclude that the taxpayer had a reasonable expectation to earn income from a business or property at the time of the investment in TDL US. The court considered a number of factors in coming to this conclusion, including the following:

1. TDL US had lost substantial sums in the four years preceding the share subscription. The court found that TDL US was not in a financial position to pay any immediate or short-term dividends at the time of the share subscription. The planning memos indicated that the loan was only intended to be outstanding for a short period of time, suggesting that the company would not have had the financial capacity to pay dividends during the anticipated term of the note. The court also noted that TDL US had no history of paying dividends.
2. The taxpayer's corporate group had a policy of not declaring dividends until all capital expenditures were funded. The court had in evidence a 10-year plan for TDL US indicating that substantial capital investments would be made over the 8-year period from 2003 to 2010, such that no funds were anticipated to be available for dividends. Moreover, the 10-year plan had a line item for dividends specifically indicating that no dividends were anticipated. Similarly, the planning memos and corporate resolutions gave no indication that any intention to declare dividends existed at the time of the March 2002 share subscription.
3. Although TDL US declared dividends in the 2007-2012 calendar years, they were declared following the sale of the TDL group, when it was understood that the dividend policy had changed. Accordingly, the court found that at the time of the March 2002 share subscription, such dividends were not reasonably anticipated.
4. The taxpayer was already the sole shareholder in TDL US. Accordingly, it was not apparent that the March 2002 share subscription increased the income-earning potential of the taxpayer (particularly in light of the interest-free loan by TDL US to the parent).

62 Ibid., at paragraph 31.

63 Supra note 57, at paragraph 44.

5. The interest-free loan to the parent evidenced by the note was only intended to be in place for a short period of time. The taxpayer recognized that the note had to be reorganized and replaced with an interest-bearing note. Although a plan was in place to effect the reorganization as early as May 2002, the implementation of the reorganization was delayed for reasons unrelated to the series of transactions and the reorganization.
6. The court found that there was no credible evidence that any portion of the funds invested in TDL US was used or intended to be used for any purpose other than to loan monies to the parent on an interest-free basis.
7. Contemporaneous documentation suggested that there was initially an intention to make the note interest-bearing. However, it is clear that the parties changed their intention before the note was issued without interest. As mentioned above, the record includes evidence that various considerations related to US state tax, thin capitalization, and FAPI caused TDL US not to initially issue the note with interest.

On the basis of these factors, Pizzitelli J concluded:

> I simply cannot find that the [taxpayer] had any reasonable expectation of earning non-exempt income of any kind, directly or indirectly, at the time of its purchase of additional shares in Tim's U.S. [TDL US] on or about March 26, 2002. The evidence clearly and unambiguously only points to the sole purpose of the borrowed funds as being to facilitate an interest free loan to [the parent] while creating an interest deduction for the [taxpayer].[64]

Commentary

The *TDL* decision provides a helpful reminder to approach interest-bearing borrowings cautiously. In assessing any proposed reorganization or borrowing, taxpayers should undertake a careful analysis of the plan in light of the criteria set out in the *Shell* test before they assume that interest may be deducted.

However, the application of *TDL* to other factual circumstances is unclear. Tracking downstream uses of funds is reasonably straightforward in circumstances like those in *TDL*, where a particular sum of money is sequentially transferred between related entities. However, such tracking is more difficult (perhaps impossible) where the sequential transfers occur over longer periods of time, with less consistent sums being transferred, and where the investing shareholder does not have control of the investee. Further, it is arguable that cascading uses of funds that are potentially traceable to an original borrowing could all be relevant in assessing interest deductibility.

The decision in *TDL* also introduces uncertainty about the appropriate time frame in which to consider whether a taxpayer has a reasonable expectation of earning income from property. As noted above, the court concluded that the purpose test must be applied at the time at which the taxpayer subscribed for shares in TDL

64 *TDL Group Co.*, supra note 52, at paragraph 32.

US. Although it may have been appropriate at that time to conclude that the taxpayer did not have a reasonable expectation of earning income over the short term, there was evidence that the taxpayer's corporate group always intended to replace the non-interest-bearing note with an interest-bearing replacement note (as was done in the reorganization). Arguably, if the expectation that the replacement would occur was reasonable at the time of the share subscription, the fact that the note was initially non-interest-bearing should not be given much weight in applying the purpose test.

It is unclear to what extent the decision will affect CRA administrative policy. As noted above, the court concluded that the purpose test must be applied as at the time the taxpayer subscribed for shares in TDL US. Under the test articulated by the court, the November 2002 reorganization that replaced the non-interest-bearing note with the interest-bearing new note did not create a new investment in TDL US or otherwise give reason to re-evaluate the taxpayer's reasonable expectations of profit under the test articulated by the court. However, the CRA nonetheless accepted the taxpayer's interest deductions on the loan for the period commencing on the date of issuance of the interest-bearing new note. Similarly, the CRA appears to have accepted the taxpayer's interest deductions on the loan for the period commencing on the date of issuance of the loan and ending on the date the funds were loaned back to the parent on an interest-free basis under the note.

As previously noted, the Tax Court's decision also seems to imply that capital gains may be "income from a business or property" for the purposes of satisfying the statutory criteria of subparagraph 20(1)(c)(i). As discussed in some detail above, it is difficult to reconcile this view with past Supreme Court jurisprudence and subsection 9(3).

The taxpayer has appealed the Tax Court's ruling. Accordingly, there should be an opportunity for the Federal Court of Appeal to elaborate on these issues.

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WHAT ARE "COMPARABLE CIRCUMSTANCES" FOR A DIRECTOR'S DUE DILIGENCE DEFENCE?

Whissell v. The Queen
2014 TCC 350

KEYWORDS: DIRECTORS' LIABILITY ■ DUE DILIGENCE ■ CORPORATIONS

INTRODUCTION

Whissell[65] is one of several recent cases to leave uncertainty about the scope of the Tax Court's analysis of what constitutes "comparable circumstances" for the purposes of the director due diligence defence.

65 *Whissell v. The Queen*, 2014 TCC 350.