after the last celebratory drink has been consumed by jubilant Canadian legal professionals. Such amendments may replace the champagne taste from the positive outcome in *CNQ* and *Thompson* with something far less palatable.

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FEDERAL COURT OF APPEAL

INTEREST DEDUCTION ON A CIRCULAR CASH FLOW ARRANGEMENT ALLOWED

TDL Group Co. v. Canada
2016 FCA 67

KEYWORDS: INTEREST ■ INTEREST DEDUCTIBILITY

Introduction

The Federal Court of Appeal's decision in *TDL Group Co. v. Canada*[14] provides welcome relief to taxpayers by overturning a decision of the Tax Court of Canada[15] that had denied TDL Group Co. ("the taxpayer") a tax deduction in respect of approximately $10 million of interest that it had paid to a related party. The taxpayer had been denied the deduction by the Tax Court on the basis that such borrowed funds had purportedly not been used for the purpose of earning income from a business or property, as required by subparagraph 20(1)(c)(i) of the Income Tax Act.

Unfortunately, the rather brief judgment of the Court of Appeal left unanswered a number of questions raised by the Tax Court decision. Accordingly, the tax community will have to wait for future jurisprudence to address what role, if any, (1) the indirect uses of borrowed funds and (2) capital gains derived on investments play in assessing whether interest paid in respect of a borrowing will be tax-deductible.

Notwithstanding these outstanding issues, the TDL decision provides welcome input from the Court of Appeal on the regularly litigated issue of interest deductibility.

Facts

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").

14 2016 FCA 67.

15 2015 TCC 60.

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 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 TDL US Finance Co., 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 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 (March 28, 2002) and extending to the day before the new note was issued to the parent (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).

Since the purpose test in paragraph 20(1)(c) is a point-in-time test (in this case, the time of acquisition of the shares of TDL US), it is not clear why the CRA allowed the taxpayer to deduct interest paid in respect of the loan after the original note was replaced with the new note. Following the reasons of the Court of Appeal, as discussed below, it might be fair to wonder whether the CRA weakened its position on appeal by not more robustly reassessing the taxpayer.

Decision of the Tax Court

Briefly stated, the task of the Tax Court was to assess whether the interest paid on the loan to Delcan was deductible under subparagraph 20(1)(c)(i) in accordance with the four-part test from *Shell Canada Ltd. v. Canada* ("the *Shell* test"):

> 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.[16]

The first two criteria of the *Shell* test were not at issue before the Tax Court. The bulk of the Tax Court's decision instead focused on the third criterion, assessing whether the proceeds of the loan from Delcan were used for the purpose of earning income from a business or property. The Tax Court declined to rule on whether the amount of interest charged under the loan from Delcan was reasonable, in light of its finding that the loan was not used for the purpose of earning income from a business or property.

In analyzing whether the third criterion of the *Shell* test had been satisfied, the Tax Court noted that there was no dispute that the direct *use* of the borrowed funds had been to acquire common shares of the taxpayer's wholly owned subsidiary, TDL US. Accordingly, the issue in dispute was whether the *purpose* of the borrowing had been to earn non-exempt income.

The Tax Court cited the Supreme Court of Canada's decision in *Ludco Enterprises Ltd. v. Canada* for the proposition that the requisite test for assessing the "purpose" of a borrowing was "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made."[17]

The Tax Court reasoned that the reference to considering "all the circumstances" in *Ludco* gave courts wide latitude to review both the direct use of borrowed funds and the indirect use of funds used by members of the same corporate group or as part of the same series of transactions to assess the purpose of a borrowing.

On the basis of its review of the evidence led at trial, the Tax Court concluded that the taxpayer did not have a reasonable expectation of earning non-exempt income at the time it acquired the shares in TDL US. Rather, the Tax Court concluded that "the sole purpose of the borrowed funds [was] to facilitate an interest free loan to [the parent] while creating an interest deduction for the [taxpayer]."[18]

Decision of the Court of Appeal

Purpose of the Borrowing

In concluding that the taxpayer should be entitled to deduct the impugned interest amounts, the Court of Appeal noted that *Ludco* had clearly established that the time for assessing a taxpayer's purpose for borrowed monies is the time at which the investment is made. Accordingly, in the case of the taxpayer, the inquiry was to be in respect of the point in time when the taxpayer subscribed for additional shares in TDL US.

Since the taxpayer's purpose for a borrowing is to be assessed at a single point in time, the Court of Appeal stated that there was

16 [1999] 3 SCR 622, at paragraph 28.

17 2001 SCC 62, at paragraph 54.

18 *TDL*, supra note 15, at paragraph 32.

> an unanswered paradox [that] runs through the reasons of the Tax Court: how is it that there was no income earning purposes during the first seven months the additional common shares were owned by the appellant, but an income earning purpose thereafter?[19]

The Court of Appeal reasoned that this paradox was attributable to two legal errors made by the Tax Court. The first error was the Tax Court's importing into subparagraph 20(1)(c)(i) a requirement that a taxpayer must have a reasonable expectation of receiving income within the first seven months following an investment rather than over some longer period of time.

However, it may be an oversimplification of the Tax Court judge's analysis to suggest that he was looking for an income-earning purpose only during the first seven months. In applying the income-earning test, the trial judge asked, "Can it be said that the Appellant 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?"[20] Excluding the reference to capital gains, as discussed in greater detail below, this is the correct test, and the same test that the Court of Appeal applied.

The trial judge then reviewed the evidence and concluded that there was no income-earning purpose (whether within the first seven months or over any longer period of time). In the words of the Tax Court judge,

> [t]here is no credible evidence any portion of the funds invested in [TDL US] [was] used or intended to be used for any other purpose other than to loan monies to [the parent] on an interest free basis at the time of the investment in [TDL US] shares.[21]

It may be fair to question the trial judge's conclusion on this point, considering that he found that

1. the initial plan called for the taxpayer to make an interest-bearing loan to the parent, but owing to US state tax concerns and Canadian FAPI issues, it was decided that the loan be made interest-free until the matter was sorted out; and
2. a revised plan to convert the loan into an interest-bearing debt was prepared within two months but was not implemented until seven months after the initial loan was made, owing to a preoccupation with another transaction.

In this regard, it may be that the Court of Appeal's finding regarding the second error of the Tax Court was what led the Tax Court into its erroneous conclusion regarding the purpose of the borrowed money.

19 *TDL*, supra note 14, at paragraph 18.

20 *TDL*, supra note 15, at paragraph 31.

21 Ibid.

The Court of Appeal asserted that the second error of the Tax Court was its focus on tax avoidance; the Tax Court concluded that the sole purpose of the borrowed funds was to facilitate an interest-free loan to the parent while creating an interest deduction for the taxpayer. In support of its finding of an error, the Court of Appeal cited the following passage from *Shell*, where it was noted that a court's "overriding concern with tax avoidance not only coloured its general approach to the case, but may also have led it to misread the clear and unambiguous terms of s. 20(1)(c)(i) itself."[22] The Court of Appeal found that the Tax Court had committed the same error in arriving at its conclusion about the purpose of the borrowed funds.

Reasonableness of the Amount of Interest

As noted above, the Tax Court declined to make a finding in respect of the *Shell* test's fourth requirement that the amount of interest payable under the loan be reasonable. Accordingly, it was left to the Court of Appeal to make a determination in this regard.

The Court of Appeal noted that in *Shell*, the Supreme Court observed that the reasonableness of the interest paid must be assessed by reference to the first three requirements of the *Shell* test. Put another way, the Court of Appeal indicated that "the reasonableness must be assessed by reference to the terms upon which the monies were lent and the purpose for which the borrower used the money."[23]

After noting that it had found that the temporary use of the subscription proceeds by TDL US (that is, for the initial seven-month interest-free loan to the parent) did not detract from the taxpayer's income-earning purpose behind its acquisition of additional shares in TDL US, the Court of Appeal noted that the rate of interest on the loan from Delcan had been acceptable to the minister following the reorganization in which the interest-free loan was replaced with an interest-bearing loan. On that basis, the Court of Appeal accepted that the interest paid during the seven-month period that was subject to reassessment was also reasonable. Interestingly, the Court of Appeal did not directly address any of the arguments that were presumably argued by the Crown before the Tax Court as to why the interest charged was not reasonable, but on which the Tax Court declined to rule.

Commentary

While the outcome of the case would presumably have been satisfying to the taxpayer, the Court of Appeal's relatively brief judgment unfortunately did not address several potentially troubling issues raised in the Tax Court's decision.

For example, the Court of Appeal did not specifically address whether the indirect use of borrowed funds is relevant in assessing the purpose of a borrowing. The Court of Appeal noted that "[i]n the Tax Court's view," the requirement from *Ludco*

22 *TDL*, supra note 14, at paragraph 22, citing *Shell*, supra note 16, at paragraph 47.

23 *TDL*, supra note 14, at paragraph 25.

that consideration be given to "all the circumstances" permits a court to review the indirect uses of borrowed funds to assess the purpose of a borrowing.[24] However, the Court of Appeal did not directly address whether it agreed with this view.

Instead of specifically addressing whether it agreed with the Tax Court on the relevance of indirect uses of borrowed funds, the Court of Appeal simply noted that it had found that "the temporary use of the subscription proceeds by [TDL US] did not detract from the [taxpayer's] income earning purpose behind its acquisition of additional shares."[25] The Court of Appeal also viewed (albeit somewhat problematically, as described above) the Tax Court as finding that there was no income-earning purpose for the first seven months of the borrowing but that an income-earning purpose existed thereafter, without explaining what the Court of Appeal viewed as the relevant criteria for determining whether an income-earning purpose existed.

Given the uncertainty surrounding this point, it appears that taxpayers will still need to be cognizant of the indirect use of funds when investing with borrowed funds. In the case of investments made as part of a series of transactions with related parties, this may arguably be a reasonable requirement. However, as I noted in my case comment on the Tax Court judgment, "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."[26]

The Tax Court also seemed to imply that capital gains may be "income from a business or property" for the purposes of satisfying the statutory test in subparagraph 20(1)(c)(i).[27] The Court of Appeal did not address how such a finding could be reconciled with the statement 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,"[28] or with subsection 9(3), which states that "income from a property does not include any capital gain from the disposition of that property."

An additional observation about the decision relates to the Court of Appeal's criticism of the Tax Court for the "unanswered paradox" as to how funds without an income-earning purpose during the first seven months of the borrowing could subsequently acquire an income-earning purpose. Such criticism would have been more fairly levelled at the CRA rather than the Tax Court. It was the CRA that decided

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24 Ibid., at paragraph 13.

25 Ibid., at paragraph 26.

26 Andrew Stirling, "Interest Deductibility: Navigating the Purpose Test," Current Cases feature (2015) 63:3 *Canadian Tax Journal* 762-68, at 767.

27 *TDL*, supra note 15, at paragraphs 27 and 31.

28 *Ludco*, supra note 17, at paragraph 44, quoting *Bronfman Trust v. The Queen*, [1987] 1 SCR 32, at paragraph 23.

not to reassess the taxpayer in respect of interest deductions claimed for interest accruing after the first seven months of the borrowing. Accordingly, it would not have been within the jurisdiction of the Tax Court to deny such interest deductions because they were not before the court. Once it is accepted that the Tax Court properly turned its mind to the purpose of the borrowing at the time of the acquisition of the shares of TDL US, as discussed above, the "first error" identified by the Court of Appeal seems misplaced.

That said, with respect to the "second error" identified by the Court of Appeal, taxpayers will be pleased to see the Court of Appeal's reaffirmation that courts should be careful not to let an overriding concern with tax avoidance colour the courts' approach to cases. Although the Court of Appeal did not provide much context in connection with the statement, it is a welcome reminder to the Tax Court and the CRA.

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