Interest Deductibility

Introduction
The question of interest deductibility arises in many different cases, both for individuals and corporations. In particular, the question of interest deductibility often arises where funds are borrowed and a life insurance policy is used as collateral security for the loan. The traceable use of the borrowed funds will determine whether the interest is deductible.

The rules relating to the deductibility of interest expense for tax purposes appear straightforward. However, case law, several releases of draft legislation, and changing Canada Revenue Agency ("CRA") interpretations have caused uncertainty as to the interpretation of these rules. This Tax Topic discusses the current legislation on interest deductibility, CRA's current views as expressed in Income Tax Folio S3-F6-C1, "Interest Deductibility," drawn from recent case law and proposed legislative changes. Note that Income Tax Folio S3-F6-C1replaced and cancelled all of the older interpretation bulletins issued by the CRA relating to interest deductibility, including Interpretation Bulletin IT-533, "Interest Deductibility and Related Issues," and any other CRA positions expressed prior to October 31, 2003. In addition, the folio does not take into account proposed amendments to the Income Tax Act (the "Act") including the Draft Proposals regarding the deductibility of interest and other expenses released on October 31, 2003, which will be dealt with in the "Technical Issues" section. Tax planning strategies in relation to insurance policies are also discussed.

General Rules
The courts have traditionally considered interest and financing charges to be non-deductible expenditures for tax purposes since they are on account of capital. Consequently, such costs are only deductible if they meet the conditions of paragraph 20(1)(c) and related provisions of the Act.

Simple Interest
Under paragraph 20(1)(c), interest is deductible when it is paid or payable in respect of the year (depending upon the method regularly followed by the taxpayer) pursuant to a legal obligation. The borrowed money must be used for the purpose of earning income from a business or property, to acquire property for the purpose of gaining or producing income from the property or to acquire property for the purpose of gaining or producing income from a business. Interest on borrowed money used to earn exempt income or to acquire a life insurance policy (including an annuity contract) will not be deductible. However, subparagraph 20(1)(c)(iv) of the Act allows an interest deduction for borrowed money used to acquire an interest in a non-prescribed annuity contract to the extent of the taxable portion of the annuity payments from the contract included in income under section 12.2 of the Act. (Refer to IT-355R2, *Interest on Loans to Buy Life Insurance Policies and Annuity Contracts, and Interest on Policy Loans*, discontinued on September 30, 2012, for CRA's views on this topic).

In addition to meeting the above criteria, interest on borrowed money will only be deductible to the extent that it is reasonable in the circumstances. In determining whether or not an interest rate is reasonable, consideration should be given to prevailing market rates for debts with similar terms and credit risks. As stated in the Shell Canada Limited v. Canada, [1999] 3 S.C.R. 622, "Where an interest rate is established in a market of lenders and borrowers acting at arm's length from each other, it is generally a reasonable rate […]" .

A taxpayer who uses the cash method of reporting income may deduct interest in the year in which the interest is paid, while a taxpayer using the accrual method may deduct interest in the year in which it is payable.

Compound Interest
It is important to distinguish compound interest from simple interest. Compound interest is not "interest charged on borrowed money" and does not arise on borrowed money used for producing income. Rather, compound interest arises on unpaid interest. As a result, there is a separate provision of the Act, paragraph 20(1)(d), that permits a deduction for compound interest. Under this provision, a deduction for compound interest is allowed if the interest is paid in the year and the related simple interest is deductible. Note that, unlike simple interest, which is deductible when paid, or payable (i.e., accrued), compound interest is only deductible when it is physically paid. Compound interest is not deductible in the year it arises if it is simply added to the outstanding loan balance (i.e., capitalized). In the context of leveraged life insurance strategies, this means that if interest is capitalized, the interest arising on that interest (i.e. compound interest) will only be deductible when it is paid. Since many of these loans intend to be outstanding until the death of the insured, the compound interest will only be paid, and therefore, deductible at death.

Although subsection 20(1)(c) allows the deduction of interest on money borrowed to earn income from a business or property, consider a taxpayer that has a loan that meets the purpose test in subsection 20(1)(c) of the Act and subsequently takes out a second loan in order to pay interest on the first loan. Is the interest on the second loan deductible? Interest on the second loan could be viewed as being compound interest that would only be deductible when paid. However, the purpose of the second loan could also be seen as merely paying interest; not to earn income. The second loan would not appear to meet the purpose test under subsection 20(1)(c) of the Act since the borrowed funds are not used for the purpose of producing income. Subsection 20(3) of the Act provides that where money is borrowed to re-pay the first loan, the principal of the second loan is deemed to have been borrowed for the same purpose as the first loan. However, there is no provision in the Act that deems the interest on the second loan to have been paid for the same purpose as the first loan.

CRA's longstanding administrative position accepts the deductibility of the interest paid on the second loan as confirmed in several CRA technical interpretations (2009-0331651E5, 2005-0116661C6 and 2004-0070341E5). CRA has indicated that interest on the second loan that is paid or payable during the year, depending on the method normally used by the taxpayer in computing his income, will be deductible under subsection 20(1)(c) of the Act if, the interest on the first loan is deductible under the same section. In other words, where a taxpayer obtains a loan to pay the interest on an earlier loan, the interest on the second loan will be deductible. If interest is accrued, the accrued interest will be viewed as being compound interest and will only be deductible under subsection 20(1)(d) of the Act in the year in which it is actually paid.

Technical interpretation, 2006-0188621E5, dated May 23, 2006, outlined three specific situations where the taxpayer obtained a second loan. CRA considered whether the interest was deductible in each of the following situations:

1. Interest on a line of credit is payable annually at the end of each year. At the end of each year, the taxpayer takes an additional advance on the line of credit to pay the loan interest owing, pursuant to the line of credit agreement;
2. Pursuant to the line of credit agreement, interest on the line of credit is added to the loan balance (i.e. is capitalized) each year; and
3. Instead of a single line of credit, the loan has two separate accounts. Each year, the taxpayer takes a loan advance from account A and arranges for interest on the loan to be charged to account B. Then the taxpayer takes an additional advance from account A to pay the interest that was charged to account B.

Although CRA has a longstanding administrative position of accepting the deductibility of interest related to the second loan, CRA noted in this technical interpretation that these series of transactions were not similar to the transactions considered in the earlier documents. CRA went on to note that where a series of transactions is entered into merely to derive the benefit of an interest deduction, the General Anti-Avoidance Rules ("GAAR") might be relevant. As a result, it remains unclear when interest on a loan used to pay interest may be deductible.

Substituted Borrowings
Where a taxpayer has used borrowed funds to repay funds that were previously borrowed, the new borrowings will be deemed under subsection 20(3) of the Act to be used for the same purpose as the original borrowings. Therefore, if interest was deductible on the original loan, it would also be deductible on the new loan.

Loss of Source of Income
Prior to 1994, interest ceased to be deductible where the borrowed money was used to earn income from a business or to finance the acquisition of property, and either the business was discontinued, the property was disposed of or the business/property became worthless but the debt remained outstanding. Subsection 20.1(1) was added to the Act to ensure that interest on borrowed money continued to be deductible even after the source of income

disappeared. This section provides that after 1993, where borrowed money ceases to be used for the purpose of earning income from a capital property, other than real property or depreciable property, a portion of the outstanding borrowings will be deemed to continue to be used by the taxpayer for the purpose of earning income from property. A similar rule, subsection 20.1(2) of the Act, exists for borrowed money that is used for the purpose of earning business income where the taxpayer ceases to carry on the business.

For example, consider a taxpayer that purchases shares of a corporation worth $15,000 using $12,000 of borrowed funds and $3,000 of personal funds. The shares are later sold for the fair market value of $9,600 (referred to below as the “proceeds”); $4,320 of the original borrowings is deemed to continue to be used for the purpose of earning income from property and the corresponding interest would be deductible. The $4,320 is calculated by first determining the portion of the original borrowing that is considered to have been recovered on the sale and then subtracting this amount from the original borrowing. The borrowed amount recovered on the sale is $7,680 (80% ($12,000/$15,000) of the proceeds of $9,600). The remaining $4,320 ($12,000-$7,680) of the original funds borrowed is deemed to continue to be used for earning property income. Depending on the subsequent use of the proceeds, the $7,680 portion of the loan may still generate deductible interest.

Note that if the $9,600 proceeds are used to repay a portion of the loan, the deemed amount would be reduced from $4,320 to $2,400, as the amount is limited to the extent to which the original debt remains outstanding. It may be more tax effective to leave the borrowed money outstanding and use the proceeds to pay down other non-deductible debt.

Technical Issues

The purpose of earning income test

For interest to be deductible, subparagraph 20(1)(c)(i) of the Act requires that the borrowed money is used for or used to acquire property for “the purpose of earning income from a business or property”. Income refers to things like interest, rents, royalties, business income or trading gains. Income does not include capital gains. For example, funds borrowed to invest in mutual funds that only generate capital gains will not earn “income”; therefore, the interest on such borrowed funds is not deductible.

In the past, the CRA has attempted to apply an additional restriction by interpreting income to mean “net income”. This interpretation was rejected in a 2001 Supreme Court of Canada (“SCC”) decision in Ludco Enterprises Ltd. v. Canada [2001] 2 S.C.R. 1082 (“Ludco”).

In the Ludco case, the corporate and individual taxpayers borrowed substantial amounts to finance the acquisition of shares of certain offshore corporations. The taxpayers incurred approximately $6 million in interest expense, earned dividend income of approximately $600,000 and ultimately sold the shares for a significant gain (approximately $9.2 million). The Federal Court of Appeal (“FCA”) denied the interest expense of $6 million on the basis that the true purpose of the borrowing was said to be the production, not of the dividend income, but rather, the capital gain. The SCC later reversed the FCA decision and concluded that an ancillary purpose of making gross income is enough to satisfy the test for interest deductibility. Furthermore, the SCC confirmed that for purposes of interest deductibility, the term "income" refers to the income that is subject to tax, not tax-exempt income and not net income.

The CRA has accepted the interpretation of the courts on this issue, and paragraphs 1.26 and 1.27 of Folio S3-F6-C1 reiterate the SCC’s comments in Ludco:

> “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.”

and

> “[…] The plain meaning of s. 20(1)(*c*)(i) does not support an interpretation of "income" as the equivalent of "profit" or "net income".... Therefore, absent a sham or window dressing or similar vitiating circumstances, courts should not be concerned with the sufficiency of the income expected or received”.

In paragraph 1.69 of the same folio, the CRA goes on to say that where an investment carries a stated interest or dividend rate, the purpose test will generally be met (absent a sham or window dressing or other vitiating circumstances). As a result, where the stated interest or dividend rate is less than the interest rate on the debt, provided all the other requisite tests are met, CRA states that interest will neither be denied in full nor restricted to the amount of income from the investment.

In the case of borrowing to invest in an investment such as common shares where there is no stated dividend or interest rate, it is more difficult to assess whether there is a reasonable expectation of income at the time the investment is made. Paragraph 1.70 of Folio S3-F6-C1 says that normally the CRA considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that there is a reasonable expectation, at the time the shares are acquired, that the common shareholder will receive dividends. Nonetheless, each situation must be dealt with on the basis of the particular facts involved.

It should be noted that although CRA is currently administering the Act as stated earlier, on October 31, 2003, Finance released draft legislation which, if it had been enacted, would have significantly restricted the ability to deduct interest in situations such as those described earlier.

The draft amendments proposed a new section of the Act (section 3.1) that would have introduced the following concept: a loss generated from a source that is business or property will only be deductible in a particular year if it is reasonable to assume that the taxpayer will realize a cumulative profit from the business or property during the time the taxpayer has carried on or held, or can be reasonably be expected to carry on or hold, the business or property. Subsection 9(3) of the Act was to be modified to explicitly exclude any capital gain or capital loss from the determination of profit under proposed subsection 3.1(2) of the Act. At the 2014 Canadian Tax Foundation Annual Conference, the Department of Finance officially withdrew these proposals.

The use of the borrowed money test
Subparagraph 20(1)(c)(i) requires that borrowed money must be used for the purpose of earning income from a business or property in order to obtain an interest deduction. Therefore, in order to claim a deduction, the taxpayer must be able to demonstrate that the borrowed money was used for an eligible purpose. The CRA states that in determining what borrowed money has been used for, "the onus is on the taxpayers to trace or link the borrowed money to a particular eligible use, giving effect to the existing legal relationships". This means that the taxpayer must have a paper trail which demonstrates the flow of the borrowed money to the eligible purpose.

In 2001, the SCC decided a case dealing with this issue (Singleton v. Canada, [2001] 2 S.C.R. 1046) ("Singleton"). The Singleton case involved a lawyer who used $300,000 of equity in his law firm to purchase a house. The taxpayer refinanced his law firm equity with borrowed money and deducted interest on the borrowed funds pursuant to subparagraph 20(1)(c)(i) of the Act. The deduction was based on his claim that the borrowed money now represented his investment in his law firm. The CRA reassessed and denied the deduction on the grounds that the borrowed money was used to finance the purchase of the house and not the partnership equity in the law firm. The Tax Court of Canada ("TCC") dismissed the taxpayer's appeal, but the FCA allowed the appeal. The SCC subsequently upheld the FCA decision. The argument rejected by the SCC was that of the "economic realities" of the taxpayer's transactions and whether the economic realities should determine whether the purpose test in paragraph 20(1)(c) of the Act was met. In rejecting the economic realities test, the SCC relied on its previous decision in Shell where it had held that, absent a sham or specific provision in the Act to the contrary, the economic realities of a transaction cannot be used to re-characterize a taxpayer's bona fide legal relationships. In Singleton, a direct link could be drawn between the borrowed money and an eligible use.

It appears that as a result of this decision, a taxpayer can draw down on his or her after-tax investments and borrow to repurchase the investments without affecting the deductibility of the interest expense. The CRA originally stated that they accepted the outcome of this decision and therefore would assess taxpayers on this basis. While the SCC held in favour of the taxpayer in Singleton and upheld the specific legal form of the transactions, that case did not consider the application of GAAR. For a discussion of how GAAR might apply, see the discussion further on under "Interest Deductibility and The General Anti-Avoidance Rules".

In the context of life insurance with leverage, consider the following example. A taxpayer intends to purchase a life insurance policy and leverage the cash value to provide cash for personal expenditures. Further, the taxpayer wants to be able to deduct the interest on the loan for tax purposes. If the taxpayer simply uses the loan proceeds (obtained by leveraging the cash value of the policy) to provide cash for personal expenditures, the interest will not be deductible; the loan proceeds flow from the bank to the personal expenditures, which is not an eligible use. If instead, an investment portfolio is sold to meet personal cash requirements, and the investments are subsequently repurchased with the borrowed funds, the interest may be deductible since the borrowed funds have been used to acquire property that will earn income. Although this series of transactions is not offensive, actual sales and purchases of the investments must occur. The transactions cannot simply be reflected on paper by journal entry only. Depending on the type of property, accrued capital gains or losses or income from property may be realized. Where there are capital losses realized on the disposition, a superficial loss may be triggered where the taxpayer or an affiliated person acquires and owns the same or identical properties or a right to acquire the property ("substituted property") during the period that begins 30 days before and ends 30 days after the disposition of the property. An affiliated person includes, among others, a spouse or common-law partner of the individual. The superficial loss is denied and added to the cost base of the substituted property so that on a future disposition, the loss will increase or the gain decrease.

CRA has confirmed that where a taxpayer restructures borrowings and the ownership of assets the direct use test will be met (paragraph 1.33 of Folio S3-F6-C1). Consider the example of a taxpayer who has borrowed to purchase a life insurance policy and also owns investment assets. Because the direct use of the borrowed funds was to purchase a life insurance policy, the interest on the loan is non-deductible. However, the taxpayer could sell the investment assets, use some or all of the proceeds from the sale to repay the loan, and subsequently obtain additional borrowed money to reacquire the investment assets. Now the direct use of the borrowed money is to acquire investment assets, and accordingly provided the other criteria for interest deductibility are met, the interest should be deductible.

Cash damming is another method accepted by CRA as enabling taxpayers to link borrowed funds to a specific use (paragraph 1.34 of Folio S3-F6-C1). Cash damming segregates borrowed funds (typically in a separate account) from funds received from other sources, such as business operations.

The funds from other sources are used for non-eligible purposes such as the acquisition of a life insurance policy. The borrowed funds are used for eligible purposes such as the acquisition of investment assets or investment in the business. The CRA has also stated, in paragraph 1.42 of Folio S3-F6-C1, that even where borrowed money is deposited to one account and commingled with other cash […],taxpayers are entitled to apply a flexible approach to tracing/linking. In this case, the taxpayer can look at all the uses of the cash in the account, and choose which use to "link" the borrowed funds with (provided, of course, that the borrowed funds were in the account prior to or on the same day as the funds were used and that the amount used was equal to or greater than the amount borrowed).

Exceptions to the direct use test
Even though generally, borrowed funds must be "traceable" to an eligible use, the courts have accepted that in certain "exceptional circumstances" an indirect use will be accepted as an exception to the direct use test. See for example, Trans-Prairie Pipelines v. MNR, 70 DTC 6357 (Ex. Ct.), The Queen v. Bronfman Trust, [1987] 1 S.C.R. 32 and The Queen v. The Chase Manhattan Bank of Canada, 2000 DTC 6018 (FCA). Accordingly, CRA administratively allows interest deductibility in certain circumstances even though the direct use of the borrowed funds is not an eligible purpose. The exceptions, as outlined in Folio S3-F6-C1, include the following:

- Borrowing to Make a Distribution
  Borrowed money may be used to redeem shares, pay dividends to a shareholder or return capital to a shareholder or partner. Although the direct use of these funds is to make a distribution, the CRA accepts that the borrowed money is used to "fill the hole" created by removing the capital (paragraph 1.45 of Folio S3-F6-C1). As a result, CRA accepts that the purpose test is met, provided the distribution does not exceed the capital of the corporation and that the capital, before it was distributed, was being used for purposes that would have qualified for interest deductibility had the capital been borrowed money. "Capital" for this purpose generally includes contributed capital and accumulated profits. Paragraph 1.50 of Folio S3-F6-C1 indicates that "Accumulated profits would generally be the retained earnings of the corporation computed on an unconsolidated basis with investments accounted for on a cost basis". Similarly, in the case of a partnership, the capital would generally be the balance in the partner's capital account (paragraph 1.53 of Folio S3-F6-C1);

- Borrowing to Make Interest-Free Loans and Contributions of Capital
  Generally, interest on money borrowed to make an interest-free loan to a corporation would not be deductible since the direct use is to acquire a property that cannot generate any income. However, where money is borrowed "[…] to make an interest-free loan to a wholly-owned corporation (or in cases of multiple shareholders, where shareholders make an interest-free loan in proportion to their shareholdings) and the proceeds have an effect on the corporation's income-earning capacity", thereby increasing the potential dividends to be received, CRA is prepared to allow a deduction for the interest. This applies equally to interest on money borrowed by a shareholder to make a contribution of capital to a corporation or by a partner to make a contribution of capital to a partnership; and

- Generally, CRA allows a deduction for interest where borrowed money is used to make an interest–free loan to employees in their capacity as employees. The provision of such loans can be viewed as a form of remuneration for the services of the employees. "However, interest on money borrowed to make interest-free loans to individuals in their capacity as shareholders would not generally qualify." (Paragraph 1.58 of Folio S3-F6-C1).

Policy Loan Interest
A policy loan made after March 31, 1978 is considered a disposition in relation to an interest in a life insurance policy. Accordingly, any gain arising as a result of a policy loan is added to the adjusted cost basis ("ACB") of the policy and the proceeds of disposition from the policy loan reduce the ACB of the policy.

If a policy loan is invested by the policyholder and earns income from a business or property (i.e., meets the deductibility requirements for interest under paragraph 20(1)(c) or paragraph 20(1)(d) of the Act as discussed earlier), the interest may be deductible.

If interest on the policy loan is paid after 1977 and is not deductible from income under paragraph 20(1)(c) or (d) of the Act, it is considered a "premium" under the definition of the term in subsection 148(9) of the Act. The amount of the interest payment is added to the ACB of the policy. However, if the policyholder deducts the interest for tax purposes, the payment is not considered a premium and is not added to the ACB of the policy.

Similarly, if the policy loan interest is added to the policy loan balance (i.e., capitalized) and is not deductible from income under paragraph 20(1)(c) or (d) of the Act, it is considered a premium and the capitalized interest represents a further policy loan advance. In this case, the proceeds of disposition arising from the policy loan are reduced by the premium so that the net proceeds on the policy loan equal zero (subsection 148(9)(b)(i) of the definition of "proceeds of disposition). In addition, the capitalized interest is not deducted from the ACB of the policy (excluded by virtue of "B" in the definition of "adjusted cost basis" in subsection 148(9) of the Act). The net result is that when interest is capitalized and not deductible, there is no net adjustment to the ACB of the policy.

However, when policy loan interest is capitalized and is deducted by the policyholder, the payment of interest is not considered to be a premium and consequently, there is not a decrease to the proceeds of disposition arising on the policy loan. As a result, the ACB of the policy will be reduced by the proceeds. To the extent that the proceeds exceed the ACB of the policy, a taxable policy gain will result and the policy ACB will be increased by the gain.

To obtain a deduction for policy loan interest, the policyholder must obtain a completed form T2210, *Verification of Policy Loan Interest by the Insurer* from the insurer and file it with their tax return. This form states that the interest was paid in the year and that the policy loan interest has not been added to the ACB of the policy as a premium payment. Note that form T2210 must be submitted no later than the last day on which the taxpayer is required to file his/her income tax return for the taxation year in respect of which the interest was paid. Accordingly, the life insurance company should be notified of the requirement for form T2210 well ahead of the date the taxpayer's income tax return is due.

For additional information on the taxation of policy loans please refer to the Tax Topic entitled, "Taxation of Life Insurance Policy Loans and Dividends".

Special Rules in Quebec
In Quebec there is an additional test with respect to investment expenses that may limit interest deductions. The 2004 Quebec Budget introduced rules (effective March 30, 2004), that limit the deductibility of investment expenses to the amount of investment income earned from passive investments in property during the year. These rules are applicable only to individuals and trusts. There are carryover provisions (3 yrs back and forward indefinitely) that allow the deduction of unused investment expense deductions in other years. Investment income includes such things as taxable dividends, interest, royalties, taxable capital gains, foreign investment income and life insurance policy gains. Rental properties are excluded from the rules altogether. Investment expenses are all expenditures incurred to earn income from property (other than rental income) including the following: investment administration or management expenses, stock or securities custody expenses, fees paid to investment advisors, interest on money borrowed to acquire bonds, stock, or mutual funds and certain partnership losses.

Interest Deductibility and the General Anti Avoidance Rule
The previous discussion of the requirements for interest deductibility are based on the requirements of paragraph 20(1)(c) of the Act, and CRA's administrative positions as outlined in Folio S3-F6-C1. Notwithstanding that a taxpayer may have structured their affairs to meet the specific requirements of this provision, it is possible that CRA may apply the GAAR to a series of transactions designed to achieve interest deductions.

The CRA attempted to use the GAAR to deny an interest deduction in a SCC decision, Lipson *v.* Canada, 2009 SCC 1 ("Lipson").

In this case, a husband and wife (Mr. & Mrs. Lipson) entered into a series of transactions designed to make their mortgage interest deductible. Briefly, the facts of the case were as follows: Mrs. Lipson borrowed funds to purchase the shares of a corporation from Mr. Lipson using a demand loan; Mr. Lipson used the proceeds from the sale of the shares to purchase a home; Mr. And Mrs. Lipson then mortgaged the home to repay the original loan. Since the mortgage on the home provided financing in substitution for the demand loan used to acquire the shares, the interest on the mortgage would normally qualify for a deduction under subsection 20(3) of the Act. There was no gain on the sale of the shares to Mrs. Lipson due to the application of the spousal rollover provision (subsection 73(1) of the Act). Because of the rollover, the attribution rule in subsection 74.1(1) of the Act applied so that the income (i.e., dividends) and expenses (i.e., the loan interest) related to the share investment were attributed back to Mr. Lipson. As a result, the interest expense was claimed as a deduction by Mr. Lipson rather than Mrs. Lipson.

At the TCC level, it was held that GAAR applied to the series of transactions as the transactions constituted a misuse of the provisions of the Act. According to the Trial Judge, the money was borrowed to, in the end, buy a residential property and therefore the interest should not be deductible. The Lipsons appealed to the FCA. The FCA was deferential to the trial judge and accepted his finding that "these transactions formed part of a series, the purpose of which was to make interest payable on the mortgage deductible.". On this basis, the interest deduction was denied in its entirety.
In October of 2007, the Lipson case was granted leave to appeal to the SCC; the case was heard in April of 2008. On January 8, 2009, the SCC released its decision in the case. The Court, in a narrow 4-3 majority decision, found that GAAR applied to the series of transactions entered into by Mr. and Mrs. Lipson, but the reasoning of the SCC differed substantially from that of the lower courts.

GAAR applies if a transaction meets three criteria:

1. It results in a tax benefit (a reduction, avoidance or deferral of tax);
2. It is an avoidance transaction (i.e. a transaction undertaken without a legitimate non-tax purpose in order to avoid an undesirable tax result); and
3. It results in a misuse of a provision of the Act or an abuse of the provisions read as a whole.

In applying this analysis to the Lipson case, both parties conceded that the transactions met the first two criteria.

With regard to the third criterion, the majority of the Court held that the Minister had not established that subsections 20(1)(c) (interest deductibility) and 20(3) (substitute borrowing) of the Act were misused and abused, but rather concluded that the spousal attribution provisions were misused and abused. In particular, the majority stated:

> Mr. Lipson sold his shares to his wife and bought the residence with the proceeds of that sale…. In the result, Mrs. Lipson financed the purchase of income-producing property with debt, whereas Mr. Lipson financed the purchase of the residence with equity. To this point, the transactions were unimpeachable. They became problematic when the parties took further steps in their series of transactions. The problem arose when Mr. Lipson and his wife turned to ss. 73(1) and 74.1(1) in order to obtain the result contemplated in the design of the series of transactions, namely to have Mr. Lipson apply his wife's interest deduction to his own income. This was contrary to the purpose of s. 74.1(1).

As a result, the court denied the interest deductions claimed by Mr. Lipson. Interestingly, the dividend income was still included in Mr. Lipson's income and Mrs. Lipson was allowed to claim the interest deductions. Allowing the deductions to Mrs. Lipson was in sharp contrast to the denial of the interest deduction entirely by the lower courts.

A few observations can be made as a result of the Lipson decision. First, the SCC rejected the "overall purpose" approach used in the lower courts and indicated that it saw no abuse of the provisions related to the interest deduction [subsections 20(1)(c) and 20(3) of the Act]. This appears to signal that the Court is okay with straight-up "Singleton-type" organization of one's affairs to obtain interest deductibility. However, the Court concluded that the attribution rules that resulted in Mr. Lipson being able to claim the interest deduction (as opposed to Mrs. Lipson) were abused. The CRA further clarified in technical interpretation 2009-0327071C6 that in a situation similar to the Lipson case, if the taxpayer were to elect to transfer the shares to his spouse at fair market value and receive fair market value consideration, then the spouse could deduct the interest on the borrowed money used to acquire the shares, to the extent that all the conditions in subsection 20(1)(c) of the Act are met.

Secondly, the decision may have limited weight as precedent in future cases for several reasons: it was a split decision - four judges represented the majority decision discussed above. Two judges disagreed that the attribution rules were abused and one judge felt a specific anti-avoidance rule could apply and therefore the GAAR could not apply. In addition, two judges were missing; therefore, it was only a seven member panel as opposed to the usual nine. Finally, tax experts generally agree that the majority decision reached some of its conclusions without any substantive analysis to support them.

Thirdly, the case failed to contribute any useful analysis that provided more certainty around the application of GAAR in the future. As noted earlier, all three decisions (the majority and two dissenting) concluded that the steps taken to allow Mrs. Lipson to rely on subsection 20(1)(c) of the Act to deduct the interest incurred on the mortgage loan did not, on their own, constitute a misuse or abuse of the Act and that GAAR should not apply to Singleton-type transactions. However, because of the dissension in the court and the lack of clear analysis, it would appear that the decision opens the door for the CRA to attempt a GAAR attack if other provisions are used in conjunction with interest deductions. As a result care must be taken when undertaking any leveraged transaction that is "fancier" than just a reorganization of one's affairs to meet the direct use test required by subsection 20(1)(c) of the Act.

Planning Points

Borrowers should plan their loans to maximize the amount of deductible interest expense. Funds used to produce income should be borrowed, thereby making the interest tax deductible. Funds required for purposes that will not produce income should be paid out of excess cash. If excess funds are available, they should be used to repay borrowings with non-deductible interest first. Care should always be taken to maintain the connection between the loan and the use of the borrowed funds.

When an individual purchases an insurance policy and subsequently uses the cash value of the policy as collateral security for a loan, the interest on the borrowed funds may be deductible if the criteria discussed earlier are met. However, the compound interest will only be deductible if it is paid. If the interest is capitalized, the compound interest will only be considered paid in the year in which the death benefit is received and used to repay the loan. A strategy to ensure the annual deductibility of the compound interest is to arrange a new loan each year for the interest component. Investments that generate income could be sold and the proceeds from the sale used to pay the interest on the original loan. A new loan for the same amount is taken out, and the investments previously sold are repurchased with the borrowed funds (taking care not to trigger a superficial loss). Since the new loan is used to purchase an income earning property, interest on the loan will be deductible. The same series of steps will apply to compound interest. Therefore, obtaining a deduction for what would otherwise be "compound interest" requires careful and extensive planning.

Note however, that recent interpretations from CRA (mentioned earlier under "Compound Interest") have created some uncertainty in this area. In the context of leveraged life insurance, where interest deductibility is assumed and where one seeks to "capitalize" interest, this commentary would appear to allow a shortcut: one could simply take a new loan each year to pay the interest, and the interest on each new loan would be deductible. Since CRA interpretations are not law, and given CRA's comment about applying GAAR where a series of transactions is entered into in order to derive the benefit of an interest deduction, (technical interpretation #2006-0188621E5), it may be risky to rely on this shortcut.

Conclusion

Generally, interest on borrowed funds will be deductible to the extent that the borrowed funds are used to earn income. Before making a conclusion about the deductibility of interest, a tax professional should be consulted in order to review the facts of the particular situation in light of existing legislation, CRA commentary and current case law.

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