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TAX LETTER

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DEDUCTION OF INTEREST EXPENSE

Under the Income Tax Act (the "Act"), interest on borrowed money is deductible, generally if it is used for income-earning purposes rather than personal or other purposes. More specifically, interest on borrowed money is deductible if:

- There is a legal obligation to pay the interest;
- The borrowed money is used for the purpose of earning income from a business or property (or the interest is on an amount payable for property acquired for the purpose of earning income from the property or from a business); and
- Only to the extent that the interest is "reasonable".

The first condition regarding a legal obligation to pay is usually straightforward, although it can be an issue in the case of non-arm's length or inter-family loans where the payment obligations are not set out in writing. Also, if the payment of the interest is contingent and not absolute, the interest may not be deductible unless or until the contingency is resolved, if at all.

The third condition regarding reasonableness should be met if the interest rate is at or near a rate that would be payable on a loan between an arm's-length borrower and lender (according to the Supreme Court of Canada in the *Shell Canada* case).

The second condition is normally the most contentious of the three. The courts have held that the borrowed money must be used directly for the purpose of earning income from property or a business. Indirect uses are not sufficient, except in "extraordinary circumstances", as discussed under the subheading below with the same name.

For example, if I borrow money to purchase investments such as shares or mutual funds, the interest is normally deductible because the direct use of the borrowed money is to earn income from property (like dividends or interest income). Furthermore, if you borrow for the main purpose of earning capital gains (which are not considered income from property), such as a loan used to buy common shares, the courts have held that the interest is deductible as long as the property has the potential to earn income from property, such as dividends.

On the other hand, if you borrow for personal purposes and try to argue that the borrowing freed up your other capital to buy investments, the interest will not be deductible.

As such, one strategy, which has been blessed by the courts, involves a borrowing "switch". For example, say I was thinking of taking out a loan for personal purposes. Instead, if I own some investments, I could sell the investments and use the proceeds for the personal purposes (the sale of the investments may trigger a capital gain or loss). If I then borrow to re-purchase the investments, the interest expense on the borrowing will be deductible because the direct use of the borrowing will be to earn income from property, even though an indirect use allowed me to use money for personal purposes. The Supreme Court of Canada confirmed this result in the 2001 *Singleton* case.

The "direct use" requirement must be met in each taxation year in which you claim the interest deduction. As a simple example, say I borrow to buy some investments and hold on to them for years 1 and 2, but sell them at the beginning of year 3 and use the proceeds for personal purposes. The direct use requirement will be met in years 1 and 2 but not year 3. As such, if the loan is still outstanding, no interest will be deductible in year 3.

In contrast, if I used the proceeds in year 3 to purchase another investment to earn income from property, the interest expense will continue to be deductible in year 3.

But what if I borrow money to buy an investment, later sell the investment at a loss, and continue to owe the borrowed money? If I use all of the sales proceeds to buy another investment, the interest expense will continue to be deductible in full. However, a special rule in section 20.1 of the Act provides that a portion of the interest expense will continue to be deductible even if I do not use the proceeds for income earning purposes. Basically, a proportionate amount of interest, based on the "loss portion" of the investment, will continue to be deductible even if I use the proceeds for other purposes, although some adjustment may be required in certain cases. (Interestingly, this special rule does not apply to borrowing made to purchase real estate or depreciable property.)

Example

I borrowed $100,000 to buy shares in a corporation. I later sold them for $60,000, thus incurring a $40,000 loss. I used the $60,000 proceeds for personal purposes. The full amount of the loan remains outstanding.

The interest expense on $40,000 of the loan will continue to be deductible. The remaining interest expense will not be deductible.

"Exceptional circumstances" category

In some cases (they are fairly rare), interest expense on a borrowing can be deductible even if the direct use of the borrowed money appears not to be used for income-earning purposes.

For example, the Canada Revenue Agency (CRA) has held that a deduction for interest will normally be allowed if a shareholder of a corporation borrows money and uses it to make an interest-free loan to the corporation (which is not a direct income-earning purpose, since the interest-free loan is not generating income), if the

interest-free loan has an effect on the corporation's income-earning capacity, thereby increasing the potential dividends to be received. The position is based on caselaw to the same effect and is set out in CRA Income Tax Folio S3-F6-C1.

SPOUSAL AND CHILD SUPPORT PAYMENTS

In most cases, current rules provide that child support payments made to an ex-spouse or common-law partner are not deductible for the payer and are not included in the income of the recipient. An exception applies if the applicable court order or agreement was made before May 1997, was not amended or replaced by another order or agreement after April 1997, and the parties did not elect to have the current rules apply. In these rare cases (where child support is still being paid for a child who is at least 22, given that 22 years have passed since 1997), the payer may deduct the child support payment and the recipient will include them in income.

On the other hand, spousal support payments are deductible for the payer and included in the recipient's income, as long as certain conditions are met.

General conditions for deduction of spousal support

The general conditions are as follows. Exceptions, where the general conditions may be waived, are discussed under the next subheading ("Exceptions to general rules").

First, the support payment must be an "allowance on a periodic basis", rather than a lump-sum or amount that is not periodic. The courts have held that the following factors are relevant in determining the issue (the leading case is the 1989 Federal Court of Appeal decision in *McKimmon*):

- The length of the periods in which the payments are made. Amounts that are paid weekly or monthly are more easily characterized as allowances for maintenance. Where the payments are at longer intervals, the matter is less clear. If the payments are made at intervals of greater than one year, it is arguable that they are not "periodic" allowances.
- The amount of the payments in relation to the income and living standards of both payer and recipient. Where a payment represents a very substantial portion of a taxpayer's annual income or even exceeds it, the payment is unlikely to be a "periodic" allowance. On the other hand, where the payment is no greater than might be expected to be required to maintain the recipient's standard of living, it is more likely to qualify as an allowance.
- Whether the payments are to bear interest prior to their due date. A lump sum payable by instalments is more likely to bear interest than a periodic allowance.
- Whether the payments are stipulated to continue for an indefinite period or whether they are for a fixed term. An allowance for maintenance will more commonly provide for its continuance either for an indefinite period or to some event (such as the coming of age of a child or the re-marriage of the recipient) which will cause a material change in the needs of the recipient. Sums payable over a fixed term, on the other hand, may be more readily seen as a non-deductible capital payment.
- Whether the payments purport to release the payer from any future obligations to pay maintenance. Where there is such a release, it is easier to view the payments as being the commutation or purchase of the capital price of an allowance for maintenance

Second, the payments must be for the maintenance of the recipient ex-spouse or common-law partner.

Third, the recipient must have discretion over the use of the payment, meaning that the recipient, rather than the payer, will determine what to do with the funds.

Fourth, the recipient and payer must be living separate and apart because of the breakdown of their marriage or common-law partnership.

Fifth, the payment must be pursuant to a court order or a written agreement between the parties.

Exceptions to general rules

A lump-sum payment can be deductible for the payer and included for the recipient, even though it is not periodic, the recipient does not have discretion over the use of the funds, and even if the payment is made to a third party instead of directly to the recipient. This rule applies only if the court order or agreement states that the rule will apply. It can apply to expenses such as medical expenses, tuition, rent, and mortgage payments made by the payer to the recipient or to the third party (the medical facility, school, landlord, bank, and so on). In the case of mortgage payments (principal and interest) made for the recipient's home, the deduction in each year is generally limited to 1/5th of the principal amount of the original mortgage loan.

Furthermore, the CRA generally accepts that a lump-sum payment may be deductible for the payer and included for the recipient if the lump-sum:

- represents periodic amounts payable that were due after the court order or written agreement and that had fallen into arrears;
- is paid pursuant to a court order and in conjunction with an existing obligation for periodic maintenance, whereby the payment represents the acceleration, or advance, of future support payable on a periodic basis, for the sole purpose of securing the funds to the recipient, or
- is paid pursuant to a court order that establishes a clear obligation to pay retroactive periodic maintenance for a specified period prior to the date of the court order.

Since the spousal support payment must be made under a court order or written agreement between the parties, payments made before the court order or agreement are normally not deductible for the payer or included for the recipient. However, a special rule in the Act provides that prior payments made in the year of the court order or agreement and the preceding calendar year can be deductible for the payer and included for the recipient, if the court order or agreement states that this rule applies.

Ordering rule when both spousal and child support

If both spousal support and child support are paid each year on a timely basis, the ordering rule is of little significance. However, the rule can apply if payments are not made in full in any year. In general terms, the support payments will be applied towards child support until it is paid in full before they are applied towards spousal support.

> Example
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> You are required to pay $30,000 in child support and $20,000 in spousal support annually. In year 1, you pay a total of $40,000. Only $10,000 will be deductible as spousal support (rather than $20,000) because the first $30,000 will be applied towards the non-deductible child support.
>
> If you pay $50,000 in year 2, you will be entitled to deduct $20,000 as spousal support but will not be able to deduct the $10,000 shortfall from year 1. You would be able to deduct the $10,000 shortfall and the other $20,000 of spousal support due in year 2 if you paid $60,000 in year 2.

NON-ARM'S LENGTH TRANSFERS OF PROPERTY

If you sell or transfer a property to a non-arm's length person for an amount other than its fair market value, there are onerous income tax rules that may apply. The rules are discussed below, and there is an exception for transfers to spouses and common-law partners. But first, what constitutes a non-arm's length person?

In terms of individuals, a non-arm's length person includes any person that is "related" to you under the Act. This will include people related to you by blood, marriage or adoption. The list includes your children, grandchildren, great-grandchildren and so on, your parents, grandparents etc., your siblings, your spouse or common-law partner, and your in-laws. Interestingly, it does not include cousins, aunts, uncles, nieces and nephews, but it does include a brother-in-law and a sister-in-law (including through a common-law partnership).

In terms of individuals and corporations, a non-arm's length person includes a corporation that you control. It also includes a corporation if you are a member of a "related group" that controls the corporation (e.g. you and your spouse control the corporation). Control of a corporation generally means ownership of shares that entitled you to more than 50% of the votes. A "group" means two or more persons.

In terms of corporations, they will be non arm's length in various circumstances including the following: if one controls the other; if they are controlled by the same person or group of persons; if each of the corporations is controlled by one person and the person who controls one of the corporations is related to the person who controls the other corporation; and if one of the corporations is controlled by one person and that person is related to any member of a related group that controls the other corporation.

The above is a short summary of the non-arm's length rules. There are other various combinations and situations under which persons can be considered non-arm's length.

The onerous rules

If you sell a property to a non-arm's length individual for an amount that is less than its fair market value, you will be deemed to have disposed of the property at fair market value. However, this rule is one-sided, in that the recipient's cost is whatever they paid you for the property. As illustrated below, this rule can result in double taxation.

> Example
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> You own capital property (e.g. shares, real estate) that cost you $10,000. You sell it to your sister for $20,000 when its fair market value is $50,000.
>
> You will have deemed proceeds of $50,000, and therefore a $40,000 capital gain, half of which will be included in your income as a taxable capital gain. However, your sister's cost of the property will be $20,000. Thus, if she then sells the property to a (non-related) third party for $50,000, she will have a capital gain of $30,000, which was already part of your $40,000 capital gain.

Conversely, if you buy property from a non-arm's length person for an amount that is more than its fair market value, you will be deemed to acquire it at a cost equal to its fair market value. But again, this rule is one-sided, in that the seller will have proceeds equal to whatever you paid for the property.

> Example
>
> Your sister owns capital property that cost her $10,000. You buy it from her for $50,000 when its fair market value is $20,000.
>
> Your sister's proceeds will be $50,000, so that she will have a $40,000 capital gain, half of which will be included in her income as a taxable

capital gain. However, your cost of the property will be the fair market value of $20,000. Say you sell it at a later time to an unrelated third party for $50,000. You will have a capital gain of $30,000, which was already counted in your sister's $40,000 capital gain.

Gift of property

If you give property to a person, whether they are arm's length or non-arm's length, you will normally be deemed to have received proceeds at the property's fair market value. But in this case, the recipient's cost of the property is also deemed to be the fair market value, so the double taxation issue does not arise.

Example

You own capital property that cost you $10,000. You give it to your sister when its fair market value is $50,000.

You will have deemed proceeds of $50,000, and therefore a $40,000 capital gain, half of which will be included in your income as a taxable capital gain. Your sister's cost of the property will also be $50,000. Thus, if she then sells the property to a (non-related) third party for $50,000, she will have no capital gain and there will be no double taxation.

Transfer to spouse or common-law partner

An exception applies to sales and gifts of property to your spouse or common-law partner. It also applies to a transfer of property to a former spouse or common-law in settlement of rights arising out of your marriage or common-law partnership (e.g. family law obligations).

In these cases, there is an automatic "rollover", which means you have proceeds of disposition equal to your cost amount of the property and the recipient inherits that same cost of the property. As such, there will be no tax payable on the transfer.

However, you can elect out of the rollover in your tax return for the year of transfer. If you do, the rules discussed above may apply. If there is a loss, it will often be denied as a "superficial loss", a topic which we will discuss further in a future tax letter.

Finally, note that if you give or sell property or money to a non-arm's length person for less than market value, in a year when you have a tax debt (income tax or GST/HST) owing to the CRA, and you don't pay your debt, the CRA can assess the other person for your tax debt, and can seize that property or any other assets the person has to pay your tax bill.

AROUND THE COURTS

Employer-provided parking pass included in employee's income

Generally, if an employer provides free parking for an employee at or near the place of employment, the value of the parking is considered a personal benefit and therefore included as a taxable benefit in computing the employee's income. (An exception may apply if the parking is "scramble parking", under which the parking lot has fewer parking spaces than the number of employees provided with the parking.)

In the recent Smith case, the taxpayer was a flight attendant who was given a free parking pass from his airline. The CRA assessed the taxpayer on a taxable benefit, and the assessment was upheld by the Tax Court of Canada. The taxpayer appealed the decision to the Federal Court of Appeal.

The Federal Court of Appeal agreed that the airline had good business reasons for providing the parking pass, but those reasons were irrelevant in determining whether the taxpayer received a personal benefit. Free parking was a valuable economic benefit that the taxpayer enjoyed regardless of the business decision of the airline, and also regardless of whether it was impractical for him to take public transit. The value of the parking pass was therefore included in his income.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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