

The proposed interest deductibility rules

Ludco and Stewart, (discussed in turn below) have “raised uncertainties as to how taxpayers are to treat expenses, in particular interest, in computing income from a business or property.” The government felt that these decisions “could lead to inappropriate tax results where a taxpayer derives a tax loss by deducting interest expense.” Furthermore, the decisions in these cases were “inconsistent with the appropriate tax policy” and therefore the Department of Finance (Finance) warned that draft legislation would be forthcoming by year-end.

On October 31, 2003, Finance introduced its long-awaited draft legislation on the deductibility of losses, especially losses created largely by deductible interest expense. These new rules essentially bring back the concept of “reasonable expectation of profit” (REOP) that was previously dismissed by the Supreme Court of Canada (SCC).

Before discussing the draft legislation, a quick refresher on the two seminal cases is in order.

Ludco

The Ludco decision in 2001 concerned whether the interest paid on money borrowed for the purpose of purchasing shares in an offshore corporation was deductible. During the eight years in which the taxpayers held these shares, they deducted approximately \$6 million of interest expense and received dividend income of only \$600,000. The SCC held that the taxpayers had a reasonable expectation of income from this investment notwithstanding the fact that they only received \$600,000 in dividends. The court also reviewed the wording in the Income Tax Act (Canada), which states that interest is deductible where the related borrowing was made “for the purpose of earning income.” The SCC concluded that income does not necessarily mean “profit” or “net income.” In other words, the quantum of income that was actually received was not relevant and, therefore, did not need to exceed the amount of interest paid. As a result, the taxpayers were successful in having the interest fully deductible, since one of the purposes of borrowing the money was to earn income and the amount of income earned was irrelevant.

Quebec introduces its own set of rules

On March 30, 2004, the Quebec government introduced its own set of rules that govern not only interest expense but all investment expenses.

For more information, please see our Tax & Estate InfoPage entitled, *Deductibility of expenses in Quebec*.

Stewart

In 2002, the SCC released its decision in the case of Brian Stewart. Mr. Stewart purchased four condominiums from which he earned rental income. All four condominiums were highly leveraged and projections indicated that the properties would generate negative cash flows, as well as losses, for a 10-year period before becoming profitable.

From 1990 to 1992, Mr. Stewart claimed total losses of over \$58,000 and offset those losses against other income. Losses occurred primarily as a result of significant interest expense on the money borrowed to acquire the condominiums. The Canada Revenue Agency (CRA) disallowed these losses on the basis that Mr. Stewart had no “reasonable expectation of profit” and therefore no business was being carried on. If no business existed, then business losses cannot have arisen to be claimed against other income.

The SCC found in favour of Mr. Stewart, allowing the deduction of the losses. According to the court, “the reasonable expectation of profit test should not be accepted as the test to determine whether a taxpayer’s activities constitute a source of income” (i.e., a business). Instead, the SCC introduced a two-part test that should be used to determine whether a taxpayer’s activities constitute a source of business or investment income. Step one is to ascertain whether the taxpayer’s activity is undertaken in “pursuit of profit,” or whether it’s personal. If it is not personal, then the second step is to discern whether the income earned is business or investment income.

The CRA argued that an anticipated capital gain should not be included in assessing whether a taxpayer had a reasonable expectation of profit. The SCC disagreed saying “the motivation of capital gains accords with the ordinary business person’s understanding of “pursuit of profit” and may be taken into account to determine whether the taxpayer’s activity is commercial in nature.”

As a result of Stewart, the denial of deductions by the CRA of losses generated by many tax shelters because of “no reasonable expectation of profit” was put on hold and the doctrine of REOP is dead – until 2005.

The new draft legislation

Draft legislation was introduced on October 31, 2003 and will begin to apply to individuals in 2005. Under the new rules, a taxpayer will only be allowed to deduct a loss for a given year if, in that year, it is reasonable

(discussed below) to assume that the taxpayer will realize a cumulative profit (also discussed below) from the investment during the time the taxpayer holds (or can reasonably be expected to hold) the investment. The new rules also explicitly state that profit does not include capital gains, which essentially reverses the SCC's comments in Stewart, discussed above.

Under the proposed legislation, an annual evaluation will have to be made for each year in which an investor seeks to report a loss from a business or property. For example, assume that Veronica starts a business in 2005 and realizes losses from the business in 2005, 2006, 2007 and 2008. For each of those years, the test will be whether it is reasonable, in that specific tax year, to expect that Veronica will realize a cumulative profit from the business over the whole of the profitability time period. The profitability time period begins at the time the investor acquired the property or began operating the business. The end of the profitability time period will be when the taxpayer disposes of the property or ceases to carry on the business.

If in each year from 2005 to 2007 it is determined that it is indeed reasonable to expect that Veronica will realize a cumulative profit from her business over the profitability time period, she will be entitled to deduct her losses for each of those years. If by 2008, however, Veronica feels that it is unlikely that she will realize a cumulative profit over the profitability period, the new requirements will not be met for the 2008 taxation year and the loss in 2008 will not be deductible by Veronica. Under the new rules, however, this conclusion in 2008 will not affect the previous conclusions reached from 2005 through 2007 and, as a result, Veronica's losses for each of those years remain deductible.

Cumulative profit test

Cumulative profit means the total profit over the entire profitability time period. It is thus not necessary that an investor demonstrate an actual profit in any particular year in order to be considered to have a reasonable expectation of cumulative profit.

Many business owners, for example, often realize a start-up loss from the business for one or more years before the business begins to generate a profit. The relevant test is the expectation of cumulative profit over the whole of the profitability time period, meaning that the business owner would be able to claim the loss provided his or her expectations for a cumulative profit

over the entire relevant time period were reasonable. But the question remains, what is reasonable?

Reasonability

Under the cumulative profit test above, it must be reasonable, given the facts of a particular situation, for an investor to expect to profit from the property or business. For example, Jack's purchase of rental property that produces rental revenue in excess of related rental expenses might be seen as an investment that should provide Jack with a reasonable expectation of profit. However, if Jack were to take on a large mortgage to finance the purchase of the property such that the interest expense associated with the mortgage means that Jack cannot realize a profit from the rental activity, then Jack would not have a reasonable expectation of profit from his rental property. This was the issue in the Stewart case. The difference in Stewart was that the SCC found that the opportunity for profit upon ultimate sale can be considered as part of the profit. Under the new rule, even if Jack intends to profit by reselling the rental property itself at a gain, this will not count towards cumulative profit where the gain would be considered to be a capital gain, since income from a business does not include a capital gain.

Another "unreasonable" assumption might be an investor who borrows funds at a fixed rate of 8% and uses those funds to make an investment that has a fixed annual return of 5%. Assuming that the investment itself cannot increase in value, then there is no reasonable expectation of profit and the taxpayer will not be allowed to deduct the loss. On the other hand, given that the investor may have greater expenses than he or she has in revenues generated by the investment, Finance also concedes that it would be "inappropriate" to tax any amount of that revenue. This would seem to permit the deduction of expenses up to the amount of revenue earned from the investment, but no more (i.e., a loss could not be created in this manner).

What now?

The jurisprudence before the draft legislation supported the view that as long as an investment has the potential to earn income, then interest on such borrowings should be tax deductible. The draft legislation introduces a new test: whether or not it is reasonable to expect a cumulative profit from the investment, excluding any potential capital gain on ultimate disposition.

In light of these new rules, it remains to be seen whether the same would hold true with common shares that do not pay dividends or equity mutual

funds, which investors generally invest in to earn a capital gain, and which generally only pay out capital gains distributions. Interest paid on a loan to purchase common shares and equity funds is currently tax deductible as the corporation or the mutual fund itself has the ability to distribute dividends or income. This position was confirmed in CRA's new Interpretation Bulletin (IT 533), which also was released on October 31, 2003. Whether this administrative position can still be supported in light of the proposed changes in 2005 remains to be seen.

Status of legislation

On March 23, 2004 in the federal budget, the government announced that since these proposals were released, "some commentators have... expressed concern that the proposals could have... far-reaching effects. While this is not the intention behind these proposals, a number of significant issues have been raised that deserve further consideration."

As a result, the government extended the period for making written submissions on these proposals until the end of August 2004.

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