

ADDING INSULT TO INJURY: NON-DEDUCTIBILITY OF INTEREST WHEN THE SOURCE GENERATING THE INCOME HAS DISAPPEARED

Deputy Minister of Revenue of Québec v. Richard Moufarrège
2005 SCC 53

KEYWORDS: INTEREST DEDUCTIBILITY ■ SOURCES ■ INCOME ■ REASONABLE EXPECTATION OF PROFIT

The deductibility of interest is an issue that has been raised time and again by taxpayers seeking redress against reassessments in the tax courts. The Supreme Court of Canada was recently faced with the issue again in *Deputy Minister of Revenue of Québec v. Richard Moufarrège*, this time being called upon to pronounce on the deductibility of interest paid on loans used to acquire property when the property no longer exists and thus the source of income has disappeared. Although this case was examined under the provisions of the Quebec Taxation Act,⁹ parallels can be drawn with the Income Tax Act, specifically subparagraph 20(1)(c)(i).

THE FACTS

The facts in this case are simple. The taxpayer made two investments by means of two loans. The first loan was used to acquire four units of a condominium in Vancouver with the intention of producing income. The second loan was contracted for the purpose of acquiring shares in a company ("Quebec Inc.") that developed and operated a golf course. In 1991, Quebec Inc. went bankrupt, and over the course of 1992 and 1993, the Vancouver real estate market collapsed. At that time, the taxpayer sold the condo units at a loss and directed the proceeds of disposition to the reimbursement of the loan, part of which remained outstanding.

The taxpayer claimed tax deductions corresponding to the interest paid on the remaining balance of the two loans for the years 1993, 1994, 1995, and 1996. In 1997, the minister of revenue issued notices of reassessment disallowing the deduction of the interest expenses in question, and the taxpayer appealed to the Court of Québec in an effort to contest the reassessments.

In light of subsequent changes to both Quebec and federal legislation governing borrowing in respect of capital property such as shares,¹⁰ this comment focuses mainly on aspects of the courts' decisions pertaining to the Vancouver real estate properties.

⁹ RSQ, c. I-3 (herein referred to as "the Quebec Act").

¹⁰ Section 175.2.2 of the Quebec Act, which came into force on January 1, 1994, states, "Where at any time after 31 December 1993 borrowed money ceases to be used by a taxpayer for the purpose of earning income from a capital property, other than depreciable property or immovable property, and the amount of the borrowed money that was so used by the taxpayer immediately before that time exceeds the amount determined under the second paragraph, the amount of the excess, to the extent that it is outstanding after that time, is deemed to be

THE COURT OF QUÉBEC DECISION

The Court of Québec dismissed the appeal by concluding that the taxpayer had no reasonable expectation of profit during the years 1993 through 1996 because the sources of income had disappeared.¹¹ The taxpayer was therefore not allowed to claim the interest deductions.

In rendering its judgment, the court relied on the following provisions of the Quebec Act:

80. Subject to this Part, a taxpayer's income from a business or property is his profit therefrom.

128. A taxpayer may deduct, in computing his income from a business or property for a taxation year, only the outlays or expenses made or incurred by him during such year or payable in respect of such year, to the extent that they may reasonably be regarded as being related to such business or property and that they were made or incurred to gain income from such business or property and to the extent provided in this chapter, unless otherwise provided in this Part.

160. A taxpayer may deduct the lesser of a reasonable amount and the amount paid in the year or payable in respect of the year, depending on the method that he regularly follows in computing his income, pursuant to a legal obligation to pay interest on:

(a) a loan used to earn income from a business or property.

While the court stated that the legal obligation to pay the interest was not in question, it contended that the taxpayer could not prove that the loan was used to earn income from property, in light of the fact that the source of income relating to the loan had disappeared.

In its determination regarding the deductibility of the interest payments, the court purported to follow the principles set out in *Bronfman Trust*, which found that a taxpayer cannot continue to deduct interest payments on the basis that the original use of the borrowed money was to purchase income-producing assets,

borrowed money used by the taxpayer for the purpose of earning income from the property.” An equivalent federal provision (for all intents and purposes), section 20.1 of the Income Tax Act, also came into force by technical bill on January 1, 2004. If the facts of this case were brought before a court today, section 175.2.2 would apply to the shares of Quebec Inc. because they would be capital property. There would therefore be no debate over the deductibility of the interest payments related to the loan used to acquire the shares, because the portion of the borrowed money that was lost would be deemed by the statute to have been used for the purpose of earning income. Unfortunately for the taxpayer in this case, his shares were disposed of in 1991 and were therefore not subject to the new provision. With respect to the federal legislation, in CRA document no. 9502635, February 22, 1995, the CRA confirmed that the new rules apply where the loss of source of income occurs after 1993, whether or not the taxpayer has continuing debt obligations relating to a lost source that extend through 1994 and after.

¹¹ [2002] JQ no. 909 (CQ).

once he has “sold those assets and put the proceeds of sale to an ineligible use.”¹² The court also added the following quotation from *Bronfman Trust*: “A continuing obligation to make interest payments to the creditor therefore does not conclusively demonstrate that the borrowed money has a continuing use for the taxpayer.”¹³

Relying on its interpretation of the *Bronfman Trust* case and sections 80, 128, and 160 of the Quebec Act, the court disallowed the deduction of the interest payments on the basis that the properties were no longer in existence. The condominium units having been disposed of, there was no reasonable expectation of profit subsequent to the sale. The loan therefore related to a source of income that no longer existed.

THE QUEBEC COURT OF APPEAL DECISION

The Court of Appeal reversed the lower court’s decision and set aside the notices of reassessment. Drawing on several precedents, including *Stewart v. The Queen*,¹⁴ *Ludco Enterprises Ltd. v. The Queen*,¹⁵ and *Shell Canada Ltd. v. The Queen*,¹⁶ the court concluded that the facts in this case did not call for an inquiry into the capacity of the real estate properties to produce income.

Adapting the requisite elements of interest deductibility in paragraph 20(1)(c) of the Income Tax Act, as summarized in *Shell Canada*,¹⁷ to the wording of the Quebec Act, Rochon J restated these rules as follows:

- (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 to earn non-exempt income from a business or property;
- (4) the amount must be reasonable, as assessed by reference to the first three requirements.¹⁸

The court identified the issue in this case as relating solely to the third point and suggested that it be approached from two angles. First, after the sale of the property purchased with the borrowed funds, is the taxpayer required to reinvest the proceeds of disposition in another eligible-use property in order to benefit

12 *The Queen v. Bronfman Trust*, 87 DTC 5059, at 5064; [1987] 1 CTC 117, at 125 (SCC).

13 *Ibid.*, at 5065; 126.

14 [2002] 2 SCR 645.

15 [2001] 2 SCR 1082.

16 [1999] 3 SCR 622.

17 *Ibid.*, at paragraph 28.

18 *Moufarrège c. Québec (Sous-Ministre du Revenu)*, [2004] RJQ 1117, at paragraph 19 (CA) (translation).

from the interest deduction? Second, is the taxpayer required to establish the existence of the source of income and its capacity to generate income in each year for which the deduction is sought?

With respect to the obligation to reinvest, the court cited the Supreme Court's decision in *Ludco*, which concluded that "the ability to deduct interest is not lost simply because the taxpayer sells the income-producing property, as long as the taxpayer reinvests in an eligible use property."¹⁹ However, the court opined that this rule may be of limited use in the present case, because the taxpayer applied all of the proceeds from the disposition of the condo units against the amount outstanding on the loan used for the original acquisition. In such circumstances, the question of whether the proceeds were reinvested in another eligible-use property is meaningless.

The court therefore proceeded to analyze the case from the second angle, the continued existence of an income-producing source. Falling back on the two-prong test set out in *Stewart*,²⁰ the court took the position that the question as to the existence of a source of income applies only at the time the original investment is made. If the taxpayer satisfied the conditions of section 160 of the Quebec Act at that time, the issue of interest deductibility in a given year must be distinguished from the analysis of the original source of income. In support of this position, the court relied on the following passage from *Stewart*:

It is clear . . . that the deductibility of expenses presupposes the existence of a source of income, and should not be confused with the preliminary source inquiry. If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, but the relationship between that expense and the source to which it is purported to relate.²¹

The court concluded that it does not matter whether a source is income-producing in a given year. The only factor to consider is whether the link between the interest expense and the property it relates to has been maintained from the beginning. Since the taxpayer never reinvested the loan for another use, the link to the original use of the loan remained, and there was no reason to inquire into the capacity of the properties to produce income. For this reason, the court held that the interest expenses were deductible despite the fact that there was no actual source of income during the taxation years in question.

THE SUPREME COURT OF CANADA DECISION

The Supreme Court disagreed with the Court of Appeal and restored the Court of Québec's ruling. In a seven-paragraph oral judgment, Deschamps J maintained that

19 Supra note 15, at paragraph 74, quoting *Tenant v. MNR*, [1996] 1 SCR 305, at paragraph 20.

20 Supra note 14, at paragraph 50.

21 Ibid., at paragraph 57.

Bronfman Trust clearly established that the relevant factor in determining interest deductibility is the current use rather than the original use of the funds to which the interest payments relate. Deschamps J then added that “*Stewart* . . . did not alter the principle that when a reasonable expectation of income disappears, so does the right to a deduction.”²²

The court held that the loan to which the interest payments related was no longer being used for the purpose of earning income in accordance with sections 128 and 160 of the Quebec Act. The court maintained that the source of income no longer existed in the taxation years subsequent to the sale of the condo units. Therefore, the taxpayer was not allowed to deduct the interest payments for the years 1993 through 1996.

Unfortunately, the Supreme Court’s ruling appears to be based on a rather narrow interpretation of its own precedents. While *Bronfman Trust* did in fact lay down the rule of current use rather than original use as the determining factor for deductibility, the Supreme Court had done so in the context of eligible versus ineligible uses of the loans. The question before the court was whether a change in the use of a loan would nonetheless allow for continued interest deductibility. In Dickson CJ’s words, “[t]he statutory deduction thus requires a characterization of the use of borrowed money as between the eligible use of earning non-exempt income from a business or property and a variety of possible ineligible uses.”²³ As a matter of fact, Dickson CJ specifically stated, “A taxpayer cannot continue to deduct interest payments merely because the original use of borrowed money was to purchase income-bearing assets, after he or she has sold those assets and put the proceeds of sale to an ineligible use.”²⁴

In the *Moufarrège* case, there was no change in the use of the loan used to acquire the income-producing properties. As Rochon J of the Court of Appeal correctly stated, “the loan [was] contracted in order to acquire condominium units. . . . The purpose of the loan was never altered for an ineligible use.”²⁵ Therefore, it is not necessary to apply the *Bronfman Trust* principle, and the issue of current versus original use is irrelevant.

Moreover, while the Supreme Court in *Stewart* upheld the reasonable expectation of profit test, it clearly established the point at which this test is to be used. The court proposed in its two-stage approach that the reasonable expectation of profit test be applied at the first stage, which consists of determining whether the taxpayer’s activity is undertaken in pursuit of profit or as a personal endeavour. The test is therefore used solely for the purpose of assessing whether a source of income exists, the ultimate objective of which is to distinguish between commercial and

22 *Deputy Minister of Revenue of Québec v. Richard Moufarrège*, 2005 SCC 53, at paragraph 4.

23 *Supra* note 12, at 5064; 124.

24 *Ibid.*, at 5064; 125.

25 *Supra* note 18, at paragraph 42 (translation).

personal activities. In fact, the court asserted that the pursuit of profit source test requires analysis only “where there is some personal or hobby element to the activity in question.”²⁶

In *Moufarrège*, in arguing the minister’s position, the Crown never claimed that the taxpayer had any intention other than purely commercial purposes for acquiring the condominium units. The reasonable expectation of profit test from *Stewart* was therefore questionably applied by Deschamps J. Indeed, her suggestion that the right to deduction ceases with the disappearance of the expectation of profit implies that, according to the principles of *Stewart*, the taxpayer’s original use of the loan was personal in nature. This was clearly not the case in *Moufarrège*.

The most relevant excerpt from *Stewart* is the following passage, which was appropriately quoted by Rochon J: “If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, but the relationship between that expense and the source to which it is purported to relate.”²⁷ The link between the loan and the income-producing properties was at all times maintained. The fact that these sources of income ceased to exist did not alter the nature or the use of the loan in respect of which the interest deduction was sought.

It is worth mentioning that while section 175.2.2 of the Quebec Act and subsection 20.1(1) of the Income Tax Act evidently provide some relief,²⁸ these provisions nonetheless clearly differentiate between capital property that is not depreciable or real immovable property and capital property that is. In the case at hand, although the Supreme Court disallowed the deductibility of the interest relating to the loan used to purchase the shares of Quebec Inc. for the same reasons as the interest relating to the condominium units, it would have rendered a contrary judgment in respect of the shares had these provisions been in force at the time the shares were disposed of. Consequently, the law seems to favour certain types of investments over others; that is, it appears that the continued deductibility of interest in the context of the disappearing source rules would apply only to property such as shares, bonds, debentures, and partnership units and interests.²⁹

It has been suggested that these provisions were introduced “in response to decisions in the courts that have been characterized as ‘unduly harsh’ and perceived as discouraging risk-taking and entrepreneurial activity.”³⁰ It is not contested that section 20.1 did indeed overturn the non-deductibility established in the prior case

26 *Supra* note 14, at paragraph 53.

27 *Ibid.*, at paragraph 57.

28 See *supra* note 10.

29 Ryan Chang and Jane Briant, “Interest Deductibility: New Loss of Source of Income Rules,” *Personal Tax Planning* feature (1995) vol. 43, no. 1 *Canadian Tax Journal* 154-76, at 162.

30 *Ibid.*, at 154 (abstract).

law.³¹ Nevertheless, the exclusion from this provision of depreciable and real immovable property is questionable, and it is not clear why the law makes this distinction.³²

In conclusion, there is no doubt that it may seem illogical to continue deducting interest expenses when there is no further income being generated. Nevertheless, if a loan is used to acquire income-generating property and that use is not altered, it can be argued that the interest expense is incurred for the purpose of producing income. As long as the taxpayer does not subsequently apply the borrowed money to an ineligible use, he should be permitted to claim the interest deductions on an outstanding loan that he has the obligation to repay even in circumstances involving an unsuccessful venture. It seems appropriate to recall Linden J's statement in *Tonn et al. v. The Queen*: "[D]o the Act's purposes suggest that the deductions of losses from *bona fide* businesses be disallowed solely because the taxpayer made a bad judgment call? . . . The tax system does not tax on the basis of a taxpayer's business acumen, with deductions extended to the wise and withheld from the foolish."³³

The Supreme Court's decision added insult to injury in the *Moufarrège* case. Not only did the taxpayer suffer from bad investments in real estate resulting in monetary losses, but he was, in addition, denied the right to deduct the interest owing on the outstanding balance of the loan used to acquire those loss-producing investments.

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31 The leading case was *Emerson v. The Queen*, 85 DTC 5236, at 5237; [1985] 1 CTC 324, at 326 (FCTD), which upheld that "[a]n essential requirement . . . of any deduction on account of interest pursuant to 20(1)(c) is the existence of the source to which the expense relates and if the source has been terminated, . . . the interest expense is no longer deductible. The continuing obligation to meet the interest costs of an outstanding loan, after the source has been extinguished, is not relevant."

32 In light of this favourable treatment, perhaps emphasis should be placed on tax-planning strategies; for example, the interest in question would apparently be deductible if a taxpayer owned depreciable or real immovable property through a corporation and disposed of the shares once the corporation lost this source of income. It should be noted, however, that while subsection 20.1(2) does provide for the deductibility of interest relating to a lost source of income from depreciable and real immovable property, the property must be used in a business.

33 96 DTC 6001, at 6009; [1996] 1 CTC 205, at 219 (FCA).