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PRINCIPAL ISSUES: Whether interest on funds borrowed to finance a share repurchase for cancellation is deductible under the "fill-the-hole" theory.

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AUTHOR Friedlander, Lara G.

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Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: Whether interest on funds borrowed to finance a share repurchase for cancellation is deductible under the "fill-the-hole" theory.

POSITION: Yes.

REASONS: Long-standing Rulings position.

January 29, 2016

David Paradis HEADQUARTERS

Senior Technical Specialist Income Tax Rulings

Compliance Programs Branch Directorate

Legislative Application Section Lara Friedlander

Large Business Audit Division (416) 952-7343

2015-062140

Deductibility of Interest on Funds Borrowed to Repurchase Shares

This is in response to your email of December 2, 2015 regarding the deductibility under the Income Tax Act (Canada) (the “Act”) of interest on funds borrowed to repurchase shares.

1. XXXXXXXXXX (“Canco”) is a taxable Canadian corporation. Its common shares (the “Common Shares”) are listed on the XXXXXXXXXX.

2. In XXXXXXXXXX Canco repurchased (the “Repurchases”) significant numbers of Common Shares on the open market. We assume for the purposes of this memo that the Repurchases qualified for treatment under paragraph 84(6)(b) of the Act, to the extent relevant.

3. Canco financed the Repurchases (and other items) by issuing interest-bearing notes (the “Notes”) to the public.

4. The Common Shares have been cancelled.

In respect of the deductibility of interest on the Notes, you have asked whether a share repurchase for cancellation (in contrast to a share redemption or return of capital) qualifies for “fill-the-hole” treatment as described in paragraph 1.48 of Folio S3-F6-C1, Interest Deductibility. We are to assume that all the other requirements for “fill-the-hole” treatment (including the use of the capital associated with the Common Shares that were repurchased) are satisfied.

Comments

The “fill-the-hole” concept is described in paragraph 1.48 of Folio S3-F6-C1, which states as follows:

Interest expense on borrowed money used to redeem shares or return capital can be an exception to the direct use test. In connection with this use, the purpose test will be met if the borrowed money replaces capital (contributed capital or accumulated profits) that was being used for eligible purposes that would have qualified for interest deductibility had the capital been borrowed money.

The concern raised is that paragraph 1.48 refers to a redemption of shares but does not refer to a repurchase of shares for cancellation. (We note that former Interpretation Bulletin IT-80 and former Interpretation Bulletin IT-533 also did not reference repurchases of shares for cancellation.) It is our view that the fact that a share repurchase takes place outside the terms of the shares generally would not be relevant to the rationale for the fill-the-hole theory, namely that the borrowed funds are replacing capital previously used to earn income from a business or property. Therefore, we consider that the CRA’s position in paragraph 1.48 of Folio S3-F6-C1 that relates to a redemption of shares would also apply to a repurchase of shares for cancellation.

We note that Rulings has a long-standing position that the fill-the-hole theory would apply to share redemptions. In Rulings document 9700373 (XXXXXXXXXX) the Agency provided a ruling that interest on borrowed funds to redeem shares is deductible:

“Provided that the total of the "accumulated profits" of XXXXXXXXXX plus the paid-up capital, within the meaning of that term in subsection 89(1) of the Act, of the shares of XXXXXXXXXX owned by XXXXXXXXXX immediately prior to the redemption of those shares is equal to or greater than the amount paid upon the redemption of those shares, the interest expense on the borrowed funds which are used to redeem those shares will be deductible pursuant to paragraph 20(1)(c) of the Income Tax Act in computing the income of XXXXXXXXXX for the taxation year in respect of which such expense is paid or payable, depending on the method regularly followed by XXXXXXXXXX in computing its income; and

"accumulated profits" in this ruling means the retained earnings of XXXXXXXXXX computed in accordance with accounting principles generally accepted in Canada except that the computation is made on an unconsolidated basis with investments accounted for on a cost basis and those retained earnings do not include any appraisal surplus or profits resulting from non-arm's length transactions which transform appraisal surplus into profits on a non-taxable or tax-deferred basis."

In Rulings document 2000-005547, we stated:

"As for a share redemption, a corporation may borrow to the extent of the stated capital of those shares and the accumulated profits or retained earnings that are utilized to effect the redemption…. A corporation may borrow to redeem shares issued on a transaction that was subject to an election under section 85 of the Act, to the extent of the stated or paid in capital of those shares as determined under the relevant corporate law plus the accumulated profits or retained earnings that are utilized to effect the redemption."

We trust that these comments will be of assistance.

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G. Moore

for Director

International Division

Income Tax Rulings Directorate

Legislative Policy and Regulatory Affairs Branch

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