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Canada Revenue Agency

Income Tax Folio

S3-F6-C1, Interest Deductibility

Series 3: Property, Investments, and Savings Plans

Folio 6: Interest

Chapter 1: Interest Deductibility

Summary

The purpose of this Chapter is to explain the Canada Revenue Agency's (CRA) position on the deductibility of interest expense under paragraph 20(1)(*c*). The Chapter also discusses various other provisions of the Act relating to interest deductibility.

An amount is considered to be interest if, in general terms:

• it represents compensation for the use of money;
• it is referable to a principal sum; and
• it accrues day-to-day.

Generally, interest expense is considered to be a capital expenditure and is not deductible unless it meets specific requirements of the Act, such as those contained in paragraph 20(1)(*c*). Among other specific requirements is the requirement that:

• an amount be paid in the year or be payable in respect of the year under a legal obligation to pay interest; and
• an amount be reasonable,

Where money is borrowed, the **use** of the money must be established and the **purpose** of that use must be to earn income. Borrowed money used to acquire a life insurance policy or property the income from which would be exempt will not qualify. The term **use** refers to the current use of the borrowed money and in certain situations may include indirect use. Where an amount is payable for property acquired, the property must have been acquired for the purpose of earning income (other than exempt income or to acquire an interest in certain life insurance policies).

This Chapter does not address other tax consequences arising from transactions that are not directly related to the deductibility of interest expense.

The CRA issues income tax folios to provide technical interpretations and positions regarding certain provisions contained in income tax law. Due to their technical nature, folios are used primarily by tax specialists and other individuals who have an interest in tax matters. While the comments in a particular paragraph in a folio may relate to provisions of the law in force at the time they were made, such comments are not a substitute for the law. The reader should, therefore, consider such comments in light of the relevant provisions of the law in force for the particular tax year being considered.

Discussion and interpretation

General

What is interest?

1.1 Interest is not defined in the Act but has been addressed in several court decisions, including Shell Canada Limited v The Queen, [1999] 3 SCR 622, 99 DTC 5669; The Queen v Sherway Centre Ltd. , [1998] 2 CTC 343, 98 DTC 6121 (FCA); and *Miller v The Queen* , [1985] 2 CTC 139, 85 DTC 5354 (FCTD). As in *Miller*, interest for tax purposes is generally accepted to mean an amount that has met three criteria. The amount must be:

• calculated on a day-to-day accrual basis;
• calculated on a principal sum (or a right to a principal sum); and
• compensation for the use of the principal sum (or the right to the principal sum).

Participating payments as interest

1.2 Payment of an amount that is computed by reference to profit, revenue, cash flow or similar factors (often referred to as a **participating payment**), is not generally considered interest. An investor's return on equity is generally dependent on and computed with reference to profitability. Interest, on the other hand, which represents the cost of borrowing and is a lender's return on debt, is primarily dependent on prevailing market rates for debts with similar terms and credit risks.
1.3 However, consistent with *Sherway Centre*, participating payments may qualify as **interest** within the meaning of paragraph 20(1)(*c*) where:

a) the payment is limited to a stated percentage of the principal (or the facts show that the payments are intended to increase the interest rate on the loan to the prevailing market rate);

b) the limiting percentage of the principal, if any, reflects prevailing arm's-length commercial interest rates; and

c) no other facts indicate the presence of an equity investment.

1.4 In relation to (c) above, the CRA requires that there be no indication that participating payments are, in reality, a distribution of profit.

1.5 It should be noted that participating payments are not deductible under paragraph 20(1)(*e*) as an expense incurred in the course of borrowing money, on the basis that they constitute an **excluded amount** under subparagraph 20(1)(*e*)(iv.1).

Deemed interest - section 16

1.6 Where a contract or arrangement does not explicitly identify any amount as interest but an amount can reasonably be regarded as interest, that amount is deemed to be interest by section 16. Accordingly, both parties to the contract would treat that amount as interest for income and expense purposes.

See ¶1.94 – 1.95 for additional information on section 16.

Interest as an outlay on account of income or capital

1.7 Whether interest is an outlay on account of income or capital has been considered by the Supreme Court of Canada in various decisions, including *Canada Safeway Ltd. v MNR*, [1957] SCR 717, 57 DTC 1239; The Queen v Bronfman Trust , [1987] 1 SCR 32, 87 DTC 5059; Tennant v The Queen , [1996] 1 SCR 305, 96 DTC 6121; *Shell* and Gifford v The Queen , 2004 SCC 15, 2004 DTC 6120. Generally, the Supreme Court of Canada has considered interest to be an outlay on account of capital.

1.8 An outlay on account of capital is precluded from deduction by paragraph 18(1)(*b*), unless expressly permitted under another provision in Part I of the Act. Paragraph 20(1)(*c*) permits the deduction of interest on borrowed money used for certain purposes (see ¶1.10). Interest on account of capital is deductible provided the requirements of paragraph 20(1)(*c*) are met and the deduction is not otherwise precluded by another provision of the Act.

1.9 The CRA continues to accept that taxpayers in certain financing businesses (such as money-lenders), may consider interest expense for borrowed money that constitutes stock-in-trade to be on account of income that may be deducted under section 9. See ¶1.93 for other instances where the CRA will accept the treatment of interest on account of income.

Paragraph 20(1)(*c*) - The legislation

1.10 Subsection 20(1) provides that, in computing a taxpayer's income from a business or property, there may be deducted certain amounts described in that subsection as are applicable to that source of income. Among them, paragraph 20(1)(*c*):

20(1)(*c*) - "an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on:

(i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),

(ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),

(iii) …, or

(iv) …,

or a reasonable amount in respect thereof, whichever is the lesser"

1.11 This Chapter focuses primarily on the CRA's interpretation of, and the deductibility of interest under, subparagraphs 20(1)(*c*)(i) and (ii). Subparagraphs 20(1)(*c*)(iii) and (iv) are briefly discussed in ¶1.66 - 1.68.

Paragraph 20(1)(*c*) pre and post-amble

1.12 In order to deduct interest expense under paragraph 20(1)(*c*), certain requirements arising from the wording in the pre and post-amble must be met. These requirements may be described as follows:

• the amount must be paid in the year or be payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income) pursuant to a legal obligation to pay interest (see ¶1.13 – 1.18); and
• the deduction for interest must not exceed the lesser of the actual amount and a reasonable amount (see ¶1.20).

Paid in the year or payable in respect of the year pursuant to a legal obligation to pay interest

1.13 To be eligible for deduction under paragraph 20(1)(*c*), an amount must be "paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income) pursuant to a legal obligation to pay interest". Taxpayers using the cash method should deduct interest paid in the year. Taxpayers using the accrual method should deduct interest that has accrued in respect of that year.

1.14 Generally, a taxpayer incurs an expense when:

• the taxpayer has a legal obligation to pay a sum of money; and
• the liability is absolute and non-contingent.

An obligation to pay an amount will not be contingent only by reason of the fact that the payment has been deferred until a future date. However, it will be contingent if the existence of the obligation depends on whether a future event occurs.
1.15 Interest arising in respect of a borrowing will not be considered contingent by reason only of the fact that there is limited recourse with respect to the security provided to obtain that borrowing.

1.16 In addition to the requirements under paragraph 20(1)(*c*), section 143.4 may also affect deductibility for tax years ending on or after March 16, 2011. Section 143.4 applies where a taxpayer has a right to reduce or eliminate the amount that is required to be **paid** in respect of an expenditure. The amount of the expenditure that may be reduced under the right at a particular time by the taxpayer, or another taxpayer not dealing at arm's length with the taxpayer, is defined to be a **contingent amount** for purposes of section 143.4.

1.17 The effect of section 143.4 is to reduce the amount of an expenditure that would otherwise be deductible or recognized in a year for income tax purposes by the contingent amount. A right to reduce or eliminate an amount will exist, among other instances, where a right is contingent upon the occurrence of an event, if it is reasonable to conclude that the right will become exercisable. Accordingly, interest payable under an original obligation that is in excess of a lower amount that a taxpayer could elect to pay, cannot be deducted for income tax purposes until the interest is paid.

1.18 Where a taxpayer's expenditure has been reduced because of section 143.4 and the taxpayer later pays all or a portion of the contingent amount, the taxpayer will be considered to have incurred the previously reduced expenditure to the extent it was paid. Pursuant to subsection 143.4(3), the portion of the contingent amount paid by the taxpayer in the particular year for the purpose of earning income, and to that extent only, is deemed:

- to have been incurred by the taxpayer in the particular year;
- to have been incurred for the same purpose and to have the same character as the expenditure so reduced; and
- to have become payable by the taxpayer in respect of the particular year.

Compound interest

1.19 Paragraph 20(1)(*d*) requires that taxpayers deduct compound interest on a cash basis. Compound interest is discussed in more detail in ¶1.81 – 1.83.

Reasonable amount

1.20 The amount of interest deductible under paragraph 20(1)(*c*) is limited to the lesser of the actual amount and a reasonable amount. To determine whether an interest rate is reasonable, the prevailing market rates for debts with similar terms and credit risks should be considered as well as the existence of any issue premiums (see ¶1.96). Further, as stated in *Shell*, "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...".

Subparagraph 20(1)(*c*)(i)

1.21 The terms borrowed money, purpose, income and used in subparagraph 20(1)(*c*)(i) have been interpreted by the CRA and the courts and their meanings established for purposes of the deductibility of interest expense. These terms are discussed in the paragraphs that follow.

Borrowed money

1.22 For purposes of the Act, the term **borrowed money** is defined at subsection 248(1) to include, "the proceeds to a taxpayer from the sale of a post-dated bill drawn by the taxpayer on a bank" (otherwise generally referred to as a banker's acceptance). In general terms, a banker's acceptance is a negotiable commercial draft (that is, a written instruction to make payment) that has been accepted by a borrower's bank. Interest on a banker's acceptance will therefore be considered interest on **borrowed money** within the meaning of paragraph 20(1)(*c*).

1.23 In *MNR v T. E. McCool Limited*, [1949] CTC 395, 49 DTC 700 (SCC), it was noted that for income tax purposes the term borrowed money is interpreted to require "a relationship of lender and borrower between the parties". A requirement of any lender and borrower relationship is the existence of a loan outstanding between the two parties.

1.24 The unpaid purchase price of property is not borrowed money, but "an amount payable for property". Case law has clearly established a distinction between the unpaid purchase price of property and a loan. The unpaid purchase price of property is a debt that does not result from a loan, as confirmed by the Federal Court of Appeal in Autobus Thomas Inc. v The Queen , [2000] 1 CTC 3, 2000 DTC 6299. The unpaid purchase price of property implies a seller-purchaser relationship, while a loan requires the creation of a lender-borrower relationship and involves the borrowing of money. Interest expense arising on the unpaid purchase price of property may only be deducted under subparagraph 20(1)(*c*)(ii) (see ¶ 1.62 - 1.65).

Purpose test

1.25 Under subparagraph 20(1)(*c*)(i), for interest to be deducted, it must be on "borrowed money used for the purpose of earning income from a business or property". Whether the purpose test is met in a particular situation is a question of fact.

1.26 The interpretation of the term **purpose** was addressed by the Supreme Court of Canada in Ludco Enterprises Ltd. et al. v The Queen , 2001 SCC 62, 2001 DTC 5505 as follows:

... [T]he requisite test to determine the purpose for interest deductibility under s. 20(1)(*c*)(i) is whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made.

With regard to purpose, the court also stated:

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.

Income

1.27 It is a further requirement of subparagraph 20(1)(*c*)(i) that to be deducted, interest be payable on borrowed money used for the purpose of earning **income** from a business or property. The interpretation of the term **income** was addressed in *Ludco* as follows:

... [I]t is clear that "income" in s. 20(1)(*c*)(i) refers to income generally, that is, an amount that would come into income for taxation purposes, not just net income.

The court also said:

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.

See ¶1.69 for additional comments regarding the income-earning purpose test.

Use of borrowed money

1.28 Subparagraph 20(1)(*c*)(i) requires that to be deducted, interest be payable on borrowed money **used** for the purpose of earning income from a business or property. The interpretation of the term **used**, and in particular whether **used** means **directly used** or **indirectly used** and whether **used** means **first used** or **currently used**, is discussed below.

Direct or indirect use

1.29 In *Bronfman Trust*, the Supreme Court of Canada stated that, "[t]he text of the Act requires tracing the use of borrowed funds to a specific eligible use...." The SCC also stated that, "[t]he onus is on the taxpayer to trace the borrowed funds to an identifiable use which triggers the deduction." In *Shell*, the Court described the test by saying that, "[i]f a direct link can be drawn between the borrowed money and an eligible use...," then the money was used for the purpose of earning income from a business or property. In addition, "[i]nterest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use...."

1.30 In The Queen v. Singleton, 2001 SCC 61, 2001 DTC 5533, the Supreme Court of Canada stated, "It is now plain from the reasoning in *Shell* that the issue to be determined is the direct use to which the borrowed funds were put." The Court held that "...it is an error to treat this [a sequence of transactions] as one simultaneous transaction. In order to give effect to the legal relationships, the transactions must be viewed independently."

1.31 The SCC commentary in these cases means that the test to be applied is the direct use of the borrowed money. In certain circumstances, however, the courts have stated that indirect use will be accepted as an exception to the direct use test. See ¶1.45 – 1.58 for a further discussion of the direct use exceptions.

1.32 In determining what borrowed money has been used for, the onus is on a taxpayer to trace or link the borrowed money to a specific eligible use, giving effect to the existing legal relationships.

Restructuring borrowings

1.33 A taxpayer may restructure borrowings and the ownership of assets to meet the direct use test.

Example 1

Ms. A owns 1,000 shares of X Corp., a corporation listed on the TSX. Ms. A also owns a personal use condominium that was financed with borrowed money. At this point, the direct use of the borrowed money was to acquire the condominium. Ms. A may choose to sell the 1,000 shares of X Corp., use the proceeds from the sale of these shares for any purpose, including paying down the borrowed money used to acquire the condominium, and subsequently obtain additional borrowed money to acquire another 1,000 shares of X Corp. At this point, the additional borrowed money is directly used to acquire 1,000 shares of X Corp.

Cash damming

1.34 Taxpayers may segregate (typically in separate accounts) funds received from borrowed money and funds received from other sources. Funds from other sources might include funds received from operations or other sources that are otherwise not linked to money previously borrowed. This fund segregation commonly referred to as cash damming, makes it easier for taxpayers to trace borrowed money to specific uses.

Example 2

B Corp. establishes two accounts with its financial institution. The only deposits to account X are those consisting of borrowed money. All other deposits (from operations, etc., and that are not linked to money previously borrowed) are made to account Y. B Corp. ensures that all payments from account X are for expenditures for which the conditions for interest deductibility are clearly met. Some expenditures from account Y would not give rise to a deduction for interest if borrowed money had been used to make them. Although some expenses of B Corp. would be for uses that would not otherwise allow for a deduction for interest, the borrowed money is for specific eligible uses and the taxpayer can clearly demonstrate those uses.

First use or current use

1.35 Several decisions of the Supreme Court of Canada, notably *Canada Safeway*, *Bronfman Trust* and *Shell*, have made it clear that the relevant use is the **current use** and not the original use of borrowed money. In determining the current use of borrowed money, taxpayers must establish a link between the money that was borrowed and its current use.

Tracing/linking borrowed money to its current use

1.36 In simple situations where one property is replaced with another, linking the original borrowing with its current use is straightforward. The current use of the borrowed money is linked entirely to the replacement property since all the proceeds of disposition from the original property are reinvested in the replacement property, as was the case in *Tennant*.

1.37 As a result, where one income source is disposed of and the proceeds are used to acquire another income source, interest on the borrowed money that was used to acquire the first income source will continue to be deductible to the extent that the borrowing is reflected in the cost of the new income source.

Example 3

Mr. A borrowed money to acquire property X for use as an income-earning property. Mr. A subsequently disposed of property X. All of the proceeds from that disposition were used to acquire property Y. The current use of the entire amount of borrowed money is with respect to property Y, as was the finding in *Tennant*. Accordingly, if all of the requisite deductibility tests are met with respect to property Y, all of the interest would be deductible with respect to that use. However, if the current use of the borrowed money is not to earn income, the disappearing source rules (discussed in ¶1.41) may be applicable.

1.38 In situations where property acquired with borrowed money is replaced with more than one property, a flexible approach to linking is permitted, as applied, for example, in *Ludco*. Under the flexible approach to linking, taxpayers are entitled to allocate, on a dollar for dollar basis, the outstanding borrowed money to the value of the replacement properties acquired.

Example 4

Ms. A acquired property X with $100,000 of borrowed money, the entire amount of which remains outstanding. Ms. A subsequently disposed of property X for $100,000 and used the proceeds of disposition to acquire property Y for $60,000 and property Z for $40,000. In linking the borrowed money to its current use, 60% ($60,000/$100,000) would be allocated to property Y and 40% to property Z.

Example 5

B Corp. acquired property X with $1,000,000 of borrowed money, the entire amount of which remains outstanding. B Corp. subsequently disposed of property X for $1,500,000 and used the proceeds of disposition to acquire property Y for $1,200,000 and property Z for $300,000.

Under the flexible approach to linking, B Corp. may choose that the current use of the borrowed money is entirely for property Y, since the value of property Y exceeds the outstanding amount of borrowed money ($1,000,000). Alternatively, B Corp. could choose to allocate $300,000 of the current use of the borrowed money to property Z (and consequently the remaining $700,000 to property Y).

1.39 However, where the value of the replacement properties is less than the amount of borrowed money outstanding, a pro-rata allocation of the borrowed money based on the relative value of each property would be required.

Example 6

Assume property X from Example 5 (which was acquired with $1,000,000 of borrowed money) was disposed of for $800,000. The proceeds of disposition were used to acquire property Y for $600,000 and property Z for $200,000. The current use of the borrowed money would be $750,000 (that is, $600,000/$800,000 × $1,000,000) for property Y and $250,000 for property Z.

1.40 Where a corporation reduces the paid-up capital of certain shares in order to return a portion of the shareholder’s initial investment, any interest on borrowed money used by the shareholder to acquire the shares will only be deductible to the extent that the proceeds from the return continue to be used for eligible purposes.

Example 7

In 2007, Mr. A purchases 100 common shares of X Corporation for $100. In 2009, Mr. A borrows $1,000 from a financial institution and uses the borrowed money to purchase 50 new common shares of X Corporation. Following the purchase, Mr. A holds 150 common shares of X Corporation with an adjusted cost base and stated capital of $1,100. In 2013, Mr. A receives a payment of $1,000 representing a reduction of the stated capital of the common shares of X Corporation. Immediately after this reduction, the adjusted cost base and the stated capital of Mr. A’s 150 common shares is $100 and the fair market value of the shares is $4,000. Mr. A does not use the $1,000 received from the corporation to repay the loan immediately to the financial institution, but instead uses the $1,000 for an ineligible use.

As noted in ¶1.35, in determining the current use of borrowed money, taxpayers must establish a link between the money that was borrowed and its current use. In this example, there is a direct link between the borrowed money and funds received by Mr. A as a return of capital from X Corporation. Interest expenses arising on the $1,000 loan following the return of capital of the same amount would not be deductible by Mr. A because the funds received were not used for eligible purposes.

Disappearing source rules

1.41 In general terms, the disappearing source rules in section 20.1 apply where borrowed money ceases to be used for the purpose of earning income from a capital property (other than real or immovable property or depreciable property), and the borrowed money can no longer be traced to any income earning use. Generally, under these rules, the borrowed money that is no longer linked to any income-earning use is nonetheless deemed to be used for the purpose of earning income. This enables interest on this amount to continue to be deductible. Several specific conditions in section 20.1 must be met for that section to apply.

Example 8

Mr. A borrows $100,000 to purchase an income-earning property. The entire amount of the loan remains outstanding and interest on the loan is deductible. Mr. A subsequently disposes of the property for its fair market value, now down to $60,000. He uses the $60,000 to reduce the outstanding loan. If the conditions in section 20.1 are met, the remaining $40,000 loan balance will be deemed to be used for the purpose of earning income and interest arising on the loan will continue to be deductible.

Tracing/linking when cash and borrowings are commingled

1.42. When the cash damming technique described in ¶1.34 is not followed or is not available, borrowed money might be commingled with other cash in one account. In such situations, tracing/linking is problematic since cash is fungible and taxpayers are unable to trace the funds to identifiable uses. However, in such situations, taxpayers are entitled to apply the flexible approach to tracing/linking described in ¶1.38. Consequently, where borrowed money and other money is commingled, taxpayers may choose the uses of the borrowed money from all of the uses of the money. The timing of transactions is relevant for this linking exercise because:

• this approach is only applicable for times when borrowed money and other money is commingled, and
• a specific use of money can never be linked to a borrowing that occurs subsequently.

Generally, however, there is no timing issue for transactions occurring on the same day.

Example 9

On a particular day, X Corp. had an opening account balance of nil. Into that account, it deposited $100 of borrowed money and $200 from sales not linked to money previously borrowed. It also purchased two properties. Property #1 was an income-earning property and cost $100. If Property #1 had been acquired with borrowed money, interest on the borrowed money would be deductible. Property #2 was not an income-earning property and cost $200. If Property #2 had been acquired with borrowed money, interest on the borrowed money would **not** be deductible. In determining the use of the borrowed money, X Corp. can allocate the $100 of borrowed money to the purchase of Property #1 such that interest on that borrowed money is deductible.

1.43 The flexible approach to tracing/linking borrowed money to eligible uses cannot be applied to the repayment of borrowed money where a single borrowing account (such as a line of credit, mortgage or loan) is used for eligible and ineligible purposes. In the CRA's view, any repayment of the principal portion of a borrowing would reduce the portions of the line of credit, mortgage or loan that are used for both eligible and ineligible purposes.

Example 10

Assume an individual has a $100,000 line of credit. The individual uses $60,000 for personal purposes and $40,000 to acquire income-producing property. Accordingly, 40% of the line of credit is used for eligible purposes. Where a repayment of a portion of the borrowed money occurs, it will be necessary to apply this percentage to the remaining balance of the line of credit to calculate how much interest is deductible. If the individual makes a $20,000 payment, the balance on the line of credit will be $80,000. The individual cannot allocate the repayment specifically to the ineligible portion of the borrowing. Instead, applying the original eligible use percentage to the balance, interest on $32,000 of the borrowed money (being 40% of $80,000) will be deductible.

Tracing/linking applied to an amalgamation or winding-up

1.44 A corporation might acquire shares of another corporation with borrowed money. Subsequently, the other corporation may be wound-up or amalgamated with the borrowing corporation. Under the tracing/linking process described above, a link for the current use of the borrowed money is readily established between the shares that were initially acquired (and have disappeared) and the assets formerly held by the acquired corporation that has been wound-up or amalgamated. There is no arm's-length requirement in establishing such a link.

Exceptions to the direct use test: general

1.45 As noted in ¶1.31, in certain circumstances, the courts have accepted that indirect use will be accepted as an exception to the direct use test (referred to as **exceptional circumstances** in several court decisions). In *Trans-Prairie Pipelines Ltd. v MNR*, [1970] CTC 537, 70 DTC 6351, the Exchequer Court concluded that interest was deductible where the taxpayer borrowed money to redeem preferred shares. The court concluded that the borrowed money returned to the shareholders "[a]s a practical matter of business common sense, went to fill the hole left by redemption…" of the preferred shares.

1.46 The indirect use concept was also addressed in *Bronfman Trust* as follows:

... [T]here are exceptional circumstances in which, on a real appreciation of a taxpayer's transactions, it might be appropriate to allow the taxpayer to deduct interest on funds borrowed for an ineligible use because of an indirect effect on the taxpayer's income-earning capacity....

1.47 Subsequent court decisions, including The Queen v The Chase Manhattan Bank of Canada, 2000 DTC 6018 (FCA), The Queen v Canadian Helicopters Limited, 2002 FCA 30, 2002 DTC 6805, 74712 Alberta Ltd. (formerly Cal-Gas &

Equipment Ltd.) v The Queen, [1997] 2 FC 471, 97 DTC 5126 and Lewisporte Holdings v The Queen, [1999] 1 CTC 2056, 99 DTC 253 (TCC), have also discussed the indirect use concept.

Exceptions to the direct use test: borrowed money used by a corporation to redeem shares, return capital or pay dividends

Redeem shares or return capital

1.48 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.

1.49 Contributed capital generally refers to funds provided by a corporation's shareholders to commence, or otherwise further, the carrying on of its business. While in most situations the legal or stated capital for corporate law purposes would be the best measurement of contributed capital, other measurements may be more appropriate depending on the circumstances. In situations where some proportion of shares is being replaced with borrowed money, only the capital of those shares, computed on a pro-rata basis, would be considered to be replaced with the borrowed money. A corporation's deficit does not reduce contributed capital for purposes of this exception to the direct use test.

Pay dividends

1.50 Similarly, interest expense on borrowed money used to pay dividends (including deemed dividends), 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 accumulated profits of a corporation that have been retained and used for **eligible purposes**. Accumulated profits would generally be the retained earnings of the corporation computed on an unconsolidated basis with investments accounted for on a cost basis. The accumulated profits of a corporation do not track any particular shareholdings.

1.51 Generally, accumulated profits can reflect transactions arising in the ordinary course of business between non-arm's length parties. The impact on accumulated profits of other non-arm's length transactions must be examined on the basis of the particular facts involved.

1.52 The key concept in this context remains that of **filling the hole** of capital withdrawn from the business.

Exceptions to the direct use test: borrowed money used by a partnership to return capital to a partner

1.53 The concepts described in ¶1.48 – 1.52 are equally applicable where a partnership borrows money to return capital to a partner. In such a case, the hole that can be filled generally consists of:

• the capital contributed by the partner to commence or further the carrying on of the business,
• plus any partnership income allocated to the partner,
• less any partnership losses allocated to the partner, and
• less any previous distributions to the partner.

Generally, the balance in the partner's capital account would represent this amount.

Exceptions to the direct use test: borrowed money used to make interest-free loans and contributions of capital

1.54 Interest expense on borrowed money used to make an interest-free loan is not generally deductible since the direct use is to acquire a property that cannot generate any income. However, where it can be shown that this direct use can nonetheless have an effect on the taxpayer's income-earning capacity, the interest may be deductible.

1.55 Such was the case in *Canadian Helicopters Limited*, where the Federal Court of Appeal found that the taxpayer had a reasonable expectation of earning income from the indirect use of the borrowed money, which was used to make an interest-free loan. Generally, a deduction for interest will be allowed if borrowed money is used 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. That is, an increase in the income-earning capacity of the corporation will increase the parent's (or shareholders') potential future dividend income from the corporation (indirect eligible use). Such a determination will depend upon the facts of a particular situation.

1.56 These comments are equally applicable to interest on borrowed money used to make a contribution of capital to a corporation of which the borrower is a shareholder (or to a partnership of which the borrower is a partner).

1.57 In assessing the facts of a specific loan arrangement, particular attention should be given, where relevant, to the international nature of a corporate organization. In *Mark Resources Inc. v The Queen*, [1993] 2 CTC 2259, 93 DTC 1004 (TCC), the Tax Court of Canada disallowed a corporation's deduction for interest on borrowed money used to make a contribution of capital to its foreign subsidiary. The Court determined that the real purpose of the borrowing was to enable the Canadian corporation to absorb into its income the losses of its foreign subsidiary.

Exceptions to the direct use test: borrowed money used to make interest-free loans to employees and shareholders

1.58 As indicated in ¶1.54 – 1.57, a deduction for interest in circumstances involving interest-free loans may be warranted depending upon the situation's particular facts. Generally, a deduction for interest would be allowed where borrowed money is used to make an interest-free loan to employees in their capacity as employees. This is because the value of such loans would 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 generally not qualify.

No deduction for interest on a loan to acquire a life insurance policy

1.59 Interest on borrowed money used to acquire a **life insurance policy** (as defined in subsection 138(12)) is specifically excluded from deduction under subparagraph 20(1)(*c*)(i). A deduction for interest on an amount payable for property that is an interest in a life insurance policy is also prohibited by subparagraph 20(1)(*c*)(ii). However, for the purposes of paragraphs 20(1)(*c*) and 20(1)(*d*), subsection 20(2.2) excludes certain policies from the definition of a life insurance policy. As a result, a deduction is allowed, to the extent permitted by paragraphs 20(1)(*c*) and (*d*) and subject to the limitation in subsection 18(11), for interest on borrowed money used to acquire the following types of policies:

(a) a policy that is or was issued pursuant to a pooled registered pension plan, registered pension plan, registered retirement savings plan, an income-averaging annuity contract, or a deferred profit sharing plan;

(b) an annuity contract issued before 1978 that provided for annuity payments to commence not later than the day on which the policyholder attains 75 years of age; and

(c) for 1987 and subsequent tax years, an annuity contract issued by an insurer where all of the insurer's reserves for the contract vary in amount depending on the fair market value of a specified group of properties.

1.60 As the term **life insurance policy** is defined in subsection 138(12) to expressly include an **annuity contract**, interest paid or payable on borrowed money used to acquire an annuity contract is not deductible under subparagraph 20(1)(*c*)(i). However, where certain conditions are satisfied, such interest may be deducted under subparagraph 20(1)(*c*)(iv). This is discussed in more detail in ¶1.67.

No deduction for interest on a loan to acquire property producing exempt income

1.61 Interest on borrowed money used to acquire property the income from which would be exempt is specifically excluded from deduction under subparagraph 20(1)(*c*)(i).

Subparagraph 20(1)(*c*)(ii)

Amount payable for property acquired

1.62 Subparagraph 20(1)(*c*)(ii) allows the deduction of interest on an **amount payable for property acquired** for the purpose of gaining or producing income from the property or from a business. This is distinct from subparagraph 20(1)(*c*)(i) which permits a deduction for interest on **borrowed money**. If a taxpayer assumes another person's indebtedness, it cannot be said that the taxpayer has borrowed money. However, if a taxpayer has assumed another person's indebtedness as part of the purchase price of an asset acquired by the taxpayer, the taxpayer will have an amount payable for property acquired. Interest paid on that assumed indebtedness may be deductible under subparagraph 20(1)(*c*)(ii).

1.63 Unlike subparagraph 20(1)(*c*)(i), there is no **use test** in subparagraph 20(1)(*c*)(ii). However, where a property referred to in subparagraph 20(1)(*c*)(ii) is disposed of, the substituted property will be relevant for the continuing application of that subparagraph as well as for the disappearing source rules in section 20.1. The provisions of section 20.1 apply equally to an amount payable referred to in subparagraph 20(1)(*c*)(ii) by virtue of subsection 20.1(4).

1.63.1 The substituted property concept could also apply to an amalgamation or wind-up, similar to the situation described in ¶1.44. Thus, where a corporation acquires the shares of another corporation in exchange for an assumption of debt or a note payable to the vendor, the CRA would consider the shares that were initially acquired (and have disappeared) to have been substituted for assets formerly held by the acquired corporation that has been wound-up or amalgamated. These assets would then be tested for an eligible purpose.

1.63.2 In situations such as those in ¶1.63.1 but where the debt represents only partial consideration for the share acquisition, if some assets do not meet the purpose test, the taxpayer may adopt a flexible approach in linking the debt to the eligible assets formerly held by the acquired corporation, similar to the situation described in ¶1.38. Similarly, if some of those eligible assets are subsequently distributed as a dividend or a return of capital, taxpayers would be entitled to link the debt to any remaining eligible assets, such that the tax consequences outlined in ¶1.65 would not apply.

Purpose of gaining or producing income

1.64 The phrase "purpose of gaining or producing income" in the English version of subparagraph 20(1)(*c*)(ii) is considered to have the same meaning as the phrase "purpose of earning income" in subparagraph 20(1)(*c*)(i). It is noted that in the French version of the Act, the expression “en vue de tirer un revenu” is used in both subparagraphs. As is the case with borrowed money, no deduction is permitted for interest on an amount payable to acquire property the income from which would be exempt or to acquire an interest in a life insurance policy (see ¶1.59 - 1.61).

Note issued to redeem shares

1.65 Where a note is issued to purchase and cancel (or otherwise redeem) shares, interest expense may be deductible under subparagraph 20(1)(*c*)(ii) to the extent of the interest on the amount of the note issued. Any deduction must be within the limits described in ¶1.48 and 1.49. This is consistent with the decision in Penn Ventilator Canada Ltd. v The Queen, [2002] 2 CTC 2636, 2002 DTC 1498 (TCC). Interest on notes issued to pay dividends or to return capital would not qualify since no property is acquired in such a transaction, as required by subparagraph 20(1)(*c*)(ii).

Subparagraph 20(1)(*c*)(iii)

Interest on an amount paid under an appropriation act

1.66 Subparagraph 20(1)(*c*)(iii) provides a deduction for interest paid or payable in the year pursuant to a legal obligation to pay interest on:

• amounts paid to the taxpayer under an appropriation act and for the purpose of advancing or sustaining the technological capability of Canadian manufacturing or other industry; or
• certain amounts paid to the taxpayer in respect of the Northern Mineral Grants Program.

Subparagraph 20(1)(*c*)(iv)

Interest on borrowed money used to acquire an interest in an annuity contract

1.67 Subparagraph 20(1)(*c*)(iv) provides a deduction for interest paid or payable on borrowed money used to acquire an interest in an annuity contract. If the interest was last acquired after 1989, the annuity contract must be a contract to which:

• the income accrual rules in section 12.2 apply; or
• the income accrual rules in section 12.2 would apply if the contract had an anniversary day in the year at a time when the taxpayer held the interest.

1.68 Where payments under an annuity contract commenced in a particular year, the interest deduction available in any subsequent year in respect of the taxpayer's interest in that contract will be limited to the amount included in computing the taxpayer's income for that subsequent year under section 12.2.

Other interest deductibility and related issues

Borrowing for investments including common shares

1.69 Based on Ludco, where an investment carries a stated interest or dividend rate, the income-earning test will be met "absent a sham or window dressing or similar vitiating circumstances". Further, given the meaning of the term **income** as discussed in ¶1.27, and assuming all of the other tests are met, interest will neither be denied in full nor restricted to the amount of income from the investment where the income does not exceed the interest expense.

1.70 Where an investment does not carry a stated interest or dividend rate, such as some common shares, it is necessary to consider whether the purpose test is met. Generally, the CRA considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that at the time the shares are acquired there is a reasonable expectation that the common shareholder will receive dividends. However, it is conceivable that in certain fact situations, such reasonable expectation would not be present. If a corporation has asserted that it does not pay dividends and that dividends are not expected to be paid in the foreseeable future such that shareholders are required to sell their shares in order to realize their value, the purpose test will not be met. However, if a corporation is silent with respect to its dividend policy, or its policy is that dividends will be paid when operational circumstances permit, the purpose test will likely be met. Each situation must be dealt with on the basis of the particular facts involved. These comments are also generally applicable to investments in mutual fund trusts and mutual funds.

Example 11

X Corp. is an investment vehicle designed to provide only a capital return to the investors in its common shares. The corporate policy with respect to X Corp. is that dividends will not be paid, that corporate earnings will be reinvested to increase the value of the shares and that shareholders are required to sell their shares to a third-party purchaser in a fixed number of years in order to realize their value. In this situation, it is not reasonable to expect income from such shareholdings and any interest expense on money borrowed to acquire X Corp. shares would not be deductible.

Example 12

Y Corp. is raising capital by issuing common shares. Its business plans indicate that its cash flow will be required to be reinvested for the foreseeable future. Y Corp. discloses to shareholders that dividends will only be paid when operational circumstances permit (that is, when cash flow exceeds requirements) or when it believes that shareholders could make better use of the cash. In this situation, the purpose of earning income test will generally be met and any interest on borrowed money used to acquire Y Corp. shares would be deductible.

Loss consolidation arrangements within a corporate group

1.71 In order to transfer losses between corporations in a corporate group, an arrangement is generally structured such that the corporation in the loss position lends money at a stated rate of interest to the profitable corporation, which in turn uses the borrowed funds to invest in preferred shares of the loss corporation, although other techniques may also be used. Generally, a loss consolidation arrangement may be undertaken between corporations in a corporate group that are:

a) related and affiliated;

b) related but not affiliated; or

c) affiliated but not related.

1.72 In relation to ¶1.71 (c), the meaning of **affiliated** must be determined using the same criteria as stipulated in subsection 69(11), which is if section 251.1 were read without reference to the definition of **controlled** in subsection 251.1(3). In other words, where two corporations are not related, but are affiliated, a loss consolidation arrangement may only be undertaken if the corporations are affiliated by reason of **de jure** (that is, legal) control.

1.73 In order to deduct interest expenses in a loss consolidation arrangement, the requirements of paragraph 20(1)(*c*) must be met. In a typical arrangement, the direct use of the borrowed money will be to acquire preferred shares. The purpose test will be applied to the acquisition of the preferred shares. In order to satisfy the direct use test, the purchaser of the preferred shares should have a realistic expectation of dividend income from the preferred shares acquired. In order for the purchaser of the preferred shares to meet the purpose of earning income requirement in paragraph 20(1)(*c*), consideration must be given to the income producing capacity of the issuer of the preferred shares. In the context of a loss consolidation arrangement, it is the CRA’s view that there should be a **positive spread** between the dividend yield on the preferred shares acquired with the borrowed funds and the interest rate on that debt.

1.74 In a loss consolidation arrangement, for tax purposes, losses are effectively transferred from a loss corporation to a profitable corporation within a corporate group, in circumstances where:

- the profitable corporation may deduct the interest expense and receive deductible inter-corporate dividends; and
- the loss corporation may receive interest income that can be offset by its accumulated losses.

The transactions that are undertaken must not be blatantly artificial, must be legally effective and otherwise comply with the technical provisions of the Act.

1.75 More information about loss consolidations is available in Income Tax Technical News 30 .

Borrowed money used to honour a guarantee

1.76 A taxpayer who provides a guarantee in respect of a debt may be called upon to honour that guarantee. In such instances, the guarantor acquires a property (by right of subrogation) that is a claim on the defaulting party for the amount paid on the guarantee.

1.77 Where providing a guarantee is part of a taxpayer's business (that is, for a fee), interest expense on borrowed money to honour the guarantee would generally meet the requirements of deductibility under paragraph 20(1)(*c*).

1.78 Where providing a guarantee is not part of a taxpayer's business, the direct use of borrowed money to honour a guarantee is generally not for an income-earning purpose and such interest would not be deductible. This was the finding in 74712 Alberta Ltd. However, where interest is charged by the guarantor to the defaulting party, the purpose test could be met.

1.79 In certain situations there could be exceptions to the direct use rule. Where the taxpayer can show that the guarantee was given for the purpose of increasing its income-earning capacity and must subsequently borrow money to honour the guarantee, the borrowed money may be considered to be used for the purpose of earning income. For example, there may be circumstances where the guarantor had access to the proceeds of the loan that was guaranteed. In this situation, a deduction would be permitted for interest on the amount borrowed to honour the guarantee that can be traced to the funds that were used by the taxpayer for the purpose of earning income.

1.80 There may be other situations where the taxpayer can demonstrate that the indirect use test is met. Such would be the case where a parent company guaranteed the debts of its wholly owned subsidiary (or in cases of multiple shareholders, where shareholders guarantee a loan in proportion to their shareholdings) and can show that it reasonably expected to earn income from the transaction. An example might be the expectation of increased future dividend income from the subsidiary. A deduction for interest in other situations involving borrowings to honour a guarantee may also be warranted, such as in Lewisporte. In this case, the Tax Court of Canada concluded that the purpose of the borrowing to honour the guarantee was to obtain complete control over all the assets of two subsidiaries for the purpose of gaining or producing income from these assets.

Compound interest

1.81 Compound interest (that is, interest on interest) is only deductible pursuant to paragraph 20(1)(*d*), and only in the year in which it is actually paid. Specifically, paragraph 20(1)(*d*) refers to "an amount paid in the year pursuant to a legal obligation to pay interest on an amount that would be deductible under paragraph 20(1)(*c*) if it were paid in the year or payable in respect of the year". It is a question of fact whether an amount of interest paid, or payable, in a year is simple or compound interest.

1.82 Interest paid or payable in the year on a second loan that is used to pay interest on a first loan, is deductible in computing the income of a business or property under paragraph 20(1)(*c*), if the interest on the first loan is deductible under that paragraph.

1.83 In circumstances where accrued interest is added to the outstanding principal amount of an existing loan resulting in a new obligation or novation, an interest payment will not be considered to have been made. A portion of the interest charged in respect of the new loan will constitute compound interest and may only be deductible under paragraph 20(1)(*d*) in the year it is paid. It is a question of fact whether a transaction results in the payment of interest from a second borrowed amount, or results in the addition of accrued interest to an outstanding principal amount with the creation of a new loan.

Interest on a policy loan

1.84 A **policy loan** refers to an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of a life insurance policy in Canada. The terms **policy loan** and **life insurance policy in Canada** are each defined in subsection 138(12). Interest on a policy loan is generally deductible under paragraph 20(1)(*c*) or (*d*) if the proceeds of the loan are used for the purpose of earning income from a business or property (other than exempt income or to acquire a life insurance policy). However, subsection 20(2.1) prohibits the deduction of interest on a policy loan under paragraphs 20(1)(*c*) and (*d*) unless certain conditions are met.

1.85 Specifically, in order for the interest to be deductible, the insurer must verify in prescribed form that it is:

- interest paid in the year on that loan; and
- interest that was not otherwise added to the adjusted cost basis to the policyholder of the policyholder's interest in the underlying policy.

1.86 Form T2210, Verification of Policy Loan Interest by the Insurer, is prescribed by section 4001 of the Regulations for purposes of making such verification. The form must be completed by the policyholder and the insurer on or before the due date for filing the policyholder's income tax return for the tax year in which the interest was paid.

Interest on 10/8 policies

1.87 The 2013 Federal Budget introduced measures to address certain leveraged life insurance arrangements, including arrangements that involve investing in a life insurance policy and borrowing against that investment to create an annual interest expense deduction (generally until the death of an individual whose life is insured under the policy). Where the life insurance policy used in such arrangements meets the definition of **10/8 policy** as described in ¶1.88 and 1.89, a deduction for interest expense is precluded by subsection 20(2.01). This is discussed further in ¶1.90.

1.88 For purposes of the Act, a **10/8 policy** is defined in subsection 248(1), and means, in addition to the factors described in ¶1.89, a life insurance policy (other than an annuity) where an amount is or may become:

• payable under the terms of a borrowing, to a person or partnership that has been assigned an interest in the policy or an investment account in respect of the policy; or
• payable under a policy loan made in accordance with the terms and conditions of the policy.

An amount payable under a policy loan at a particular time refers to the amount of the policy loan and the interest on that policy loan that is outstanding at that time.

1.89 In addition, in order for a life insurance policy to meet the definition of **10/8 policy** in subsection 248(1), either:

• the return credited to an investment account in respect of the policy (the **Return**) is determined by reference to the rate of interest on the borrowing or policy loan described in ¶1.88, and the Return would not be credited to the account if the borrowing or policy loan were not in existence; or
• the maximum amount of an investment account in respect of the policy is determined by reference to the amount of the borrowing or policy loan described in ¶1.88.

1.90 For tax years ending after March 20, 2013, subsection 20(2.01) applies to prevent a deduction under paragraphs 20(1)(*c*) and (*d*) for amounts that are described in ¶1.88 in circumstances where:

• the amount is paid after March 20, 2013 in respect of a period after 2013, in respect of a life insurance policy that is, at the time of the payment, a 10/8 policy; or
• the amount is payable, in respect of a life insurance policy, after March 20, 2013 in respect of a period after 2013 during which the policy is a 10/8 policy.

Borrowing to make non-deductible expenditures

1.91 The restriction or prohibition of the deductibility of an expense under a specific provision of the Act may also extend to interest paid on borrowed money used to pay the expense. In some situations, the wording of a particular provision will extend to any expense incurred in respect of a given use such that the interest expense would also be denied (for example, section 67.5). In other situations, the wording of the provision would not, in and of itself, restrict interest deductibility (for example, section 67.1).

Security provided for borrowed money or an amount payable

1.92 Lenders and other parties providing credit may require certain property to be given as security. The nature of the security provided in connection with borrowed money, or an amount payable for property acquired, has no impact on the tests for interest deductibility. For example, whether an individual has given his or her principal residence or other personal property as security to obtain a loan, or an income-earning property (such as real estate used to earn rental income) will not be relevant in determining the deductibility of interest on that loan. It is the **use** of borrowed money and the **purpose** of that use that is relevant.

Interest on amounts payable where no property acquired

1.93 A taxpayer may incur interest on accounts payable with service providers where payment for services (such as bookkeeping and janitorial services) is made after the due date. As noted in ¶1.7 – 1.9, interest is generally considered to be an outlay on account of capital, deductible only under the provisions of paragraph 20(1)(*c*). Interest on accounts payable for service costs is not deductible under paragraph 20(1)(*c*), as the amount payable does not:

• constitute borrowed money for purposes of deducting interest under subparagraph 20(1)(*c*)(i); and
• form part of the acquisition cost of property for purposes of deducting interest under subparagraph 20(1)(*c*)(ii).

On an administrative basis, however, the deduction of interest expense on accounts payable for service costs that are currently deductible expenses is permitted under section 9.

Discounts arising on the issuance of debt obligations

1.94 Where money is borrowed with a stated rate of interest and in consideration of a promise to pay a larger amount, subsection 20(2) will deem the larger amount to be the amount borrowed for purposes of paragraph 20(1)(*c*). The difference between the larger amount and the amount of debt that was issued is generally referred to as the **discount**. Paragraph 20(1)(*f*) provides for a full or partial deduction of such discount when the debt is repaid, depending on the extent of the discount.

1.95 Where there is no interest stipulated to be payable, the provisions of subsection 16(1) may apply with the result that an amount would be deemed to be interest on a debt obligation to both the investor and the issuer. Since subsection 16(1) refers to an amount under a contract as opposed to a payment, the interest expense would be deductible on a paid or payable basis. Contracts having terms greater than one year would be considered to include both simple interest (deductible on a paid or payable basis), as well as compound interest (deductible only on a paid basis). The deductibility of compound interest is discussed in more detail at ¶1.81 – 1.83.

Example 13

X Corp. raises capital by issuing commercial paper for which no interest is stipulated to be payable. The terms of the commercial paper contract are structured such that X Corp. receives an amount from an investor and in return promises to pay that investor a larger amount at a future date. The difference between the two amounts can reasonably be regarded as interest and X Corp. can deduct that amount subject to meeting all of the other requirements for interest deductibility.

Premiums arising on the issuance of debt obligations

1.96 Where debts are issued with a stated interest rate greater than prevailing market rates, the debt issuer will receive greater than 100% of the principal amount of the debt issue (that is, a premium). Where the borrowed money constitutes stock-in-trade for taxpayers in the financing business (for example, moneylenders), the premium amount will be included in computing income under section 9. For other taxpayers it will generally be considered a non-taxable capital receipt. Where the premium arises because the debt was deliberately priced to give rise to a premium, the interest expense otherwise deductible will not be considered reasonable. As such, the interest expense will be reduced over the life of the debt with reference to the amount of the premium. Since the issue premium serves to adjust the overall yield to reflect the market yield currently being offered on similar instruments, it is the CRA's position that the stipulated interest rate on the debt is in excess of a reasonable amount as determined for the purposes of paragraph 20(1)(*c*).

Interest on credit card transactions

1.97 It is common for small business owners and proprietors to use a credit card for both business and personal use. The amounts charged for business and personal use can readily be determined. Generally, where the credit card balance is not paid in full, the payments are applied firstly to interest and secondly to the oldest charges, with the result that the outstanding balance on which interest is charged can be divided between amounts owing for business and personal use. Adequate records must be kept to verify the interest deduction in these circumstances. In situations where this cannot be done, the CRA will allow the interest to be apportioned according to its use (business vs. personal) based on the proportion of total business charges to total personal charges on the credit card for the period in question.

Interest on death duties

1.98 In certain situations, interest expense may accrue in respect of succession duties, inheritance taxes or estate taxes. Such interest accruing within the tax year is deductible under paragraph 60(*d*). The person who is primarily liable for the duties or taxes may deduct such interest (generally the executor of an estate or liquidator of a succession).

Refinancing transactions

1.99 Subsection 20(3) provides a deeming rule where a taxpayer uses borrowed money to repay money previously borrowed, or to repay an amount for previously acquired property described in subparagraph 20(1)(*c*)(ii). Where this occurs, for the purposes of paragraph 20(1)(*c*), the borrowed money will be deemed to be used for the same purpose as the original borrowing, or as having been used to acquire the same property, as the case may be.

Other provisions of the Act regarding interest deductibility

1.100 In addition to the legislation discussed in this Chapter, other provisions of the Act may also have application to the deduction of interest expense. A discussion of all of these provisions would be beyond the scope of this Chapter, but some are noted below for reference purposes:

- sections 15.1 and 15.2, interest on small business development bonds and small business bonds;
- paragraph 18(1)(*g*), payments on income bonds;
- subsections 18(2) to (3.7), limit on certain interest and property tax;
- subsections 18(4) to (6), limitation re: deduction of interest by certain corporations [thin capitalization];
- subsection 18(9), limitation respecting prepaid expenses;
- subsections 18(9.1) to (9.8), penalties, bonuses and rate-reduction payments;
- subsection 18(11), limitation [on interest expense];
- subsection 18.3(3), interest on a liability of an entity that is a stapled security;
- paragraph 20(1)(*ll*), repayment of interest;
- subsection 20(14), accrued bond interest;
- subsection 20(14.1), interest on debt obligation;
- section 20.2, interest - authorized foreign bank;
- section 20.3, weak currency debt;
- section 21, cost of borrowed money;
- section 67.2, interest on money borrowed for passenger vehicle;
- subsection 138(5), deductions not allowed [insurance corporations]; and
- subsection 144.1(8), interest payable by employer re: employee life and health trust.

Application

This updated Chapter, which may be referenced as S3-F6-C1, is effective March 18, 2016.

When it was first published on March 6, 2015, it replaced and cancelled Interpretation Bulletin IT-533, *Interest Deductibility and Related Issues*.

The history of updates to this Chapter as well as any technical updates from the cancelled interpretation bulletin(s) can be viewed in the Chapter History page.

Except as otherwise noted, all statutory references herein are references to the provisions of the *Income Tax Act* R.S.C., 1985, c.1 (5th Supp.), as amended and all references to a Regulation are to the *Income Tax Regulations*, C.R.C., c. 945, as amended.

Links to jurisprudence are provided through CanLII.

Income tax folios are available in electronic format only.

Reference

Paragraph 20(1)(*c*) (also sections 9, 12.2, 16, 20.1, 67.1 and 67.5, 143.4, subsections 16(1), 18(12), 20(2), 20(2.01), 20(2.1), 20(2.2), 20(3), 20.1(4), 84(4.1), 87(7), the definitions of **life insurance policy**, **life insurance policy in Canada**, and **policy loan** in subsection 138(12), the definitions of **borrowed money** and **10/8 policy** in subsection 248(1), paragraphs 18(1)(*e*), 20(1)(*d*), 20(1)(*f*) and 60(*d*), and subparagraphs 20(1)(*c*)(i), (ii), (iii) and (iv) and 20(1)(*e*)(iv.1) of the Act and section 4001 of the Regulations).

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