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# THE PURPOSE TEST — WHERE DOES IT END?

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Paragraph 20(1)(*c*) of the *Income Tax Act* (the "Act") entitles a taxpayer to take a deduction on interest paid or payable on a debt obligation where certain conditions are met. As discussed further below, the general test for interest deductibility is described in *Shell Canada Ltd. v. The Queen*[1] ("*Shell*"), which provides that, in order for interest expense to be deductible, the borrowed money must, *inter alia*, be used for the purpose of earning income from a business or property. This test was later modified in *Singleton v. The Queen*[2] ("*Singleton*") and *Ludco Enterprises Ltd. et al. v. The Queen*[3] ("*Ludco*"), two simultaneous decisions of the Supreme Court dealing with the use element and the purpose element, respectively, of the test outlined in *Shell*. The *Shell* test was most recently considered in *The TDL Group Co. v. The Queen*[4] ("*TDL*"), where TDL Group Co. (the "Taxpayer") used borrowed funds to subscribe for additional shares of its wholly owned subsidiary, Tim Donut U.S. Limited, Inc. ("Tim's U.S."). Based on the findings of the Court in *TDL*, it appears as though the purpose test spelled out in *Ludco* has been expanded to include consideration of how the invested funds were used by the recipient, Tim's U.S.

## Summary of the Case Law

The Supreme Court in *Shell* set out the following four-part test for interest deductibility, of which all elements must be met:

(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 for the purpose of earning non-exempt income from a business or property; and

(4) the amount must be reasonable, as assessed by reference to the first three requirements.

*Singleton* and *Ludco* are decisions of the Supreme Court of Canada that focused on the third element of the *Shell* case. As a result of these decisions, it became clear that the

[1] [1999] 3 S.C.R. 622, at page 637.

[2] 2001 SCC 61.

[3] 2001 SCC 62.

[4] 2015 DTC 1098 (TCC).

third element requires a two-part analysis, being (1) the direct "use" of the borrowed funds; and (2) whether the "purpose" in using the borrowed funds was to earn income. The *Singleton* case concentrated on the direct "use" test of the borrowed funds, while the *Ludco* case focused on the "purpose" test with respect to the use of the borrowed funds.

In determining whether the "purpose" for interest deductibility pursuant to paragraph 20(1)(*c*) is met, the Supreme Court in *Ludco* held that this is the appropriate test:

> [54] Having determined that an ancillary purpose to earn income can provide the requisite purpose for interest deductibility, the question still remains as to how courts should go about identifying whether the requisite purpose of earning income is present. What standard should be applied? In the interpretation of the Act, as in other areas of law, where purpose or intention behind actions is to be ascertained, courts should objectively determine the nature of the purpose, guided by both subjective and objective manifestations of purpose: . . . In the result, the 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.
>
> [55] Reasonable expectation accords with the language of purpose in the section and provides an objective standard, apart from the taxpayer's subjective intention, which by itself is relevant but not conclusive. It also avoids many of the pitfalls of the other tests advanced and furthers the policy objective of the interest deductibility provision aimed at capital accumulation and investment, as discussed in the next section of these reasons.

These two paragraphs can be summarized as standing for the following basic premises: (1) the purpose test seeks to determine whether any purpose of the taxpayer, including an ancillary one, was to earn income (i.e., not a sole purpose or primary purpose test); (2) the purpose test is an objective test requiring a review of all the circumstances to determine whether a reasonable expectation of earning income existed; and (3) the taxpayer's subjective intent is relevant to the objective examination but is not determinative. These were the same premises that needed to be considered in *TDL*.

## The *TDL* Case

On March 18, 2002, Wendy's International Inc. ("Wendy's") lent C$234 million to its U.S. subsidiary, Delcan Inc. ("Delcan") at an interest rate not to exceed 7%. On the same day, Delcan lent the full amount to the Taxpayer at a rate of 7.125%. On March 26, 2002, the Taxpayer used the full amount of the loan to subscribe for 1,840 additional common shares of Tim's U.S. At the time the investment was made, Tim's U.S. had a 10-year plan which projected zero dividends to be paid and the corporate group had a "no dividend" policy until all capital expenditures were funded. However, substantial dividends were in fact paid to the Taxpayer in 2007 to 2012, ranging from $100,000 to $1 million per year.

On March 27, 2002, Tim's U.S. advanced the funds received from the Taxpayer to Wendy's "at such interest rate (including without interest) as may be acceptable to any one or more officers of" Tim's U.S. (the "Wendy's Loan"). In fact, no interest was charged on the Wendy's Loan. The Wendy's Loan was originally intended to be on an interest-bearing basis pursuant to planning memorandums, although no rate was specified due to concerns the effect an interest-bearing note would have on state and Canadian taxes. It was decided that the Wendy's Loan would be non-interest bearing until the tax issues were sorted out.

In June 2002, the Wendy's Loan was assigned by Tim's U.S. to its newly incorporated subsidiary, Buzz Co., in exchange for common shares of Buzz Co. The Wendy's loan was repaid by Wendy's on November 4, 2002, in the form of a new promissory note bearing interest at a rate of 4.75% (the "New Wendy's Loan").

The Minister disallowed the interest deduction of the Taxpayer on the loan from Delcan during the period from March 28, 2002 to November 3, 2002 on the basis that, pursuant to subparagraph 20(1)(*c*)(i) of the Act, the funds were not used for the purpose of earning income from a business or property and the interest expense was not reasonable. Notably, the Minister allowed the interest deduction on the Delcan loan for periods after November 3, 2002 in respect of the New Wendy's Loan.

The Taxpayer argued the following three points:

> (1) the funds borrowed from Delcan were used to earn future dividends from Tim's U.S. and the use of the funds by Tim's U.S. was irrelevant;
>
> (2) the funds advanced to Wendy's were ultimately available to Tim's U.S. through the group's internal funding mechanisms, which satisfied the indirect purpose test through "exceptional circumstances"; and
>
> (3) even if the primary purpose of the loan from Delcan was to make an interest-free loan to Wendy's, the secondary purpose was to earn future dividend income from Tim's U.S.

The Minister contended that the series of transactions undertaken by the Taxpayer was for the purpose of making an interest-free loan to Wendy's while at the same time incurring an interest deduction. The Minister argued that the Taxpayer had no income-earning purpose from its investment in the shares of Tim's U.S. at the time of the initial loan, and the interest deduction taken by the Taxpayer was not a reasonable expense pursuant to paragraph 20(1)(*c*).

## Analysis

The primary issue in *TDL* was whether the funds borrowed from Delcan were used by the Taxpayer for the purpose of earning income from the common shares it acquired in Tim's U.S.

The Tax Court found that the direct "use" of the borrowed funds by the Taxpayer was to invest in additional common shares of Tim's U.S. and, therefore, the direct "use" test was satisfied. Consequently, the only remaining question to be answered was whether the additional common shares of Tim's U.S. were acquired for the purpose of earning non-exempt income.

The Tax Court, in its application of the "purpose" test as articulated in *Ludco*, expanded the test to consider the use of the borrowed funds by other members of the corporate group, stating that:

> [25] It is clear from *Ludco* that the test must be applied at the time the investment is made, namely at the date the Appellant acquired the shares in Tim's U.S., and furthermore that "all the circumstances must be considered".
>
> [26] The language of "all the circumstances must be considered" is very broad. In my view, such language cannot be consistent with any position that would suggest the use of the funds by the subsidiary or other members of the group cannot be considered nor that any series of transactions related to the direct investment cannot be considered. While *Singleton* made it clear that there was no room to consider a series of transactions in determining the "use" of the funds for the "use" test components, i.e. that the direct use is the test that must be ascertained, the determination of the "purpose" for buying the shares does not preclude looking at the indirect use of the funds or any other relevant factor. <u>All circumstances must be considered</u>. In this regard, it seems that the Respondent's reference to "use" in paragraph 14(m) of the Amended Reply above discussed accords with this premise. [emphasis in the original]

The Taxpayer argued that in its application of the "purpose" test the Tax Court should not treat the Taxpayer and Tim's U.S. as the same taxpayer, since doing so would not respect their individual existence and would pierce the corporate veil. However, the Tax Court held that considering the use of the borrowed funds by other group members did not constitute piercing of the corporate veil and was clearly required in the application of the "purpose" test as part of the "all the circumstances" analysis.

The Tax Court then applied the "purpose" test to the evidence and concluded:

> [31] Can it be said that the Appellant had the reasonable expectation to earn income; either immediate or future dividend income or even increased capital gains as a result of the purchase of shares at the time of such purchase? I simply cannot agree this was a reasonable expectation of the Appellant at the time of such purchase . . .

The Tax Court concluded that the evidence of purpose was clear and unambiguous and dismissed the Taxpayer's appeal:

> [32] In analyzing all the evidence pertaining to the circumstances of this case, I simply cannot find that the Appellant had any reasonable expectation of earning non-exempt income of any kind, directly or indirectly, at

> the time of its purchase of additional shares in Tim's U.S. on or about March 26, 2002. The evidence clearly and unambiguously only points to the sole purpose of the borrowed funds as being to facilitate an interest free loan to Wendy's while creating an interest deduction for the Appellant . . .

## Commentary

The decision in *TDL* provides that the "all the circumstances" element of the "purpose" test includes all subsequent or related transactions as opposed to simply focusing on all the circumstances surrounding the investment of the taxpayer. The Tax Court suggests that there must be a link between the funds used to invest in the investee corporation and how the investee corporation uses such funds, thereby creating a cascading "use" and "purpose" analysis. As such, the question is whether the funds invested in the investee corporation have a reasonable expectation of generating income for the investor corporation. Is this the new "purpose" test?

It is curious that, pursuant to the expanded "purpose" test, the Tax Court did not consider the interest-bearing New Wendy's Loan as part of "all the circumstances" when deciding that the Taxpayer did not have a reasonable expectation of producing income. It is clear from the facts that the Wendy's Loan was originally intended to be on an interest-bearing basis even though such loan was non-interest bearing for a seven-month period. The interest-bearing New Wendy's Loan is evidence that there was the intention, at the time the investment was made, that the Taxpayer had a reasonable expectation of earning income from its investment in Tim's U.S.

Another interesting element of this case was the application of the "purpose" test to a specific period of time — the period in which the Wendy's Loan was non-interest bearing. While not dealt with by the Court, it is unclear to us how the Minister could allow the interest deduction in respect of the period where the amount owing by Wendy's became interest bearing (i.e., the New Wendy's Loan) when the "purpose" test is a point-in-time test that looks only to the time the investment was made.

Lastly, it is worth noting that the *Ludco* case stated that the object of paragraph 20(1)(c) is to create an incentive to accumulate capital with the potential to produce income, but it did not go as far as to suggest that capital gains are sufficient to satisfy the non-exempt income test. However, by asking at paragraph 31 whether the Taxpayer could realize increased capital gains as a result of the purchase of the shares, the Court in *TDL* suggests that an increase in capital gains could be sufficient to satisfy the non-exempt income test.

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# RECENT CASES

## Corporate taxpayer not entitled to SR&ED-related input tax credits relating to development of software program

The corporate taxpayer's business involved providing computer software services. It had expertise in programming websites. In assessing the taxpayer for 2012, the Minister disallowed its claim for input tax credits relating to expenses incurred in developing a computer software program that was capable of inspecting and verifying websites. The Minister of National Revenue (the "Minister") refused to characterize the taxpayer's development expenses as SR&ED, but did permit their deduction as ordinary business expenses. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. In *C.W. Agencies Inc. v. The Queen*, the Federal Court of Appeal set out the following criteria for determining whether development expenses can be characterized as SR&ED: (a) the existence of technological uncertainty, which cannot be removed by resorting to current studies; (b) research work that is actually directed at solving this technological uncertainty and carried on using scientific methodology, which is properly recorded; and (c) a resulting technological advance. The taxpayer's activities in developing its software in this case did not meet the foregoing criteria or the definition of SR&ED in subsection 248(1) of the *Income Tax Act*. In particular, these activities constituted nothing more than normal analyses carried out by competent programmers using current technology and techniques, and, hence, did not involve SR&ED. The Minister's assessment was affirmed accordingly.

¶49,037, *Hypercube Inc.*, 2015 DTC 1089

## Common-law duty of procedural fairness did not allow for extension of time for taxpayer to file a notice of objection

The taxpayer filed an application requesting an extension of time to serve a notice of objection on the Minister of National Revenue (the "Minister") for 2009 and 2010. The application was filed on September 2, 2014. On November 5, 2015, the taxpayer filed an amended application requesting that the application apply only to 2010. The Minister opposed the application because it was filed more than one year and 90 days after the notice of assessment was issued. The taxpayer argued that the common-law duty of procedural fairness should apply.

The taxpayer's appeal was dismissed. Common-law duty does not override the objections process under the *Income Tax Act*. Paragraph 166.2(5)(*a*) provides a strict deadline for filing an extension, which was not met, and the doctrine of discoverability did not apply.

¶49,035, *Odebala-Fregene*, 2015 DTC 1087

## Minister correctly assessed taxpayer for repayment of OAS amount

The taxpayer was appealing a determination by the Minister of National Revenue (the "Minister") that he was to repay $3,269 of old age security ("OAS") pension received in 2012. In 1969, while working for Sydney Steel, the taxpayer was burned by molten steel, resulting in a bad injury and continued pain. He made a claim to the Workers' Compensation Board ("WCB") in 2011, and in 2012 he received a retroactive lump-sum award of $53,816. This sum was included in his income leading to the assessment for the repayment of OAS. The taxpayer had not included the WCB award in income, arguing it was a non-economic loss award for pain suffered from a 1969 work injury.

The appeal was dismissed. Compensation received from the WCB is to be included in the calculation of income if it is received "in respect of an injury". "In respect of" is to be interpreted broadly and includes pain suffered as a result of an injury. The award received by the taxpayer was in respect of the 1969 work injury and was for scars and pain suffered from that injury. If there had been no injury there would have been no award and, as such, the award was to be included in income. The lump sum was to be included in the taxpayer's income in order to calculate the tax under Part I.2 of the *Income Tax Act*. The Minister correctly determined that the taxpayer was to repay the OAS pension amounts.

¶49,040, *Butler*, 2015 DTC 1092

## Taxpayer required to include support payments received from former spouse in income

The taxpayer and her husband, H, separated and began divorce proceedings. The executed minutes of settlement (the "Minutes") and a related court order referring to those Minutes both provided for monthly support payments (the "Payments") to be made to the taxpayer by H, although both documents described the Payments as "non-taxable". The taxpayer appealed the Minister's reassessment, which included the Payments in her income for 2012, alleging that the Payments were payments in lieu of equalization payments and, hence, should not be included in her income as support payments.

The taxpayer's appeal was dismissed. The language in the Minutes and the court order left no doubt that the Payments were intended to be support payments. In addition, they met all of the *indicia* of support payments set out in the definition of "support amount" in subsection 56.1(4) of the *Income Tax Act*, including the statutory requirements that they be periodic in amount and that the taxpayer be free to use them as she saw fit. It was also irrelevant that the Payments were erroneously described as "non-taxable" in both the Minutes and the related court order. The Minister's reassessment was affirmed accordingly.

¶49,039, *McBride*, 2015 DTC 1091

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