INTEREST DEDUCTIBILITY - AUSTRALIA AND CANADA COMPARED

By Dr Justin Dabner

During the last decade, the judiciary and policy makers in both Canada and Australia have struggled to define coherent principles pertaining to the deductibility of interest on borrowed funds. Neither jurisdiction has appeared to make reference to the experiences in the other.

In both jurisdictions the test prescribed in the legislation is, "were the funds borrowed for the purpose of deriving income?" Each jurisdiction has authority directing this inquiry to the use of the funds and thereby asserting a tracing principle.

However, this approach has been flawed in dealing with complex factual scenarios. In Australia subsidiary tests such as the "occasion principle", "the preservation of assets test" and the "refinancing principle" have been embraced by the courts. However, the tests often march in opposing directions leading to considerable uncertainty and irreconcilable authorities.

On the other hand, in Canada the judiciary has substantially adhered to the tracing principle but the uncommercial nature of this principle encouraged administrative concessions by Revenue Canada and, more recently, has witnessed the issue of draft legislation.

The position now established in both jurisdictions is similar although achieved in a very different manner. However, the Canadian legislative approach is to be preferred given the uncertainty still inherent in the judicial solution in Australia.

In drafting legislation, it is the writer's view that no coherent general principle is achievable due to the diversity of potential scenarios. Rather a recognition that certainty will require arbitrary rules generating anomalies and inequities must be appreciated.

1. INTRODUCTION

The Canadian and Australian legal systems have many similarities and, in particular, their respective tax systems reflect a commonality. However, the extent to which both jurisdictions have encountered similar problems in framing principles of interest deductibility might surprise many practitioners, judges, academics and policy makers. Unfortunately, the jurisprudential and legislative developments in each jurisdiction have proceeded without any reference to the lessons being learnt in the other. As this article will illustrate, whilst hemispheres apart, the same conundrum is being sought to be resolved.\(^1\)

2. LEGISLATIVE BACKGROUND

The income tax legislation in each jurisdiction states a similar rule for interest deductibility, although reached from opposing poles.

2.1 Australia

Prior to 1 July 1997, the main provision which applied to determine the deductibility of interest was the general deductions provision contained in s 51(1) of the Income Tax Assessment Act 1936 ("ITAA36"). As part of the redrafting of the Australian legislation into a simplified form this provision has been re-enacted as s 8-1 of the Income Tax Assessment Act 1997 ("ITAA97") with

\(^1\) For a purely southern hemisphere comparison (Australia and New Zealand), see GA Richardson & CJ Mancer, "The deductibility of Interest Expenditure: Can Australia Learn from the New Zealand Experience?" (1995) 7 CCH Journal of Australian Taxation 20.
effect from 1 July 1997. The terminology and style of this provision differs only slightly from the original and, in any event, the effect of the new Act (as expressed in s 1-3) is not to change the law but to restate it in a clearer or simpler style. Thus, the law is not intended to be changed by this re-enactment and the old case law and administrative pronouncements are to apply with equal force to the new s 8-1.

Section 8-1(1) states:

You can deduct from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

Subsection (2) goes on to provide that you cannot deduct a loss or outgoing of a capital, private or domestic nature or which is incurred in the production of exempt income.

The first part of subsection (1), traditionally referred to as the first limb, has been interpreted as applying to non-business taxpayers whereas the second limb is seen as providing a less restrictive deduction principle and applicable to businesses. However, this distinction has seldom been an issue in the context of interest deductibility where the courts have tended to always approach the issue in terms of whether the purpose of the borrowings on which the interest is payable is to produce assessable income.

On this basis, it has been doubted whether the "private" and "production of exempt income" exclusions add anything to the provision as subsection (1) would not be satisfied in either of the circumstances in which these exclusions would operate. As to the "capital" exclusion, interest has traditionally been viewed as a revenue expense in Australia although, as discussed below, recent decisions have cast some doubt on this proposition.

2.2 Canada

The Canadian Income Tax Act ("CITA") states in s 18 a provision with a similar effect as s 8-1 of the Australian legislation but reversing the positive and exclusionary limbs.

Thus, s 18(1) provides:

... in computing the income of a taxpayer from a business or property no deduction shall be made in respect of:

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;

(b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this part ...

As will be noted below, given that interest has been treated as a capital expense in Canada, without more this provision would have the effect of denying a deduction for interest. However, s 20(1)(c) provides:

Notwithstanding paragraphs 18(1)(a), (b) ... there may be deducted ...

(c) an amount 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 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).

Thus, in contrast to Australia, in Canada the approach has been to deny a deduction and then provide a specific exception on money borrowed for the purpose of earning non-exempt income.  

Notwithstanding this structural difference, the legislation in both jurisdictions has a commonality in that in each case it focuses on the purpose for which the borrowed funds were used, in particular whether the funds were used for the purpose of earning (non-exempt) income.

3. THE CONUNDRUM

The _prima facie_ simplicity of a purpose test belies the difficulties inherent in such a test. Issues with which the judiciary and the tax administrators in both jurisdictions have been faced include:

(1) Is it the objective or subjective purpose of the taxpayer that is relevant?

(2) How is the purpose to be ascertained - is it by reference to the use of the borrowed funds and if so, is a tracing of those funds through to their use required?

(3) If the borrowed funds are provided to other entities or persons, is it permissible to trace through these entities to identify the ultimate application of the funds?

(4) Is it only the immediate purpose that is relevant or may subsidiary or indirect purposes also be referred to?

(5) What if the purpose funds are used for changes - is the initial purpose for which they were borrowed or only the current purpose relevant?

(6) In the event of refinancing do the new borrowings embrace the same purpose as the original?

(7) What if there is a multitude of purposes - is an attempt to identify the dominant purpose required or is an apportionment approach envisaged?

4. JUDICIAL TREATMENT OF INTEREST DEDUCTIBILITY - AUSTRALIA

4.1 The Use Test

The leading authority in Australia is the High Court decision in _FC of T v Munro_. This case concerned the deductibility of interest on borrowings secured over an income-producing asset where the funds were used for a private purpose. The case has traditionally been viewed as authority for a "use" test. That is, in determining the purpose for which funds were borrowed it is necessary to examine the use of these funds, which may require a tracing of the proceeds.

Difficulties arising from the application of this test have, in recent times, prompted the judiciary and commentators to emphasise that this test is only a guide to the application of the statutory purpose test and is not a substitute for it.

---

2 There have been suggestions that interest deductibility ought to be determined under the general deduction provision, as in Australia, but little support for this change exists. Discussed in BJ Arnold & T Edgar, "Deductibility of Interest Expense" (1995) 43 Canadian Tax Journal 1216, 1232-1233. Also see T Edgar & BJ Arnold, "Reflections on the Submission of the CBA-CICA Joint Committee on Taxation Concerning the Deductibility of Interest" (1990) 38 Canadian Tax Journal 847.

3 (1926) 38 CLR 153 ("Munro").

4 The suggestion has been made that rather than establishing a use test the case was simply decided on the basis that there was an insufficient connection between interest outgoings and the production of assessable income. See K Burford, "Hayden's Case: Overuse of the Use Test" (1997) 5 Taxation in Australia (Red Edition) 262, 263.

5 See eg, Hill J in _FC of T v Roberts & Smith_ (1992) 23 ATR 494; 92 ATC 4380 and in Kidston Goldmines Ltd v _FC of T_ 91 ATC 4538. In the latter case, his Honour, at 4545, canvasses some difficulties inherent in the test.
4.2 Preservation of Assets Test

The impetus for this watering down of the Munro use test has been the attempt to rationalise with Munro a series of cases that have suggested that an indirect purpose, not borne out by a tracing of the funds to their immediate use, can supply the necessary purpose for deductibility.

The first of these cases was Begg v DFC of T. In that case, an executor of an estate borrowed funds in order to meet a death duty liability in lieu of selling off income-producing assets. The South Australian Supreme Court held that the interest was deductible because the purpose of the borrowing was to enable the estate to continue to produce income from its assets.

Attempts to reconcile the use test with this recognition of indirect purposes came to a head in the Federal Court decision of Hayden v FC of T. At issue was a borrowing, secured over an income-producing asset, used to purchase a private asset. Naturally the taxpayer argued that the alternative to borrowing was to dispose of the income-producing asset and therefore the interest was deductible as the purpose of the borrowing was to preserve income-producing assets. On the other hand, the Commissioner of Taxation argued that the use of the funds, as evidenced by a tracing of them to the purchase of the private asset, indicated a non-income producing purpose.

The court concluded that the two authorities of Begg and Munro could not be reconciled and that the High Court decision in Munro was to take precedence and on the application of the use test the interest was not deductible. The preservation of assets test was rejected as potentially permitting a deduction for interest on funds borrowed for any purpose in circumstances where the taxpayer also owned income-producing assets.

Uncertainty remains however because, as will be illustrated below, there have been a series of other decisions in the context of partnerships which, consistent with Begg, have embraced indirect purposes and given less weight to the use test. It has also been suggested that Hayden’s case placed too much emphasis on the use test.

4.3 The Tracing Principle

Borne from the use test the tracing principle permitted the Commissioner to argue that only the immediate application of borrowed funds could support interest deductibility. Thus, interest on funds borrowed by a company to redeem or buy back shares or pay dividends initially treated as not deductible notwithstanding that the borrowings permitted working capital to be retained.

This was viewed as commercially unsound by taxpayers and eventually a test case came before the Full Federal Court in the form of FC of T v Roberts & Smith. At issue was the deductibility of interest on borrowings by a partnership to permit the repayment of capital to partners. A tracing of the application of these funds to their immediate purpose, namely the repayment of capital, and the subsequent use of the funds for personal purposes by the partners was the basis for the Commissioner’s submission that the interest was non-deductible. However, the Full Federal Court retreated from a rigid tracing principle

---

6 (1937) 4 ATD 257 ("Begg").
7 96 ATC 4797 ("Hayden").
8 See the discussion of these decisions by G Richardson, "Section 51(1): A "But For" Approach to Deductibility of Interest?" (1994) 6 CCH Journal of Australian Taxation 32, 36. He favours the restriction of the preservation test to business taxpayers claiming a deduction under the second limb.
9 Burford, above n 4.
10 Exposure Draft Ruling EDR 73. Rather inconsistently, Income Taxation Ruling IT 2582 permitted a deduction for interest on borrowings by a business taxpayer to fund the payment of income tax. It is understood, however, that this ruling was the result of substantial political pressure upon the Australian Taxation Office ("ATO").
11 92 ATC 4380 ("Roberts & Smith").
stating that this was not always necessary or appropriate. Rather the facts were more appropriately categorised as the replacement of one form of working capital with another.

This was viewed as a watershed case in Australia and a substantial revision of the Munro use test with its associated tracing principle. Parsons saw this case as establishing a new rule, namely that if the function of the borrowing was the sustaining of the holding of the business assets then the interest was deductible. Thus, in effect, he saw the decision as endorsing the Begg preservation of assets principle over the Munro use test.

Whilst the Commissioner was not prepared to embrace the decision as establishing such a wide ranging principle, the case did cause it to retract some earlier narrow rulings. Thus in Taxation Ruling TR 95/25, the Commissioner acknowledged that a rigid tracing was not always appropriate and accepted that the "refinancing principle" established in Roberts & Smith could apply to general law partnerships and companies. Thus, interest on borrowings to fund dividends and the repayment of capital was accepted as deductible. However, the Commissioner was not prepared to extend this principle to individuals and thereby endorse the preservation of the assets principle established in Begg. His concern to restrict the Roberts & Smith principle arose from the perception that it was "pregnant with avoidance possibilities" and to ensure that those possibilities were still born.

The result was to create, or at least maintain, two anomalies namely:

(1) a taxpayer who invests in a business asset through an intermediary entity may replace that investment with borrowed funds and thereby achieve an interest deduction in circumstances where an individual holding an investment in an income-producing asset could not, and

(2) an individual who borrows to acquire an income-producing asset whilst using their capital for private purposes will achieve a tax deduction on the interest payable whereas an individual who initially purchases the asset with his or her own capital will not secure a deduction where he or she subsequently replaces those funds with borrowings and uses the withdrawn capital for private purposes.

Notably, no comment is made in the ruling as to the application of the refinancing principle to trusts. This had been acknowledged in Draft Taxation Ruling TR 93/D38 but the statement was removed prior to finalisation. It is suggested that the principle could readily apply to unit trusts and possibly fixed trusts but it is difficult to envisage its application to discretionary trusts in the absence of the beneficiaries or objects having capital invested in the trust.

4.4 Changes in Use and Post-business Interest Deductibility - The Occasion Principle

When an income-producing asset purchased with borrowed funds is disposed of or converted to private use, then the issue arises as to whether the interest remains deductible. This turns on whether the purpose test is to be applied only once, upon the taking out of the loan, or is to be applied on a continuing basis. Typically, the Australian courts

---

12 A tracing approach may be more appropriate upon an application of the first (non-business) limb of s 8-1 of the ITAA97. See Wallschutzky & G Richardson, "The Deductibility of Interest" (1995) 24 Australian Tax Review 5, 11.

13 See eg, G Cooper, "Interest Deductibility; Are the Courts Heading in a New Direction?" (1994) 28 Taxation in Australia 511; C Evans & W Scholtz, "Corporate Borrowings: The Limits of Interest Deductibility" (1994) 2 Taxation in Australia (Red Edition) 222.

14 RW Parsons, "Robert's & Smith: Principles of Interest Deductibility" (1993) 5 Taxation in Australia (Red Edition) 261. There is some merit in this "function of sustaining the holding" test as it also assists in providing a coherent principle to deal with the change in use scenario discussed below. Others have not read as much into the decision. See R Thomson, "Interest Deductions - The Use Test - Robert's Case" [1993] CCH Journal of Australian Taxation 29.

15 Parsons, above n 14, 270.
have adopted the latter approach. Thus, upon the asset being sold or converted to private use the interest ceases to be deductible.\textsuperscript{16}

However, the courts have struggled with variations on this scenario where interest has been prepaid or where the commitment to interest payments can be characterised as an obligation occasioned by the acquisition of the erstwhile income-producing asset. Thus, in \textit{FC of T v Riverside Road Pty Ltd (in liq)}\textsuperscript{17} interest on funds borrowed to purchase a motel business remained deductible after the motel was sold up until such time as the loan was refinanced. The Court characterised the obligation to pay interest as part of the contractual arrangements the taxpayer entered into when it acquired the business. Refinancing the loan, however, broke the business nexus.

This is consistent with a series of Australian decisions which have held that if the occasion of an outgoing could be found in the prior carrying on of a business then the amount was deductible notwithstanding that it was incurred after the business had ceased.\textsuperscript{18}

However as the \textit{Riverside Road} decision illustrates, in the context of an on-going expense like interest, this principle is problematical. Recently, in \textit{Brown v FC of T}\textsuperscript{19} a partnership had borrowed $105,000 to purchase a business, the loan being payable over ten years, but after three years the business was sold for $65,000 leaving $42,000 outstanding on the loan. The issue was the deductibility of the interest for the four years following the cessation of the business until full repayment of the loan. The Federal Court held that the interest remained deductible. An argument that the use of the funds after the business ceased was to fund the ownership of private assets was rejected on the basis that the use of the funds was to be ascertained at the time of the initial borrowings and this use had not changed. The Court stated that the argument amounted to an attempt to notionally transmogrify the loan from being a source of business funds into a fund applied for private purposes. In other words, there was an attempt to assess the taxpayer on the basis of what he ought to have done rather than on the basis of what he actually did.

This approach raises problems. Presumably the same conclusion would have been called for had the business been converted to private use rather than sold. What about the scenario where a private asset is applied to business ends? Would this predominance of the occasion principle mean that interest on funds borrowed to purchase the originally private asset would remain non-deductible?

On appeal, the Full Federal Court upheld the decision of the lower Court focussing on the purpose of the taxpayer at the occasion of the initial borrowing.\textsuperscript{20} Whilst the Court accepted that a time lag between the cessation of a business and the incurring of an outgoing could be of such magnitude to render the payment no longer sufficiently proximate to the business activities, this was not the case on the facts.

The Court distinguished between the loan at issue and a "roll over business loan facility". Had the loan been in the nature of a roll over facility, which upon falling due for repayment could, at the election of the taxpayer, be renewed, then the occasion of the outgoing may have been the election to roll over the loan rather than the original borrowing. In such a case, the cessation of the business might have been regarded as breaking the business nexus in the same way as the loan refinancing in \textit{Riverside Road}.

\textsuperscript{16} As to change in use from income-producing to private see \textit{FC of T v Ilbery} 81 ATC 4661.
\textsuperscript{17} 90 ATC 4567 ("Riverside Road").
\textsuperscript{18} See \textit{Placer Pacific Management Pty Ltd v FC of T} 95 ATC 4459 and \textit{AGC (Advances) Ltd v FC of T} (1975) 132 CLR 175. Contrast these with \textit{Amalgamated Zinc (de Bavay's) Ltd v FC of T} (1935) 54 CLR 295.
\textsuperscript{19} 98 ATC 4695 ("Brown (FC)").
\textsuperscript{20} \textit{FC of T v Brown} 99 ATC 4600 ("Brown (FFC)").
The Court also placed significance on the fact that the partners used the net proceeds of the sale of the business to partially repay the loan and did not appear to have any other partnership assets they could liquidate. Presumably had they used the sale proceeds for private purposes then the deduction would have ceased to have been available. If this is stating a requirement that for continued deductibility of the interest, any proceeds from the sale of the business assets must have been applied in reduction of the loan funds, then it is difficult to reconcile with the application of the occasion principle and the finding that the loan agreement and acquisition of the business was the relevant occasion.

These difficult distinctions illustrate that the occasion principle and use test do not sit well together.

5. INTEREST DEDUCTIBILITY AND PRE-BUSINESS ACTIVITIES

Whilst this issue of the deductibility of interest after an income-producing asset has been disposed of or a business has ceased has long been problematical, until recently the other end of the spectrum had been considered as relatively settled. Interest on funds borrowed to construct business premises, and hence incurred prior to any income-producing activities, had been accepted as deductible by the Commissioner in two rulings following Board of Review decisions.

However, the recent decisions of the Privy Council in Wharf Properties Ltd v CIR (Hong Kong) and the Federal Court in Steele v FC of T initially cast doubt on this principle. In both cases the Courts had denied interest deductions on funds borrowed to purchase property which the taxpayers had earmarked for income-producing activities but upon which no construction had yet commenced.

Following these decisions it was unclear whether there was a new principle that there is no deduction available until the acquired asset produces income or whether the decisions were simply based on the facts which suggested that the connection between the interest expense and the proposed income-generating activities was too remote. The cases also raised, for the first time in the Australian context, the proposition that interest may be on capital account, a proposition that has been roundly criticised.

The High Court, hearing the appeal in Steele, has now confirmed that there is no such new principle in Australia nor was the interest on capital account. The matter was remitted to the original tribunal for reconsideration as to whether the requisite connection existed.

6. APPORTIONMENT AND OBJECTIVE AND SUBJECTIVE PURPOSE

Section 8-1 clearly envisages an apportionment of interest where a borrowing is for a mixture of purposes only one of which is income-producing.

Thus, in Ure v FC of T borrowings at commercial rates which were on lent at 1% to associates of the taxpayer, only permitted a

---

21 The distinction between the loan at issue and a roll over facility was particularly fine. Whilst the evidence was unclear as to whether the bank was legally obliged to allow early repayment without penalty, the Court nevertheless accepted that this was the bank's policy. Thus, the distinction between this loan and a roll over facility amounts to whether the borrower has an election to repay or an election to renew a loan.

22 Income Taxation Rulings IT 166 and IT 2374. The latter ruling drew support from the National Court of Papua New Guinea decision in Travelodge Papua New Guinea Ltd v Chief Collector of Taxes 85 ATC 4432.

deduction equal to the 1% interest received. On an objective assessment of the facts, the purpose of the taxpayer in incurring the interest expense was a mixture of both commercial and non-commercial.

In Ure the taxpayer's subjective purpose and the objective purpose were the same. However, the Court was careful to distinguish between the two. The enquiry was as to the taxpayer's objective purpose.

This distinction is strikingly illustrated by the decision in FC of T v Phillips. A partnership had established a trust to which it was paying fees for the provision of administrative services. These fees contained a commercial mark up which generated a profit in the trust which was distributed to the families of the partners. Whilst the Court accepted that the subjective purpose of the partners may have been to minimise their tax liability, the fact that the mark up was at commercial rates permitted the Court to conclude that the objective purpose of the service fee payments was commercial.

However, whilst the enquiry has traditionally been as to the objective purpose behind the borrowing, more recent authority suggests that the subjective purpose of the taxpayer may be relevant where there is no obvious commercial explanation for the incurring of the interest.

The high water mark of this reference to subjective purpose is the High Court decision in Fletcher & Ors v FC of T. This case involved a complex annuity scheme designed to produce substantial tax deductions in its early years. The High Court stated that where an outgoing was voluntarily incurred and the objective purpose behind the outgoing was not immediately obvious, then the taxpayer's subjective purpose would be a relevant, possibly decisive, consideration. The critical test as to whether subjective purpose was relevant was whether the outgoing was disproportionate to the potential income.

This decision introduces an anti-avoidance gloss into the general deductions provision and to this extent can be criticised for introducing an additional layer of uncertainty. It would have been more appropriate for the case to have been resolved under the general anti-avoidance provisions but the scope of the appeal to the High Court did not encompass a consideration of these provisions.

7. JUDICIAL PRINCIPLES OF INTEREST DEDUCTIBILITY - CANADA

7.1 An Outgoing of Capital

Whilst there is some doubt as to its correctness, there is authority to the effect that interest deductions are on capital account. Nevertheless, as noted earlier, the legislative scheme of the CITA permits interest to be deductible where the money was borrowed for the purpose of generating (non-exempt) income.

7.2 Direct and Indirect Purposes

As in Australia, Canadian taxpayers have had to consider the extent to which indirect purposes are relevant to the deductibility question. The leading decision is that of The Queen v Phyllis

28 Contrast FC of T v Total Holdings (Aust) Pty Ltd 79 ATC 4279 where a holding company borrowed funds at interest which it on lent to its operating subsidiary interest free. The interest was held to be deductible in its entirety because the interest free loan was designed to render the operating company profitable and generate income to the holding company in the form of assessable dividends. However, the mere advance of funds interest free without evidence of the potential for income generation will result in the interest on borrowings to fund the advance being non-deductible. See Sheil v FC of T 87 ATC 4430.

29 Also see the High Court decision in John v FC of T (1989) 166 CLR 147; 20 ATR 1; 89 ATC 4101.


31 Canada Safeway Ltd v Minister of National Revenue [1957] DTC 1239, 1242 and 1244.
In lieu of selling some of its investments in order to make a distribution of capital to a beneficiary, the trust borrowed funds for this purpose. The Supreme Court held that the interest was not deductible on the basis that the borrowed money was not used for the purpose of earning income but rather to make a distribution of capital. In other words, it is the current direct and actual use of the borrowed money that is at issue not any indirect use from which a benefit might be derived.

Thus, a strict tracing to the use of the funds is required. Furthermore, the focus is to be on the economic or commercial reality of the transaction such that any manipulation, like a sale and buy back of assets with borrowed funds, will not achieve a deduction.

The Court was concerned that permitting a deduction on the basis of indirect purpose would permit a deduction to any taxpayer who owned income-producing assets although the borrowings were used to fund a personal residence or pay death duties. This was at odds with a series of earlier authorities.

This is a particularly uncommercial position and it is notable that Revenue Canada had previously issued a number of interpretation bulletins providing a more commercial approach. In particular, under IT-80 interest on funds borrowed to redeem shares or pay dividends is typically deductible. Also IT-445 provides for deductibility in respect of interest free loans to domestic corporations where the funds are applied to produce taxable income, no tax advantage is obtained and, effectively, the shareholder can borrow the funds at a lower rate of interest than the corporation. The Bronfman Trust decision cast doubt on these administrative pronouncements with the result that in June 1987 the Department of Finance issued a notice of ways and means motion to the effect that the administrative pronouncements would be given legislative effect on a temporary basis until such time as the interest deductibility rules could be reviewed.

In December 1991, draft legislation was released by the Department of Finance, which does not purport to overhaul the rules but simply enact the administrative pronouncements. The legislation has yet to be passed but is to have a retrospective operation.

The draft legislation has four aspects namely:

- s 20(3.1) and (3.2) dealing with the advance of borrowed funds to a corporation or partnership where there is no direct return to the lender;

---

34 87 DTC 5059 ("Bronfman Trust").
35 Bronfman Trust was recently followed in 74712 Alberta v The Queen 97 DTC 5126.
36 It has been suggested that the Supreme Court in Bronfman Trust ought to have restricted its decision to the narrow issue involved in the case and ought not to not have made obiter statements without careful and comprehensive analysis of the issues. One result of the decision was the issue of 10 pages of complicated legislation (discussed below) to restore the law to the position prior to the case. BJ Arnold & T Edgar, "The Draft Legislation on Interest Deductibility: a Technical and Policy Analysis" (1992) 40 Canadian Tax Journal 267, 303.
38 Discussed further below.
39 In addition to these two bulletins, a commercial approach was also adopted in IT-315, interest expense incurred for the purpose of winding up or amalgamation, May 10 1976; IT-355R, interest on loans to purchase life insurance policies and annuity contracts and interest on policy loans, January 12 1981; IT-445, the deduction of interest on funds borrowed either to be loaned at less than a reasonable rate of interest or to honour a guarantee given for inadequate consideration in non-arm's length circumstances, March 14 1986 and IT-498, the deductibility of interest on money borrowed to reloan to employees or shareholders, October 6 1953.
- s 20(1)(qq) dealing with the deductibility of interest on borrowings used to acquire shares returning less than the interest expense;
- s 20(1)(c)(v) and (vi) dealing with the deductibility of interest on borrowings used to fund interest free loans to employees or shareholders; and
- the deductibility of interest on borrowings used to pay dividends or return capital to shareholders or partners.

The rationale behind the draft legislation is an acceptance of the direct tracing rule together with an acknowledgment of specific exceptions where the purpose of deriving income can be identified as an indirect purpose. These exceptions were those previously identified in the administrative concessions.

Whilst commentators had hoped that the legislation would respond to the uncommerciality of the purpose test and provide more generous rules for the deduction of interest, they were generally disappointed. It has been suggested that these rules will be difficult to apply in practice and may damage the competitiveness of Canadian businesses and rather than complex rules, interest expense should simply be treated as a cost of doing business.

The draft legislation will be considered under the relevant headings below.44

7.3 Interest Free Loans

As noted above, Revenue Canada in IT-445 provides for the deductibility of interest on borrowings to fund interest free loans to domestic corporations. This is an administrative concession to the obiter comments made in DWS Corporation v MNR to the effect that interest incurred to finance an interest free loan to a company, the shares in which are owned by the lender, was not deductible because the dividend earning potential of the shares was too remote to satisfy the purpose test.

Subsequently, a different view was suggested in Business Art Incorporated v MNR which held that the investment by a shareholder, whether in the form of debt or equity, should be viewed as an overall investment for the purposes of applying the purpose test. However, this decision predated the Bronfman Trust case and is inconsistent with the decision in Scott v MNR.

The December 1991 draft legislation includes proposed s 20(3.1) and (3.2), which deems money borrowed for the purpose of making loans to a domestic corporation in which the taxpayer is a shareholder or controls, to have been used for the purpose of earning income.48 The company must

---

42 See EJ Heslin, "The Principles of Interest Deductibility" (1990) 54 Business Quarterly 37, 41.
44 Generally on the draft legislation see P Neilson, "Interest Deductibility" (1994) 68 CMA Magazine 28.
45 68 DTC 5045 and 69 DTC 5203.
46 66 DTC 1842.
47 69 DTC 218.
48 Proposed s 20(1)(c)(v) is to also allow a deduction for interest free loans to employees. On the other hand, proposed s 20(1)(c)(vi) would allow a deduction for interest on funds borrowed by a company and on lent to a shareholder only up to the amount of interest charged to the shareholder. This is designed to reflect the position established in IT-498 (the deductibility of interest on money borrowed to relend to employees or shareholders, October 6 1953). As Arnold & Edgar point out, there are some drafting deficiencies in this provision in that it appears that interest on a loan made to a corporate shareholder resident in Canada would not be deductible even to the extent that interest may be earned on the loan (Arnold & Edgar, above n 36, 292). Compare the Australian position established in Ure.
use the proceeds from the loan to earn Canadian source non-exempt income and be able to demonstrate that it could not have borrowed the money itself on comparable terms. With some minor modifications, this provision applies to years prior to enactment back to 1972 and also to partnerships.49

It has been suggested that it might be very difficult for the shareholder to prove that the company could not borrow from any arm's length party on terms similar to those obtained by the shareholder.50 Whilst arguably this condition in s 20(3.1) is more lenient than the corresponding requirement in IT-445,51 it is expected that Revenue Canada will adopt the same position with respect to the draft legislation.52

As Arnold & Edgar identify, the rationale for these proposed sections is that the funds provided would be used by the corporation or partnership to earn income that will result in an increased return to the lender. In accordance with this rationale the shareholder or partner should have a sufficient ownership interest.

However, it is suggested that this rationale is only partially reflected in the draft legislation. Minority shareholders or partners can deduct interest on borrowed money loaned to a corporation or partnership or used to pay a guarantee in respect of an obligation of a corporation or to make a payment in respect of an obligation of a partnership. This may provide income-splitting opportunities and thus it has been argued that the deduction ought to be limited to where the shareholder controls the company or the partner is a majority interest partner.53

The proposed section also presents arbitrage opportunities in potentially permitting a deduction to a shareholder on a higher tax rate than the corporation.54

7.4 Acquisition of Shares

Whilst the potential capital appreciation of property will not satisfy the purpose test and support an interest deduction, Revenue Canada and the courts typically permit a deduction for interest on funds borrowed to acquire shares notwithstanding that the return may be principally in the form of capital appreciation rather than dividend payments.55 The critical consideration is whether the shares have a possibility of paying dividends. It is only where no dividends are payable, the dividend rate is fixed below the interest rate, or it is otherwise clear at the outset that the dividend return will not be sufficient to meet the interest expense that the interest deduction may be limited.

Thus, in Ludner v The Queen56 an interest deduction was denied on funds borrowed to acquire shares in certain foreign companies on the basis that there was no possibility that the investment proceeds would exceed carrying costs.57

In addition, proposed s 20 (1)(qq) will permit a deduction for interest on borrowings to acquire shares where the return from the shares will be less

49 Generally, see N Boidman, "Cross Border Effect of Interest Deduction Proposals" (1992) 21 Tax Management International Journal 157. The proposed s 20(3.1) also applies to where the borrowings are used by a taxpayer to honour a guarantee of the company's debts. The provision permits a deduction to the borrower where the corporation would not have been able to obtain comparable terms without the shareholder's guarantee. In such circumstances, the absence of a return to the shareholder as compensation for the guarantee will not deny them an interest deduction: Heslin, above n 42.
50 Heslin, above n 42.
52 Arnold & Edgar, above n 36, 300.
53 Ibid, 301.
54 Ibid, 302.
56 98 DTC 6045.
57 Also see Mark Resources Inc v The Queen 93 DTC 1004 discussed below. Contrast Lessard v MNR 93 DTC 680.
than the interest outlay. Whilst the deduction is limited to the total of all amounts included in computing the taxpayer's income for the year from the shares, it is unclear whether any taxable capital gain realised on the disposal of a share may be taken into account for this purpose. Arnold & Edgar argue that the better view is that a capital gain on disposal is not an amount included in computing income from a share but rather is an amount included in computing income from the disposition of a share. This interpretation is consistent with Revenue Canada's administrative position.

The wording of the proposed provision would also appear to permit a deduction of interest by a corporate shareholder in receipt of tax-free dividends. It has been argued that this cannot be justified from a policy basis. Because dividends are grossed up for the purposes of identifying the deduction limit a similar policy issue arises where corporate tax is not actually paid on the underlying corporate income from which the dividends are paid.

Where interest on the borrowed money exceeds income from the shares, the non-deductible excess may be carried forward and deducted in the following year. Arnold & Edgar suggest that the wording of the draft section appears to restrict this carry forward to one year. Again this restriction is hard to justify on policy grounds. The draft provision also lacks clarification as to whether the non-deductible interest from the preceding year must be deducted prior to or after interest paid in the current taxation year.

It is notable that the draft provision is more restrictive than the notice of ways and means motion, which applied to interest on borrowed money used to acquire any property and not merely shares. This would have created a problem where the property was used for both income and non-income earning purposes and so allocation rules would have been required. However, it is unclear from a policy perspective as to why the provision is restricted to shares.

The proposed s 20(3.1) also applies to where borrowings are used to acquire shares in a company controlled by the taxpayer. However, the provision does not appear to apply where a shareholder acquires shares from a corporation that is controlled indirectly by the shareholder but in which the shareholder owned no shares before the acquisition. This would appear to be an unintended drafting defect.

7.5 The Timing of Acquisitions

As in Australia, the requirement to trace borrowed funds to their current and direct use results in anomalies for individuals with borrowings who hold both private and income-producing assets depending upon the relative timing of acquisition. Attempts to avoid these anomalies can be met with assessments based on economic equivalence, or what the taxpayer should have done.

Thus, in *Robitaille v The Queen* a taxpayer who withdrew capital from his partnership account in order to purchase a home and, the following day, borrowed to replace the capital was denied an interest deduction on the basis that the economic reality was that the funds were borrowed for personal purposes.

However, this principle is a double-edged sword. Should taxpayers manipulate their circumstances to attempt to satisfy the deduction requirements, deductions will be denied applying

---

58 Arnold & Edgar, above n 36, 293-294.
59 Ibid 294.
60 Ibid 295. Notably, Revenue Canada's administrative position had extended only to interest on borrowed money used to acquire preferred shares.
61 Ibid 299.
62 See Bronfman Trust 87 DTC 5059, *Tennent v MNR* [1996] 1 FCR 305 and *Trans-prairie Pipelines Ltd v MNR* 70 DTC 6351.
63 97 DTC 1286 ("Robitaille").
an economic realities test. However, if they do nothing then they cannot rely on an economic realities argument to claim a deduction.64

Some relief is, however, provided by s 20(3), which provides that borrowed money used to repay a debt is deemed to have the same purpose as the previously borrowed funds. Thus, borrowings may be refinanced with borrowings but not capital with borrowings.

7.6 Post Business Deductions

Where an investment asset or business ceases to exist, the "current use" principle would also deny the taxpayer an interest deduction for ongoing borrowings related to the asset or business. However, legislative relief is provided in s 20.1(1) which permits the continued deductibility of interest where the source of income is eroded or eliminated as long as the proceeds, if any, from the disposal are used for an income-producing purpose (or to repay the loan). The provision provides that where the original use of the borrowed money was for the purpose of earning income and this ceases the amount of the borrowed money that exceeds the market value of any disposed of or remaining property, is deemed to be used for the purpose of earning income. This deeming rule extends to the balance of the amounts payable for the property or the business and also to any replacement borrowings that previously qualified for interest deductions.65

In any event, there is some judicial support for this proposition in the decision in Tennant v MNR.66 In that case, $1 million was borrowed to acquire shares which were subsequently disposed of at the market value of $1,000. Revenue Canada reduced the deduction available for interest to equate to a loan of $1,000. The Supreme Court held that the ability to deduct interest was not lost simply because the income-producing property was sold as long as the proceeds were reinvested in similar property. The basis for the interest deduction was not the value of the replacement property but rather the amount of the original loan.

The Court was required to distinguish the decision in Emerson v The Queen.67 In that case the taxpayer had borrowed to purchase shares which he later resold at a loss. He was then required to refinance the borrowings still outstanding but was denied a deduction for the interest on the new loans on the basis that the source of the income no longer existed.68

It has been argued that the decision in Emerson is commercially unsound and lacks any strong policy rationale.69 On the other hand, the Supreme Court in Tennant was cognisant of a desire that their decision would reflect the economic reality, finding support for this approach in the Bronfman Trust case.

However, the coexistence of Tennant with Emerson produces an anomaly in that interest deductibility will only be maintained where the proceeds from the disposal are used to acquire another income-producing asset and not, for example, where they are merely used to partially repay the loan.70 That is, some income-producing source related to the borrowing needs to be maintained.71

---

64 This is well illustrated by the Bronfman Trust decision 87 DTC 5059, 5068.
65 Generally see H Frankel, "A Matter of Interest" (1994) 127 CA Magazine 33.
66 [1996] 1 FCR 305 ("Tennant").
67 86 DTC 6184 ("Emerson").
68 Also see Lyons v MNR 84 DTC 1633; McKay et al v MNR 84 DTC 1699; Alexander et al v MNR 83 DTC 459 and Deschenes v MNR 79 DTC 461.
70 Contrast the view of the Australian Full Federal Court in Brown (FFC) 99 ATC 4600 which placed significance on the fact that the disposal proceeds were used to partially repay the loan.
The amendment contained in s 20.1 is effective for distributions after 31 December 1993. Notably, this relief does not extend to permitting a deduction for interest on borrowings to acquire real or depreciable property in relation to which taxpayers will need to fall back on the decision in Tennant.72

7.7 Indirect Use/Purpose and Tax Avoidance

Whilst Bronfman Trust states the proposition that it is the direct use of the funds that is at issue, it would appear that indirect uses may be referred to where tax avoidance is involved. In Mark Resources Inc v The Queen,73 a Canadian company borrowed funds in order to make a capital contribution to a foreign subsidiary to permit that subsidiary to earn investment income to absorb its losses. Dividends were paid to the Canadian company equal to the investment income earned.

The taxpayer argued that the direct and immediate use of the borrowed funds was the injection of capital into a subsidiary to allow it to earn income to be paid by way of dividends. However, the Court held that the true purpose for the borrowing was to implement a plan to absorb into the Canadian company the losses of a foreign subsidiary and accordingly a deduction was denied.

In the first part of this decision, the Court recognised that a capital contribution (akin to an interest free loan) might generate increased dividends on the share capital investment and therefore, borrowings to support the contribution could give rise to deductible interest.

However, the second part of the decision is difficult in that the Court is apparently focussing on indirect purposes rather than the direct one which would obviously support interest deductibility. The Court specifically focussed on identifying the "true", "practical", "real" or "intermediate", "subordinate" or "incidental" objectives.74 Whilst not expressed, the Court may have been influenced by the evidence that the ultimate return to the taxpayer would be less than the required interest payments yet the anti-avoidance provisions had no application. Thus, the case may provide some support for the proposition that reference to indirect purposes may be permissible where the arrangement does not generate an economic profit.

Nevertheless, it has been suggested that this case has muddied the waters as it appears to be retreating from the focus on the direct use and an indirect use may result in a loss of deductibility.75 Taxpayers would now appear to have to concern themselves with both their apparent purpose and any over-riding purposes and identify which is primary.

7.8 Interest on Borrowings to Pay Tax

Canadian courts have held that money borrowed to pay income tax is not used for the purpose of earning income and thus the interest payable is non-deductible. However, Revenue Canada provides an administrative concession and generally does not attempt to disallow such interest.76

---

73 93 DTC 1004 ("Mark Resources").
74 Ibid 1011-1012.
75 Frankel, above n 65. The decision is also criticised in JR Owen, "Shell Canada Limited: A new Test of Economic Substance over Form" (1998) 30 Canadian Business Law Journal 449, 458. However, the decision was followed in Ludner v The Queen 98 DTC 6045 and Canwest Broadcasting Ltd v Canada 96 DTC 1375.
76 Generally see Heslin, above n 42, 39.
7.9 Economic Substance over Form

Since the decision in Bronfman Trust, with its reference to recognising economic reality, there has been a series of decisions that have grasped this comment to justify a substance over form approach. These include Mark Resources, Robitaille77 and Ludner, all discussed previously.

The high water mark of the approach to date is the Federal Court of Appeal decision in Shell Canada Limited v Canada. 78 Shell had entered into a series of arm's length loan and hedging contracts designed to achieve higher deductible interest costs but with a capital gain on maturity of the debentures, which would be sheltered by available capital losses.

As in Mark Resources the general anti-avoidance provision was held to have no application. However, the Court read into s 20(1)(c) a gloss that the interest deduction must be reasonable which it interpreted as imposing an anti-avoidance provision, permitting the disallowance of a deduction when the form of the transaction did not reflect the economic realities of the situation.

Accordingly, on an economic analysis, a portion of the interest was, in fact, a repayment of principal.

This decision has been criticised as being flawed in numerous respects.79 It has been argued that it reads too much into the comments on commercial reality in Bronfman Trust,80 inappropriately reads words into s 20(1)(c), applies an incorrect test of reasonableness, assesses a transaction based on its economic rather then its legal effect and focuses on the indirect rather than the direct purpose of the transaction.

7.10 Interest on Borrowings to Pay Dividends or Return Capital

IT-80 acknowledged that interest on funds borrowed to redeem shares or pay dividends is typically deductible. Indeed, this proposition would appear to follow from the decision in Trans-prairie Pipelines Ltd v MNR81 which adopted a refinancing principle similar to the Australian decision in Roberts & Smith. Interest on funds borrowed to redeem preferred capital was held to be deductible because "as a practical matter of business common sense" the borrowed money went to fill the hole in capital.82 The Court refused to be constrained to look only to the immediate use of the funds.

This decision was distinguished by the Supreme Court in Bronfman Trust83 on the basis that in Trans-prairie the borrowed money went to replace share capital, which had in fact been used to produce income. However, in Bronfman Trust no capital was disposed of and the borrowed money was simply used to make a distribution. This distinction creates an anomaly, which could be the subject of manipulation. Whether the two decisions can be reconciled or whether Trans-prairie has been over-ridden is the subject of debate.84 The Supreme Court in Bronfman Trust had acknowledged that interest might be deductible on an indirect use basis in exceptional circumstances.85

---

77 It has been suggested that Robitaille did not involve identifying the economic substance of the transaction but merely the actual direct use of the borrowed funds: Owens, above n 75, 457.
78 98 DTC 6177 ("Shell").
79 Owen, above n 75, 457.
81 70 DTC 6351 ("Trans-prairie").
82 Ibid.
83 87 DTC 5059, 5066-5067.
84 See Arnold & Edgar, above n 2, 1227, especially fn 46.
85 IT-80 was cancelled by Revenue Canada after Bronfman Trust although it was announced that the cancelled IT would continue to represent its administrative policy. See Revenue Canada, Interest on money borrowed to redeem shares, or to pay dividends (IT-80), News Release, February 12, 1987. Subsequently the bulletin was reinstated in October 1990.
The issue is dealt with in the draft legislation which permits a deduction for interest on borrowings to pay dividends or return capital to shareholders or partners provided the payment is not from an asset revaluation reserve or goodwill. Whilst the 1987 notice of ways and means motion required that the dividends or capital be paid out of capital or cumulative profits, the draft legislation replaces this concept, at least in relation to borrowings prior to the legislation passing Parliament, with the notion of equity calculated according to the financial accounting book value of assets. Consolidation is not permitted and gains on property transferred between non-arm's length parties are excluded. The amount of equity for these purposes is the lesser of equity at the beginning or at the end of the year.

In relation to future borrowings after the legislation is passed, equity is to be calculated using tax values of assets as opposed to their financial accounting book values. Alternatively, in relation to such borrowings, a company or partnership may elect to designate borrowed money used to make the distribution as having been used to acquire specific assets. The designated amount for any asset must be less than the excess of its tax value over any other debt related to it and the total of all such designations must be less than the recipient's equity before the distribution.

The draft legislation inherently contains a number of assumptions. First, it assumes that the borrowed funds are used first to replace capital used to acquire taxable income-producing assets rather than any assets producing non-taxable income. Second, consistent with this first assumption, on repayment of any loan the legislation assumes that the principal attributable to a taxable income earning use is repaid first.

In relation to these proposals, Arnold & Edgar identify that the limitations are intended to prevent a corporation or partnership from distributing accrued but untaxed gains. They argue that theoretically unrealised gains net of any tax liability on a notional realisation should be included in the amount available for distribution. This net inclusion would result in the equal treatment of a taxpayer that borrows against assets with accrued but unrealised gains and a taxpayer that actually realises the gains. However, they can see that taking after tax unrealised gains into account would raise valuation difficulties.

8. CONCLUSION

There is an undoubted parallel in the Canadian and Australian experience in relation to the search for guiding principles on interest deductibility. Whilst in both jurisdictions, the legislation lays down a purpose test, the difficulty is that the subsidiary tests established by the judiciary and tax administrators often march in opposite directions to each other.

Thus, in Australia there is tension between the "use" test with its tracing requirement with the "preservation of assets" test and the "occasion of the outgoing" test.

Similarly, the "use" test with its rigid tracing principle established in Bronfman Trust was recognised as generating uncommercial results in certain circumstances with the resultant

---

86 In the 1987 release interest deductibility was accepted where the borrowed funds were used to provide dividends or distribute profits which were not in excess of the accumulated profits of the corporation or partnership. However, the term "accumulated profits" was not defined and doubt existed as to whether it would be calculated in accordance with general accounting principles or whether the tax principles would apply. In addition, it was unclear as to whether it would be calculated on a consolidated basis or on an individual company basis. Finally, it was also unclear as to when the cumulative profits were to be determined, whether at the start or at the end of the year or when the distribution was made. See Heslin, above n 42, 39.

87 Arnold & Edgar assume that the 1987 release required this determination to be made at the time of the distribution and see this as the most significant change between the release and the draft legislation. Arnold & Edgar, above n 36, 289-290.

88 Arnold & Edgar, above n 36, 287.
administrative concessions by the Department of Finance and draft legislation.

In fact the tracing principle and its major two alternatives, apportionment and ordering, have been the subject of debate for many years.\(^{89}\) Tracing is criticised as being artificial, difficult to administer, results in economically similar scenarios being treated differently and encourages tax planning.\(^{90}\) On the other hand, the ordering and apportionment approaches exhibit deficiencies including arbitrariness and valuation difficulties.

There is support for a tracing approach however, arising from its familiarity and because the tax planning it encourages can be used to avoid unfairness.\(^{91}\) Unfortunately, the judicial trend towards applying anti-avoidance provisions, focussing on subjective intentions and assessing on an economic reality basis, often negates this tax planning.

The Australian Commissioner has made similar administrative pronouncements retreating from a rigid tracing approach although these were forced by the decision in *Roberts & Smith*. It is notable that *Roberts & Smith* and *Bronfman Trust* concerned essentially the same issue but the courts reached opposing views.\(^{92}\) This has resulted in the draft legislation in Canada effectively restating the position achieved in Australia by virtue of *Roberts & Smith*.

In both jurisdictions residual issues remain, in particular, the significance for non-business taxpayers of an indirect purpose of preserving income-producing assets *vis-a-vis* a direct purpose of paying private debts. In Australia, this issue is at the heart of the tension between the "preservation of assets" and "use" tests. The Canadian draft legislation does not deal with this issue so presumably the direct purpose test would prevail.

A similar scenario has arisen with interest free loans. In Australia the decision in *Total Holdings*, whilst at odds with the use test and its tracing principle, established a position that permits a deduction for interest on funds borrowed to make an interest free loan to a corporation. This was not generally recognised in Canada by the judiciary. Again this was ameliorated by an administrative concession from Revenue Canada, since taken up in the draft legislation.

The failure by the Canadian judiciary to acknowledge the "occasion of the outgoing" test adopted in the Australian decision of *Brown* resulted in the rule that interest ceased to be deductible where the acquired asset or business was disposed of or terminated. Notwithstanding that this was subsequently addressed in part by the Supreme Court, a legislative fix (at least for non-depreciable investments) was forthcoming. This amendment is expressly extended to refinancings of the original loan unlike the anomalous position, which appears to have been established by the Australian Courts in *Riverside Road* and *Brown* and the Canadian Court in *Emerson*.

Whilst both jurisdictions have approached the purpose test from an objective basis, the decisions in *Fletcher* and *Mark Resources* appear to have established the same proposition, namely that subjective or indirect purposes of tax avoidance may deny interest deductibility and may be referred to where the economic justification for the arrangement is not immediately apparent.\(^{93}\) These

---

\(^{89}\) See the articles referred to by Arnold & Edgar, above n 2, 1236, fn 64.

\(^{90}\) Recently, the tracing test has again been criticised as conceptually and practically flawed: GA Richardson & H Anderson, "The Deductibility of Interest: an Asian-Pacific Regional Comparison" (1997) 23 *The International Tax Journal* 6, 21-22.

\(^{91}\) Arnold & Edgar, above n 2, 1236-1237.

\(^{92}\) Knight attempts to reconcile the decisions in *Bronfman Trust*, *Begg* and *Roberts & Smith* but concludes that the decisions in *Bronfman Trust* and *Begg* are in direct conflict. See M Knight, "Interest Deductibility: Unsettled Issues" (1994) 2 *Taxation in Australia* (Red Edition) 230, 239. Notably the recent decision in *Hayden*, which rejected *Begg*, adopted an analysis very similar to that in *Bronfman Trust* but without any reference to that decision.

\(^{93}\) This interpretation of the *Mark Resources* decision is supported by Linden JA in *Shell Canada Ltd v Canada* 98 DTC 6177. For a criticism of this interpretation see Owens, above n 75, 457.
decisions arguably lay weight to the notion that hard cases make bad law. They are at odds with the conventional wisdom and reflect a judicial response to perceived inadequacies with the general anti-avoidance provisions under which they ought to, arguably, have been decided.94

There appears to be a recent trend in Canada, as evidenced by Ludner and Shell to take an economic equivalence approach to determining the deductibility of interest.95 This approach has so far been resisted in Australia at least in non-tax avoidance cases.96 It is suggested that should the courts start fluctuating between economic equivalence and jurist approaches to determining deductibility then this would generate even more uncertainty. In particular, this would severely impact on the adoption of the variety of financial products now on offer as their taxation consequences would be impossible to assess in advance. This could impede economic activity given that the need for and growth in the range of these products has been in response to the various risks and investment profiles displayed by businesses.

Notably, the administrations in both jurisdictions have established a similar concession in relation to income tax. Principles relating to apportionment, especially in relation to fixed investments at less than the interest rate on the borrowings, would also appear to be similar, albeit achieved through the draft legislation in Canada.

It is debateable as to which jurisdiction has the most settled and preferable position. It has been suggested that the draft legislation has reinstated the equilibrium that existed in Canada prior to Bronfman Trust.97 However, the recent trend to an economic equivalence approach to deductibility threatens that equilibrium.

The experience to date in Australia is that, in the absence of clarifying legislation, it is unlikely that the judiciary will ever be able to adequately define the interest deductibility rules especially in relation to changes in use and the tensions between the use and other tests. The problem is that once competing tests exist then the current legal authorities will sway with the predispositions of the members of the judiciary. It is suggested that it is naive to believe that a single coherent rule can be established to resolve the complex scenarios in which interest deductibility can be an issue.

Calls for a single legislative rule that acknowledges the general deductibility of interest incurred in business activities tend to follow upon decisions narrowing the scope of interest deductibility or imposing tenuous distinctions. In this category are cases such as Fletcher, which permitted reference to subjective purpose notwithstanding that the traditional enquiry was as to objective purpose, the Full Federal Court in Steele, which endorsed a notion of interest as a capital expense and Riverside Road, which acknowledged the deductibility of interest after the disposal of the business asset but only until such time as the borrowings were refinanced. Given the fine distinctions recently endorsed by the Full Federal Court in Brown, calls for reform may soon be forthcoming again.

At a time when the Federal Government is reconsidering the taxation principles applicable to businesses, such calls may this time register on sympathetic ears. The lesson from the Canadian experience may be that rather than attempt to legislate a single coherent rule, the approach of legislating specific rules may be more appropriate.98

94 In Mark Resources, the Court held that the general anti-avoidance provision had no application whereas in Fletcher the scope of the appeal to the High Court did not encompass a consideration of the anti-avoidance provisions.
96 See Brown (FFC) 99 ATC 4600 and the High Court decision in Orica v FC of T 98 ATC 4494.
97 Arnold & Edgar, above n 36, 303.
98 For a similar conclusion that an ad hoc incremental approach is preferable to comprehensive reform see Arnold & Edgar, above n 2, 1218.
To the extent that some of these rules may appear arbitrary and create anomalies and inequities, this is the trade off for certainty. At least the effects of any arbitrariness can be minimised if taxpayers can be clear about the rules before embarking upon a transaction. The fungible nature of money will often permit an opportunity to structure an arrangement to ensure interest deductibility. Then, in the absence of an economic equivalence approach, the issue will become the probity of the arrangement from the perspective of the anti-avoidance provisions. This is an issue for another day.