Ludco Enterprises Ltd. v. Canada

Ludco Enterprises Ltd., Brian Ludmer, David Ludmer and
Cindy Ludmer, appellants;
v.
Her Majesty The Queen, respondent.

[2001] 2 S.C.R. 1082
[2001] S.C.J. No. 58
2001 SCC 62
File No.: 27320

Supreme Court of Canada

2001: March 19 / 2001: September 28.

Present: Gonthier, Iacobucci, Major, Bastarache, Binnie, Arbour and LeBel JJ.

ON APPEAL FROM THE FEDERAL COURT OF APPEAL
(82 paras.)

Income tax — Deductions — Interest — Legal test for interest deductibility — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 20(1)(c)(i).

Income tax — Deductions — Interest — Taxpayers seeking deduction of interest paid on borrowed money used to purchase shares in foreign companies — Taxpayers receiving $600,000 in dividends and incurring $6 million in interest costs during period shares held in foreign companies — Whether interest costs deductible — Whether money borrowed "used for the purpose of earning income" — Concepts of "purpose" and "income" — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 20(1)(c)(i).

Income tax — Deductions — Interest — Corporate taxpayer seeking deduction of interest paid on borrowed money used to purchase shares in foreign companies — Shares disposed of in rollover transaction — Whether taxpayer entitled to deduct interest costs incurred after rollover transaction — Whether taxpayer established link between original eligible use property and current eligible use property — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 20(1)(c)(i).

Costs — Special costs — Revenue Canada denying taxpayers' interest deductions and aggressively pressing its case against taxpayers — Revenue Canada's reassessment set aside — Whether special costs should be [page1083] awarded — Supreme Court Act, R.S.C. 1985, c. S-26, s. 47.

Two foreign companies operated investment funds carefully structured to avoid the application of the Foreign Accrual Property Income ("FAPI") rules and to provide other tax

advantages to investors. Between September 1977 and June 1979, L, the President and sole shareholder of the corporate appellant ("Ludco"), purchased shares in the foreign companies on behalf of Ludco and the individual appellants, investing approximately $7.5 million using $6.5 million in borrowed funds. In 1983, Ludco disposed of the shares in the foreign companies along with other assets to a wholly owned subsidiary of Ludco for their fair market value and in accordance with the rollover provisions in s. 85 of the Income Tax Act. It received both interest-earning and non-interest-earning assets as consideration. In 1985, when the FAPI rules eliminated the tax benefits of the type of off-shore investment in issue, the appellants disposed of their shares and earned capital gains of approximately $9.2 million. In the eight years the appellants held shares in the foreign companies, they received approximately $600,000 in dividends and incurred approximately $6 million in interest charges. For the taxation years 1981 to 1985, the appellants deducted their interest costs against other reported income pursuant to s. 20(1)(c)(i) of the Income Tax Act. They were reassessed and the deductions were disallowed. The Minister of National Revenue took the position that the amount borrowed had not been "used for the purpose of earning income from a business or property" as stipulated in s. 20(1)(c)(i), but to defer taxes and convert income into capital gains. The Tax Court of Canada, the Federal Court, Trial Division, and the majority of the Federal Court of Appeal all upheld the Minister's reassessments.

Held: The appeal should be allowed. The interest costs were deductible under s. 20(1)(c)(i) of the Income Tax Act.

Per Gonthier, Iacobucci, Major, Bastarache, Binnie and Arbour JJ.: Whether a taxpayer's purpose in making an investment falls within the ambit of s. 20(1)(c)(i) of the Income Tax Act is a question of mixed fact and law. Determining and applying the proper test under s. 20 is a question of law. In this case, since the trial judge did not apply the correct legal test to determine the appellants' [page1084] purpose, this Court may interfere with his finding in this regard.

The use of the borrowed money in this case complies with the requirements expressed in s. 20(1)(c)(i), including the requirement that the borrowed money be "used for the purpose of earning income". A determination of whether borrowed money has been put to an eligible use requires a characterization of the use of the borrowed funds and of the taxpayer's purpose in using the funds. Here, the borrowed funds were directly used to purchase shares in the foreign companies, so the focus of the inquiry is whether the taxpayers' purpose in so using the funds was to earn income within the meaning of s. 20(1)(c)(i).

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. When the modern rule of statutory interpretation is applied, only the reasonable expectation of income test is consistent with the wording of s. 20(1)(c)(i). Although many courts have simply adopted the bona fide purpose test, it is not supported by the principles of statutory interpretation, especially as applied in our recent tax law jurisprudence. Nor does the text of s. 20(1)(c)(i) indicate that the requisite purpose must be the exclusive, primary or dominant purpose, or that multiple purposes are to be somehow ranked in importance in order to determine the taxpayer's "real" purpose. Absent a sham,

window dressing or other vitiating circumstances, a taxpayer's ancillary purpose may be nonetheless a bona fide objective of his or her investment, equally capable of providing the requisite purpose for interest deductibility.

For the purposes of s. 20(1)(c)(i), "income" refers to income subject to tax, not net income. This definition of income is more consistent with the objective of the interest deductibility provision, which is to create an incentive to accumulate capital with the potential to produce income by allowing taxpayers to deduct interest costs associated with its acquisition. Absent vitiating circumstances, courts should not be concerned with the [page1085] sufficiency of the income expected or received. Although the income earned in this case was relatively nominal compared to the capital gains realized and interest deductions sought, an "economic realities" view of the investments is not appropriate as it would stray from the express terms of s. 20(1)(c)(i) and supplement the provision with extraneous policy concerns. Here, the requisite purpose was present. Although earning income was not the principal factor that motivated L to invest in the foreign companies, he anticipated the receipt of dividend income and the objective documentary evidence indicates that the appellants had a reasonable expectation of earning income. Furthermore, dividend income was actually received. The purchases of the shares were genuine investments and the amount of dividends actually paid cannot be characterized as window dressing or sham.

The disposition by Ludco of its shares in the foreign companies to its subsidiary in 1983 did not affect its ability to deduct the interest costs. Ludco met the burden of establishing the necessary linkage between the original eligible use property and the current eligible use property. Although Ludco initially received a mix of income-earning and non-income-earning assets as consideration for the shares in the foreign companies, the value of the income-earning assets exceeded the amount of the borrowed money. In these circumstances, the income-producing replacement property can be linked to the entire amount of the loan and it can be said that the interest charges were "wholly applicable" to the source of the income. Consequently, the entire amount of the interest payment continued to be deductible after the rollover occurred.

This is not an appropriate case for an order for special costs pursuant to s. 47 of the Supreme Court Act. Although the Crown aggressively pressed its case against the appellants, there is no substance to the appellants' claims of abuse and misconduct.

Per LeBel J.: Subject to comments made on the interpretation of tax statutes in the companion case of Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61, there is agreement with the disposition of this appeal.

[page1086]

Cases Cited

By Iacobucci J.

Referred to: Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61; Bronfman Trust v.

The Queen, [1987] 1 S.C.R. 32; Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27; Stubart Investments Ltd. v. The Queen, [1984] 1 S.C.R. 536; Symes v. Canada, [1993] 4 S.C.R. 695; Canada v. Antosko, [1994] 2 S.C.R. 312; Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours, [1994] 3 S.C.R. 3; Friesen v. Canada, [1995] 3 S.C.R. 103; Schwartz v. Canada, [1996] 1 S.C.R. 254; Alberta (Treasury Branches) v. M.N.R., [1996] 1 S.C.R. 963; 65302 British Columbia Ltd. v. Canada, [1999] 3 S.C.R. 804; Will-Kare Paving & Contracting Ltd. v. Canada, [2000] 1 S.C.R. 915, 2000 SCC 36; Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411; Canderel Ltd. v. Canada, [1998] 1 S.C.R. 147; Shell Canada Ltd. v. Canada, [1999] 3 S.C.R. 622; Neuman v. M.N.R., [1998] 1 S.C.R. 770; Hickman Motors Ltd. v. Canada, [1997] 2 S.C.R. 336; Duha Printers (Western) Ltd. v. Canada, [1998] 1 S.C.R. 795; Continental Bank Leasing Corp. v. Canada, [1998] 2 S.C.R. 298; Spire Freezers Ltd. v. Canada, [2001] 1 S.C.R. 391, 2001 SCC 11; Backman v. Canada, [2001] 1 S.C.R. 367, 2001 SCC 10; Moldowan v. The Queen, [1978] 1 S.C.R. 480; Mark Resources Inc. v. The Queen, 93 D.T.C. 1004; Tennant v. M.N.R., [1996] 1 S.C.R. 305.

By LeBel J.

Referred to: Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61.

Statutes and Regulations Cited

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), ss. 9, 18(1)(b), 20(1)(c)(i), 85, 96.
Supreme Court Act, R.S.C. 1985, c. S-26, s. 47.

Authors Cited

Driedger, Elmer A. Construction of Statutes, 2nd ed. Toronto: Butterworths, 1983.
Krishna, Vern. The Fundamentals of Canadian Income Tax, 6th ed. Scarborough, Ont.: Carswell, 2000.

APPEAL from a judgment of the Federal Court of Appeal (1999), 240 N.R. 70, 99 D.T.C. 5153, [1999] 3 C.T.C. 601, [1999] F.C.J. No. 402 (QL), affirming a decision of the Federal Court, Trial Division (1997), 139 F.T.R. 241, 98 D.T.C. 6045, [page1087] [1997] F.C.J. No. 1707 (QL), affirming a decision of the Tax Court of Canada, 93 D.T.C. 1351, [1993] 2 C.T.C. 2494, [1993] T.C.J. No. 1 (QL), dismissing the plaintiffs' appeal from the reassessment made under the Income Tax Act for the 1981-1985 taxation years. Appeal allowed.

Guy Du Pont, François Barette and Robert Raizenne, for the appellants.
Pierre Cossette and Sophie-Lyne Lefebvre, for the respondent.
Solicitors for the appellants: Goodman Phillips & Vineberg, Montréal.
Solicitor for the respondent: The Deputy Attorney General of Canada, Montréal.

The judgment of Gonthier, Iacobucci, Major, Bastarache, Binnie and Arbour JJ. was delivered by

IACOBUCCI J.:—

I. Introduction

¶ 1 In this appeal, we are asked to decide whether interest charges incurred with respect to money the appellants borrowed to purchase shares in two foreign companies are deductible from their income from other sources pursuant to s. 20(1)(c)(i) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.).

¶ 2 The appeal was heard at the same time as Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61, reasons in which are being released concurrently herewith. The main issue in both cases is the same: whether the money borrowed by the taxpayers was "used for the purpose of earning income from a business or property" within the meaning of s. 20(1)(c)(i) of the Income Tax Act. However, the resolution of this issue requires a characterization of both the "use" of borrowed funds and the "purpose" of the use (see Bronfman Trust v. The Queen, [1987] 1 S.C.R. 32, at p. 46), and it is at this point that the inquiry in the two appeals diverges. In Singleton, the Court is asked to characterize the "use" of the borrowed funds, whereas in the present appeal we are primarily concerned [page1088] with the proper characterization of the taxpayer's "purpose" in using the borrowed money.

¶ 3 In my view, the requisite use and purpose were present in the circumstances of this case, and the requirements for interest deductibility under s. 20(1)(c)(i) were met. Consequently, I would allow the appeal for substantially the same reasons given by Létourneau J.A. in dissent at the Federal Court of Appeal.

II. Facts

A. The Companies

¶ 4 The two companies at issue in this case, Justinian Corporation S.A. ("Justinian") and Augustus Corporation S.A. ("Augustus"), operated investment funds that were carefully structured to avoid the application of the Foreign Accrual Property Income rules (the "FAPI" rules) and to provide other tax advantages to investors such as deferral of taxes and the conversion of income into capital gains. It was the policy of Justinian and Augustus (together the "Companies") to invest in debt-securities and reinvest almost all profits, retaining only a relatively small portion for the purpose of dividend distribution. In the eight years the appellants held shares in the Companies, they received approximately $600,000 in dividends, but incurred approximately $6 million in interest charges. After the FAPI rules were amended to eliminate the tax advantages of these investment funds, the appellants disposed of their shares and earned capital gains of approximately $9.2 million.

¶ 5 By way of background, it is useful to outline the taxation environment within which the Companies were set up. A document prepared in September 1976 by the Montreal law firm, Verchère & Gauthier, entitled "Memorandum Respecting the Establishment of a Non-Resident Investment Organisation for Canadian Investors", explained [page1089] that in 1976 the FAPI rules were implemented to eliminate some foreign vehicles for tax deferral and savings, such as foreign-based family investment corporations or trusts. Under the new rules, passive income

of closely held foreign holding companies and trusts was attributed to Canadian shareholders or beneficiaries in the year it was earned, even if not distributed. However, it remained open to Canadians to invest in widely held foreign investment vehicles without incurring current taxation on reinvested income provided that the interest of the Canadian investor was less than 10 percent. The Companies were conceived, and their operations planned, in light of these Canadian income tax laws and the proposal for a new investment vehicle contained in the aforementioned memorandum.

¶ 6 For our purposes, the Companies can be treated as essentially the same entity. Both were incorporated in Panama in 1977, and operated from headquarters in the Bahamas. Therefore, as non-residents of Canada, during the material times, the income of the Companies was not taxable under the Income Tax Act. The business activities of the Companies consisted of investing in Canadian and US withholding tax-exempt debt securities or fixed income securities. In order to circumvent the FAPI rules, the Companies' constituting documents restricted the acquisition and redemption of shares so that no one investor could hold more than a 9.9 percent share interest in the Companies.

¶ 7 A 1977 document prepared by Verchère & Gauthier, entitled "Memorandum Respecting the Formation and Operation of the Altanational Bond Fund" summarized the tax features of an investment in what became the Companies in this way:

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> a) the Fund would not be subject to any Canadian income tax either with respect to interest income or gains on its sales of Fund assets;
> b) the Canadian shareholders would not be subject to any income tax with respect to their investment in the Fund except to the extent of dividends received or proceeds of disposition of their shares;
> c) proceeds of dispositions of the shares by the Canadian shareholders, whether by way of sale or redemption, would give rise to taxation as capital gains.

¶ 8 The Companies' Explanatory Memoranda set out their investment strategy and dividend policy. Initially, in 1977, the Companies' strategy was to invest in debt securities and "accumulate earnings for reinvestment". The dividend policy granted the Boards of Directors a broad discretion to declare and pay a dividend at any time if that was in the best interests of the Companies and their shareholders. In 1978, the Companies' strategy was modified slightly to "accumulate the major portion of its earnings for reinvestment". Furthermore, the dividend policy was changed to indicate that "in each year that the Fund has earnings it is anticipated that the Board of Directors of the Fund will declare and pay a dividend to shareholders of some portion of the Fund's earnings". By 1981, the dividend policy reflected the practice of the Companies since 1977. It provided that, "in the past, it has been the policy of the Board of Directors of the Fund to declare and pay a dividend to shareholders for years in which the Fund has earnings, and it is anticipated that the Board of Directors will continue to follow this policy".

¶ 9 In fact, beginning in December 1978, the Companies did declare an annual dividend of US$1 per share for each year of their existence.

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B. The Investments

¶ 10 In addition to the tax advantages presented, an investment in the Companies was made attractive by the fact that the funds were managed by a Mr. Ronald Meade, whose expertise and success in this area was renowned. One of the investors who became interested in the Companies was a businessman and real estate developer named Irving Ludmer. Mr. Ludmer was the President and sole shareholder of the corporate appellant, Ludco Enterprises Ltd. ("Ludco"). He is also the father of the individual appellants in this case (the "Ludmer children"). Mr. Ludmer was introduced to the opportunity to invest in the Companies by a former business colleague named Arnold Steinberg. Mr. Steinberg had been a client of Mr. Meade and communicated to Mr. Ludmer his confidence that an investment in the Companies would be worthwhile.

¶ 11 Between September 1977 and June 1979, Mr. Ludmer entered into five separate transactions whereby he purchased shares in the Companies on behalf of Ludco and the Ludmer children. In October 1977, the Ludmer children acquired a total of 10,000 shares of Justinian at US$100 per share. In July 1978, they doubled their holdings. The total acquisition cost of their investment was $2.2 million. In July and December 1978, Ludco invested a total of $2.3 million in Augustus. Approximately eighty percent of these four investments were financed with funds borrowed from Canadian chartered banks in different loans at floating rates of prime plus 1 percent or 3/4 percent. The carrying cost of the appellants' loans increased from about 10 percent in late 1977, through 14 percent in 1979 to a peak of 20 percent in early 1981 before stabilizing at approximately 12 percent in 1983 until the disposition of their shares in 1985. In the fifth of the appellants' transactions, in June 1979 Ludco invested $3 million in Justinian. All the funds for this acquisition were borrowed through a long-term mortgage on a Ludco-owned shopping centre property with a fixed interest rate of 11.5 percent. In the result, the appellants invested approximately $7.5 million to acquire [page1092] shares in the Companies, having borrowed a total of $6.5 million to finance their acquisitions.

¶ 12 Mr. Ludmer testified at trial and explained the appellants' reasons for and expectations in investing in the Companies. He sought no professional advice before deciding to invest. His decision was driven principally by Mr. Meade's previous performance, but other factors included the tax advantages and rumours concerning foreign exchange controls. Mr. Ludmer also read the dividend policy section of the Explanatory Memorandum and anticipated the receipt of dividend income. Mr. Ludmer stated clearly that the appellants would not have invested in the Companies with borrowed funds if he had known that interest costs were not deductible from income.

C. The Rollover

¶ 13 On May 12, 1983, the appellant Ludco disposed of a group of investment assets, including the shares in the Companies, to 2154-7203 Québec Inc., a wholly owned subsidiary of Ludco. This disposition was done in accordance with the rollover provisions in s. 85 of the Act. The assets were disposed of for their fair market value of $12,685,000. Ludco received as consideration for the disposition both interest earning and non-interest earning assets. Specifically, Ludco received two non-interest bearing notes (one for $1,780,000 and the other for $5,600,000) totalling $7,380,000, a promissory note in the principal amount of $605,000 and bearing interest at the prime rate of the Mercantile Bank of Canada plus 1 percent, and 94 Class B preferred shares of 2154-7203 Québec Inc. providing an annual fixed dividend of 9 percent and a redemption value of $4,700,000.

¶ 14 At the time of the disposition, the market value of the shares in the Companies totalled $8,645,715, Ludco's outstanding debt attributable to the shares in the Companies totalled $4,800,000, [page1093] and the new income-producing assets received as consideration in the rollover totalled $5,305,000.

¶ 15 On the day the rollover occurred, Ludco pledged the 94 Class B preferred shares to Ludco's parent company, 109395 Canada Inc., to guarantee all indebtedness owing by Ludco to its parent company. At the same time, Ludco pledged the non-interest bearing promissory note of $1,780,000 to the Mercantile Bank of Canada as security for the loan used to purchase the shares of the Companies.

¶ 16 On September 6, 1985, the non-interest bearing notes were exchanged for Class D preferred shares of 2154-7203 Québec Inc. providing annual dividends of 8 percent.

D. The Share Redemption and the Tax Consequences

¶ 17 In 1984, the FAPI rules were amended to discourage the type of off-shore investment at issue in this case by eliminating the tax benefits and advantages it generated. These amendments, known as the "FAPI amendments", led to the winding up of the Companies' businesses.

¶ 18 In 1985, upon the coming into force of the FAPI amendments, the taxpayers disposed of their shares and realized a capital gain of $9.24 million. Over the eight years during which the shares had been held by the appellants, they received some $600,000 in dividends. Over the same period they incurred interest costs of $6 million.

¶ 19 For the taxation years 1981-1985, the appellants deducted their interest costs against other reported income pursuant to s. 20(1)(c)(i) of the Income Tax Act. In 1986 and 1987, the Minister of National Revenue reassessed the appellants and disallowed those deductions. The Minister took the position that the amount borrowed had not been used "for the purpose of earning income from a business or property" as stipulated in s. 20(1)(c)(i); rather the [page1094] real purpose of the investment was to defer taxes and convert income into capital gains.

¶ 20 Both the documentary evidence and the testimony of Revenue Canada personnel

indicated that Revenue Canada's policy was to allow the deduction of interest on money borrowed to purchase shares even if no dividend was paid to the investor. In particular, written statements of Revenue Canada policy indicated that taxpayers could deduct interest paid in respect of funds used to purchase shares that were precluded from paying taxable dividends, just as they could shares in speculative stock that did not actually realize income.

¶ 21 The Tax Court of Canada confirmed the Minister's reassessments and disallowed the deduction. The Federal Court, Trial Division, and a majority of the Federal Court of Appeal also disallowed the deduction. Létourneau J.A., in dissent, would have allowed the deduction.

III. Relevant Statutory Provisions

¶ 22 Section 20(1)(c)(i) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), provides:

> 20. (1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:
>
> ...
>
> (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 [page1095] income from which would be exempt or to acquire a life insurance policy),
>
> ...
>
> or a reasonable amount in respect thereof, whichever is the lesser;

IV. Judgments Below

A. Tax Court of Canada, 93 D.T.C. 1351

¶ 23 In determining whether the interest charges were deductible in this case, Tremblay J.T.C.C. interpreted the term "income" in s. 20(1)(c)(i) to mean profit or net income. He reviewed the evidence in detail and found that the appellants' interest expenses far exceeded their dividend earnings, both actual and anticipated. Accordingly, he held that the appellants did not have a reasonable expectation of earning net dividend income from their investment, and hence the interest charges in question were not deductible.

B. Federal Court, Trial Division, 98 D.T.C. 6045

¶ 24 An appeal from the decision of the Tax Court of Canada was heard by way of trial de novo. Lutfy J. interpreted s. 20(1)(c)(i) as requiring a reasonable expectation of net income before interest deductibility could be triggered under that provision. After a comprehensive review of the evidence, Lutfy J. accepted that, at the time of their initial investments in the Companies, the appellants did have a reasonable expectation of receiving dividends. However, they never expected their dividend income to exceed their interest expenses. Moreover, after reviewing the case law, Lutfy J. concluded that in order to meet this requirement the appellants must satisfy the court that their bona fide or true purpose in making the investments at issue was to earn net income. Instead, Lutfy J. concluded that the appellants' true purpose was to defer taxes and convert income into capital gains. [page1096] Therefore, Lutfy J. dismissed the appeal and confirmed the Minister's reassessment.

C. Federal Court of Appeal (1999), 240 N.R. 70

¶ 25 I prefer to deal with the dissenting reasons of Létourneau J.A. prior to those of Marceau J.A. and Desjardins J.A. since the latter two often refer to the position advanced by Létourneau J.A. in their reasons.

1. Létourneau J.A. (Dissenting)

¶ 26 Létourneau J.A., in dissent, analysed the arguments respecting s. 20(1)(c)(i) in two parts: first, the requisite intention to earn income, and second, the assertion that the term "income" refers to net income or profit. In regard to the requisite intention to earn income, Létourneau J.A. reviewed the case law and acknowledged that courts have adopted a bona fide or true purpose test to determine whether interest charges are deductible under s. 20(1)(c)(i). He noted, however, that a difficulty arises in the case of an investment in the form of shares or debt securities because of the fact that such an investor is always pursuing a dual purpose. In resolving this difficulty, Létourneau J.A. rejected the introduction of a dominant purpose test into s. 20(1)(c)(i) as being unsupported by the text of the Act, contrary to the objective of the provision and the evidence of Parliamentary intention and likely to create uncertainty and adversely affect the business community. Instead, he concluded that it is sufficient for the investor to have a reasonable expectation of income when investing borrowed money.

¶ 27 Létourneau J.A. also rejected the proposition that "income" in s. 20(1)(c)(i) refers to net income or profit. In his view, to the extent that the purpose of the use of the borrowed amount was to acquire or increase capital for the purpose of gross income, the essential condition of s. 20(1)(c)(i) is met.

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¶ 28 In respect of the s. 85 rollover of Ludco's shares in the Companies, Létourneau J.A. held that the acquisition of the taxable income-producing replacement property can be traced to

Ludco did not lose the benefit of the interest deduction when it replaced its original source of income with another source that also generated taxable income. Accordingly, Létourneau J.A. would have allowed the appeal and permitted the deduction of interest charges in this case.

2. Desjardins J.A.

¶ 29 After noting that the case law refers to the taxpayer's real or true purpose in matters of interest deductibility under s. 20(1)(c)(i), Desjardins J.A. agreed with Létourneau J.A.'s rejection of a dominant purpose test. Furthermore, she stated that she shared Létourneau J.A.'s views that a taxpayer need only have had a reasonable expectation of income at the moment the investment was made, and that the borrowed money must have been used to acquire property for the purpose of deriving gross, not net, income. However, Desjardins J.A. went on to find that the evidence in this case clearly established that the appellants' real purpose when they borrowed the money was to make capital gains. She held that because receiving dividends was not the real objective of the appellants' investments in the Companies, the interest paid is not deductible under s. 20(1)(c)(i).

3. Marceau J.A.

¶ 30 Marceau J.A. admitted to having some difficulty with the introduction of a dominant purpose test into s. 20(1)(c)(i). However, in his view Parliament clearly intended for interest deductibility to be triggered only where the taxpayer's actual or true intention was to earn income. In addition, it was Marceau J.A.'s view that the trial judge made a finding of fact that the appellants' true purpose in investing in the Companies as structured was to defer tax and transform the income into capital [page1098] gains. In his view, this finding of fact is not contradicted by the evidence and therefore is not subject to appellate interference. Accordingly, Marceau J.A. concluded that the statutory requirements for the deduction of interest were not met in this case and that the Minister's reassessment should be upheld.

V. Issues and Submissions of the Parties

¶ 31

1. What is the legal test for interest deductibility under s. 20(1)(c)(i)?
2. Are the interest costs incurred by the appellants deductible in this case?
3. Should special costs be awarded in this case?

¶ 32 The appellants submit that the lower courts erred in two ways: first, by introducing a dominant or true purpose test into s. 20(1)(c)(i) and, second, by interpreting the term "income" in that provision to mean net income or profit. The appellants state that these errors lead to an interpretation of s. 20(1)(c)(i) that is impractical and contrary to the plain meaning and objective of the provision. The appellants argue that the use of the borrowed money in this case complies with all of the requirements expressed in s. 20(1)(c)(i) and, in particular, with the requirement that the borrowed money was used for the purpose of earning income. They also seek special costs for what they characterize as an abuse of Revenue Canada's assessment power in this case.

¶ 33 The respondent submits that in order for interest charges to be deductible it must be the taxpayer's actual, true or bona fide purpose to use the funds to earn income and the taxpayer must have a reasonable expectation that the borrowing transaction would yield net income. The respondent argues [page1099] that, in the present context, the trial judge's identification of the appellants' true purpose was a finding of fact supported by the evidence and therefore not subject to appellate interference. In the result, she submits that the interest deductions at issue in this case do not meet the statutory requirements of s. 20(1)(c)(i). The respondent also argues that, even if this Court concludes that the interest charges associated with the initial investments are deductible, Ludco lost the ability to deduct interests charges when it rolled over its shares in the Companies. The respondent submits that during the rollover transaction there was a commingling of funds and that Ludco failed to meet its onus to trace the borrowed funds to a current eligible use. Finally, the respondent argues that there should be no award of special costs in this case as there is no evidence of misconduct by the respondent in connection with the litigation.

VI. Analysis

A. The Preliminary Issue: Fact or Law?

¶ 34 As a preliminary matter, it was argued that the trial judge made a finding of fact when he determined that the appellants' true purpose in making the investments at issue was not to earn income but to defer taxes and acquire capital gains. It was further argued that this Court is prevented from revisiting the trial judge's finding in this regard by the principle that, absent a palpable and overriding error, findings of fact made at trial are not subject to appellate court interference. However, whether or not a taxpayer's purpose in making an investment falls within the ambit of s. 20(1)(c)(i) of the Act is properly viewed as a question of mixed fact and law. For the reasons set out below, the main issue in this appeal is to determine and apply the proper test under s. 20. That is a question of law. Moreover, in my view, with respect, the trial judge did not apply the correct legal test to determine the appellants' purpose in this case. Therefore, it is [page1100] open to this Court to interfere with the finding of the trial judge in this regard.

¶ 35 The identification of the correct legal test in this case centres on a question of statutory interpretation. As a result, before discussing the legal test for interest deductibility under s. 20(1)(c)(i), and whether interest costs are deductible in this case, it may be helpful to review briefly the principles of statutory interpretation that apply in this case.

B. Principles of Statutory Interpretation

¶ 36 The modern rule of statutory interpretation was put succinctly by E. A. Driedger in Construction of Statutes (2nd ed. 1983), at p. 87:

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament... .

¶ 37 This passage from Driedger "best encapsulates" the preferred approach to statutory interpretation: Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27, at paras. 21 and 23. This is the case for the interpretation of any statute, and it is noteworthy that Driedger's famous passage has been cited with approval by our Court on numerous occasions both in the non-tax and in the tax context: for the latter, see Stubart Investments Ltd. v. The Queen, [1984] 1 S.C.R. 536, at p. 578, per Estey J.; Symes v. Canada, [1993] 4 S.C.R. 695, at p. 744, per Iacobucci J., and at p. 806, per L'Heureux-Dubé J.; Canada v. Antosko, [1994] 2 S.C.R. 312, at p. 326; Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours, [1994] 3 S.C.R. 3, at p. 17; Friesen v. Canada, [1995] 3 S.C.R. 103, at para. 10, per Major J.; Schwartz v. Canada, [1996] 1 S.C.R. 254, at para. 56, per La Forest J.; Alberta (Treasury Branches) v. M.N.R., [1996] 1 S.C.R. 963, at para. 14, per Cory J.; 65302 British Columbia Ltd. v. Canada, [1999] 3 S.C.R. 804, at para. 5, per Bastarache J., and at para. 50, per Iacobucci J.; and Will-Kare Paving & Contracting Ltd. v. Canada, [2000] 1 S.C.R. 915, 2000 SCC 36, at [page1101] para. 32, per Major J., and at para. 50, per Binnie J.

¶ 38 Furthermore, when interpreting the Income Tax Act courts must be mindful of their role as distinct from that of Parliament. In the absence of clear statutory language, judicial innovation is undesirable: Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411, at para. 112. Rather, the promulgation of new rules of tax law must be left to Parliament: Canderel Ltd. v. Canada, [1998] 1 S.C.R. 147, at para. 41. As McLachlin J. (as she then was) recently explained in Shell Canada Ltd. v. Canada, [1999] 3 S.C.R. 622, at para. 43:

> The Act is a complex statute through which Parliament seeks to balance a myriad of principles. This Court has consistently held that courts must therefore be cautious before finding within the clear provisions of the Act an unexpressed legislative intention... . Finding unexpressed legislative intentions under the guise of purposive interpretation runs the risk of upsetting the balance Parliament has attempted to strike in the Act. [Citations omitted.]

See also Antosko, supra, at p. 328. Having said this, it is within the jurisdiction of courts to interpret the rules enacted by Parliament, including the elucidation of otherwise undefined concepts such as "income" or "profit": see Canderel, supra, at para. 42.

¶ 39 In addition, given that the Income Tax Act has many specific anti-avoidance provisions and rules, it follows that courts should not be quick to embellish the provisions of the Act in response to concerns about tax avoidance when it is open to Parliament to be precise and specific with respect to any mischief to be prevented: Neuman v. M.N.R., [1998] 1 S.C.R. 770, at para. 63, per Iacobucci J. To do otherwise would be to fail to give appropriate weight to the well-established principle that, absent a provision to the contrary, taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation: see Stubart, supra, at p. 540, per Wilson J., [page1102] and at p. 557, per Estey J.; Hickman Motors Ltd. v. Canada, [1997] 2 S.C.R. 336, at para. 8, per McLachlin J.; Duha Printers (Western) Ltd. v. Canada, [1998] 1 S.C.R. 795, at para. 88, per Iacobucci J.; Neuman, supra, at para. 63, per Iacobucci J.; Shell Canada, supra, at para. 46, per McLachlin J.

¶ 40 With these principles in mind, I turn to consider the legal test for interest deductibility under s. 20(1)(c)(i).

C. The Legal Test for Interest Deductibility Under Section 20(1)(c)(i)

(1) Introduction

¶ 41 The deductibility of interest under s. 20(1)(c)(i) of the Income Tax Act has given rise to considerable litigation and has been the topic of much legal commentary, as pointed out by the parties. Many of the features of the interest deductibility provision are matters of settled law. However, as explained below, the appeal at bar raises two novel issues related to the concepts of "purpose" and "income" contained within s. 20(1)(c)(i).

¶ 42 Recently, in Shell Canada, supra, at para. 28, McLachlin J., writing for the Court, described the four elements of s. 20(1)(c)(i) that must be present before interest can be deducted:

> The provision has four elements: (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.

¶ 43 The first two elements are not in dispute here. As noted above, the focus of the inquiry in this case is clearly on the third element, namely, [page1103] whether the borrowed money was used for the purpose of earning non-exempt income from business or property.

¶ 44 In this connection, Dickson C.J., writing for the Court in Bronfman Trust, supra, closely analysed the third element of the interest deductibility provision and classified the various possible uses of borrowed money as: eligible and ineligible, original and current, and direct and indirect. Dickson C.J. outlined the inquiry into the third element at pp. 45-46:

> Not all borrowing expenses are deductible. Interest on borrowed money used to produce tax exempt income is not deductible. Interest on borrowed money used to buy life insurance policies is not deductible. Interest on borrowings used for non-income earning purposes, such as personal consumption or the making of capital gains is similarly not deductible. The statutory deduction thus requires a characterization of the use of borrowed money as between the eligible use of earning non-exempt income from a business or property and a variety of possible ineligible uses. The onus is on the taxpayer to trace the borrowed funds to an identifiable use which triggers the deduction... .
>
> The interest deduction provision requires not only a characterization of the use of borrowed funds, but also a characterization of "purpose". Eligibility for the deduction is contingent on the use of borrowed money for the purpose of earning income. It is well-established in the jurisprudence, however, that it is

> not the purpose of the borrowing itself which is relevant. What is relevant, rather, is the taxpayer's purpose in using the borrowed money in a particular manner: Auld v. Minister of National Revenue, 62 D.T.C. 27 (T.A.B.) Consequently, the focus of the inquiry must be centered on the use to which the taxpayer put the borrowed funds. [Emphasis in original.]

¶ 45 In short, a determination of whether borrowed money has been put to an eligible use requires a characterization of the use of the borrowed funds and a characterization of the taxpayer's purpose in using the funds in a particular manner. Dickson C.J. went on to deny the interest deduction in that case on the ground that, properly characterized, the [page1104] taxpayer's "use" of borrowed funds was a directly ineligible one. Thus, the law relating to the matter of the taxpayer's "purpose" was not fully elaborated on in that case.

¶ 46 In the case at bar, and in contrast to Singleton, supra, there is no dispute as to the particular use that the borrowed funds were put to: they were directly used to purchase shares in the Companies. Rather, the focus of the inquiry is on whether the taxpayers' purpose in so using the funds was to earn income within the meaning of s. 20(1)(c)(i). Consequently, in the present appeal, the Court is asked for the first time to explicate the law on two of the central concepts in s. 20(1)(c)(i): "purpose" and "income".

(2) When is Borrowed Money "Used for the Purpose of Earning Income" Within the Meaning of Section 20(1)(c)(i)?

¶ 47 In this case, three different tests have been advanced for determining whether the requisite income earning purpose is present; they are: the bona fide purpose test, the dominant purpose test, and the reasonable expectation of income test. In several decisions, including those of the lower courts in the case at bar, courts have simply adopted the bona fide purpose test on the strength of some obiter dicta by Dickson C.J. in Bronfman Trust, supra.

¶ 48 It is worth repeating what Dickson C.J. in Bronfman Trust, supra, stated on this point. At p. 54, the former Chief Justice explained:

> Even if there 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. I am satisfied that those circumstances are not presented in the case before us. It seems to me that, at the very least, the taxpayer must satisfy the Court that his or her bona fide purpose in using the funds was to earn income. In contrast to what appears to be the case in Trans-Prairie, the facts in the present case fall far [page1105] short of such a showing. Indeed, it is of more than passing interest that the assets which were preserved for a brief period of time yielded a return which grossly fell short of the interest costs on the borrowed money. In 1970, the interest costs on the $2,200,000 of loans amounted to over $110,000 while the return from an average $2,200,000 of Trust assets (the amount of capital "preserved") was less than $10,000. The taxpayer cannot point to any reasonable expectation that the

> income yield from the Trust's investment portfolio as a whole, or indeed from any single asset, would exceed the interest payable on a like amount of debt. The fact that the loan may have prevented capital losses cannot assist the taxpayer in obtaining a deduction from income which is limited to use of borrowed money for the purpose of earning income. [Emphasis in original.]

¶ 49 It appears to me that Dickson C.J.'s suggestion that a bona fide purpose test should apply was made as a passing comment and did not result from an analysis of the text of the provision. In my opinion, Dickson C.J.'s comments fall short of elevating the bona fide purpose test to a rule of law. Indeed, as discussed below, the importation of the bona fide purpose test into s. 20(1)(c)(i) is not supported by the principles of statutory interpretation outlined above, especially as applied in our recent tax law jurisprudence.

¶ 50 With respect to the plain meaning of s. 20(1)(c)(i), the only express requirement related to "purpose" is that borrowed money must have been "used for the purpose of earning income". Apart from the use of the definite article "the", which on closer analysis is hardly conclusive of the issue before us, nothing in the text of the provision indicates that the requisite purpose must be the exclusive, primary or dominant purpose, or that multiple purposes are to be somehow ranked in importance in order to determine the taxpayer's "real" purpose. Therefore, it is perfectly consistent with the language of s. 20(1)(c)(i) that a taxpayer who uses borrowed money to make an investment for more than one purpose may be entitled [page1106] to deduct interest charges provided that one of those purposes is to earn income.

¶ 51 In this connection, the adjectives that have been heretofore used by courts to characterize the requisite purpose in s. 20(1)(c)(i), such as "bona fide", "actual", "real" or "true", are to my mind ultimately useful only when describing whether the transaction at issue was a mere sham or window dressing designed to obtain the benefit of interest deductibility. 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.

¶ 52 This approach is consistent with that taken by this Court in the context of s. 96 of the Act, the partnership losses deductibility provision. In order to deduct partnership losses, a taxpayer must establish the existence of a valid partnership by showing an intention to carry on business in common with a view to profit. In Continental Bank Leasing Corp. v. Canada, [1998] 2 S.C.R. 298, and Spire Freezers Ltd. v. Canada, [2001] 1 S.C.R. 391, 2001 SCC 11, the taxpayers' primary intention in joining a partnership was to acquire losses deductible against income from other sources. However, this Court held that a taxpayer's overriding intention is not determinative of whether the requisite intention to form a partnership is present. Rather, it will be sufficient for a taxpayer to show that there was an ancillary intention that meets the requirements of a valid partnership: see also Backman v. Canada, [2001] 1 S.C.R. 367, 2001 SCC 10.

¶ 53 There are other compelling reasons to reject both the bona fide and dominant purpose tests proposed in this case. I note that, in this respect, Major J. has reached a similar

conclusion in Singleton, [page1107] supra, and I agree with him. Reading such tests into s. 20(1)(c)(i) would require a rewriting of the provision to introduce a concept of degree, exclusivity, or primacy in the taxpayer's purposes. Presumably, a court would take such an approach in response to concerns over tax avoidance. However, this Court has repeatedly stated that in matters of tax law, a court should always be reluctant to engage in judicial innovation and rule making: see Sparrow Electric, supra; Canderel, supra; and Shell Canada, supra. Furthermore, the application of any such test is impractical in the context of investments in securities. It would open the door to many reassessments and in each case impose on taxpayers a tremendous burden to justify that their real or dominant purpose was to earn income.

¶ 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: see Symes, supra, at p. 736; Continental Bank, supra, at para. 45; Backman, supra, at para. 25; Spire Freezers, supra, at para. 27. 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 [page1108] 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.

¶ 56 In conclusion, of the three tests proposed in this case, in my view only the reasonable expectation of income test is consistent with the wording of the section in light of all of the applicable principles of statutory interpretation. In this respect, I agree with both Létourneau and Desjardins JJ.A., who formed the majority at the Federal Court of Appeal on this point.

(3) What is Income for the Purposes of Section 20(1)(c)(i)?

¶ 57 The Income Tax Act does not define the term "income". The Act speaks of "net income", "taxable income", and income from different sources, but it neither identifies nor describes the legal characteristics of "income"; it only speaks of what is to be included or excluded from income. Similarly, tax theorists have proposed many different definitions of "income" distinguishable by their varying degrees of inclusiveness. The common feature of all the definitions of income, whether derived from tax law, economic theory or the dictionary, is that "income" is a measure of gain: see V. Krishna, The Fundamentals of Canadian Income Tax (6th ed. 2000), at pp. 97-100.

¶ 58 In the case at bar, both the Tax Court of Canada and the Federal Court, Trial Division, ostensibly applied this Court's decision in Moldowan v. The Queen, [1978] 1 S.C.R. 480, in

equating "income" with "profit". However, that case was concerned not with the meaning of the term "income" as such, but with identifying the source of income in [page1109] play and, more specifically, with differentiating between business activities as distinct from personal or hobby activities. It is clear that Moldowan, supra, does not stand for the absolute proposition that "income" necessarily means "profit".

¶ 59 Because it is left undefined in the Act, this Court must apply the principles of statutory interpretation to discern what is meant by "income" in the context of s. 20(1)(c)(i). The plain meaning of s. 20(1)(c)(i) does not support an interpretation of "income" as the equivalent of "profit" or "net income". Nowhere in the language of the provision is a quantitative test suggested. Nor is there any support in the text of the Act for an interpretation of "income" that involves a judicial assessment of sufficiency of income. Such an approach would be too subjective and certainty is to be preferred in the area of tax law. 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.

¶ 60 As noted by Létourneau J.A., Bowman J.T.C.C. (as he then was) lucidly dealt with the argument that the word "income" in s. 20(1)(c)(i) necessarily means "profit" in Mark Resources Inc. v. The Queen, 93 D.T.C. 1004, at p. 1015. Most importantly, Bowman J.T.C.C. dismissed that argument at p. 1015 in these terms:

> Interest on money that is borrowed to invest in common shares, or property, or a business or corporation is deductible because it is laid out to earn amounts that must be included in the computation of income. Amounts of income such as dividends which must be included in income under paragraphs 12(1)(j) and (k) do not cease to be income merely because they are exceeded by the cost of their production.

¶ 61 I agree. Indeed, when one looks at the immediate context in which the term "income" appears in s. 20(1)(c)(i), it is significant that within the provision itself the concept of "income" is used in contradistinction [page1110] from the concept of tax-exempt income. Viewed in this context, the term "income" in s. 20(1)(c)(i) does not refer to net income, but to income subject to tax. In this light, it 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.

¶ 62 I am bolstered in this conclusion by the other evidence of Parliamentary intention. If Parliament had intended interest to be deductible only in circumstances where borrowed money was used for the purpose of earning "net income", it could have expressly said so. Indeed, as noted by Létourneau J.A., in both 1981 and 1991, amendments to the Act that would have restricted interest deductibility to circumstances where borrowed money is used for the purpose of making a profit were proposed but never enacted.

¶ 63 Furthermore, reading "income" in s. 20(1)(c)(i) to mean income generally, as described above, is more consistent with the objective of the interest deductibility provision. In most circumstances, ss. 9 and 18(1)(b) of the Act prohibit the deduction of amounts expended on account of capital. Section 20(1)(c)(i) is an exception to this prohibition, designed to

encourage the accumulation of capital which would produce income: see Shell Canada, supra, at para. 28, per McLachlin J.; Tennant v. M.N.R., [1996] 1 S.C.R. 305, at para. 16, per Iacobucci J.; Bronfman Trust, supra, at p. 45, per Dickson C.J. Thus, the object of s. 20(1)(c)(i) is to create an incentive to accumulate capital with the potential to produce income by allowing taxpayers to deduct interest costs associated with its acquisition. The accumulation of income-producing capital is seen as desirable because it creates wealth and increases the income tax base. It is clearly sufficient for the purpose of the provision that an investor have a reasonable expectation of gross income as described above when investing borrowed money. In contrast, the incentive would be much less effective if the investor bore the additional [page1111] burden of establishing a reasonable expectation of net income or profit.

¶ 64 Finally, in defining the taxpayer's real or true purpose by emphasizing the relatively nominal amount of income earned in this case compared to the capital gains realized and interest deductions sought, the respondent effectively asks the Court to take an "economic realities" view of the investments at issue. However, there are limits to the economic realities approach to the assessment of a particular transaction: see Shell Canada, supra, at para. 39. In particular, a court should not place so much reliance on "economic realities" so as to cause it to stray from the express terms of s. 20(1)(c)(i) and supplement the provision with extraneous policy concerns that are said to form part of its purpose. Rather, where the provision at issue is clear and unambiguous, the court's duty is to simply apply its terms to the transaction at issue: see Shell Canada, supra, at para. 43, per McLachlin J.; Continental Bank, supra, at para. 51, per Bastarache J.; Tennant, supra, at para. 16, per Iacobucci J.; Antosko, supra, at pp. 326-27 and 330, per Iacobucci J.; Friesen, supra, at para. 11, per Major J.; Alberta (Treasury Branches), supra, at para. 15, per Cory J.

¶ 65 In conclusion, where a taxpayer uses borrowed money for a purpose yielding a reasonable expectation of income from business or property as I have described above, the interest charges incurred will fall within the ambit of s. 20(1)(c)(i) and are deductible.

D. Application of the Foregoing Principles: Are the Interest Charges Incurred by the Appellants Deductible in this Case?

(1) Interest Charges for Initial Investments in Shares of the Companies

¶ 66 The question now to be determined is whether, in using borrowed money to purchase shares of the Companies, the appellants had a reasonable expectation of income? If the answer is affirmative, and [page1112] the amount of interest paid was reasonable within the meaning of the provision, the interest charges are deductible.

¶ 67 Here, the objective documentary evidence indicates that the appellants did have a reasonable expectation of income. Owing to the nature of the investments and the Companies' investment strategy, it was reasonable to expect income would be available for distribution. In addition, given the terms of the dividend policy, it is clear that the appellants had a reasonable expectation of receiving dividends.

¶ 68 Although earning income was not the principal factor that motivated Mr. Ludmer to invest in the Companies, upon reading the relevant documents he did anticipate the receipt of dividend income. In my view, Mr. Ludmer's expectation of dividend income was reasonable. Indeed, the judge at the Federal Court, Trial Division, came to the same conclusion at p. 6056.

¶ 69 Furthermore, it is notable that income was actually received in the amount of $600,000 of dividends. Although this amount may be small in comparison to the capital gains realized and the interest charges incurred, absent a sham or window dressing or similar vitiating circumstances (none of which was argued before this Court), we are not concerned with the sufficiency of the income expected or received. There is no sham in this case: the purchase of the shares was a genuine investment. Neither can the amount of dividends actually paid be properly characterized as window dressing. Six hundred thousand dollars is a significant sum and there was some expert evidence indicating that the actual rate of return on the shares of Justinian was within the norm of most of the companies publicly traded on the Toronto and Montréal Stock Exchanges.

¶ 70 I conclude that the appellants did have a reasonable expectation of income when they used the borrowed money to purchase shares in the Companies. Therefore, the requisite purpose is present in the circumstances of this case. Given that there is no dispute as to the first two elements of the interest [page1113] deductibility provision, it only remains to show that the fourth element has been met in this case. In Shell Canada, supra, at para. 34, McLachlin J. explained that:

> The fourth element -- that the amount sought to be deducted must be the actual amount paid or "a reasonable amount in respect thereof" -- has not previously been the subject of comment by this Court. It is clear, however, from the structure of s. 20(1)(c), that the phrase refers to the entirety of s. 20(1)(c)(i). Therefore, the taxpayer is entitled to deduct the lesser of, (1) the actual amount paid or, (2) a reasonable amount in respect of "an amount paid ... pursuant to a legal obligation to pay interest on ... borrowed money used for the purpose of earning income from a business or property"... . 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: Mohammad v. The Queen, 97 D.T.C. 5503 (F.C.A.), at p. 5509, per Robertson J.A.; Canada v. Irving Oil Ltd., [1991] 1 C.T.C. 350 (F.C.A.), at p. 359, per Mahoney J.A.

¶ 71 In this case, the appellants borrowed the money at issue from Canadian chartered banks at rates of between 1 percent and 3/4 percent above prime. There can be no argument that such rates are reasonable within the meaning ascribed to that word by McLachlin J. in Shell Canada, supra. Accordingly the fourth element is met in this case.

¶ 72 Therefore, I conclude that the interest charges incurred in respect of the initial purchase of the shares are deductible under s. 20(1)(c)(i).

(2) Interest Charges and the Rollover Investments

¶ 73 It remains to be determined whether the appellant Ludco is entitled to deduct the interest charges incurred following the May 1983 disposition of its shares in the Companies to 2154-7203 Québec Inc.

¶ 74 This issue is resolved primarily by the application of the principles set out in Tennant, supra. In that case, the issue was under what conditions a taxpayer could deduct interest charges pursuant to s. 20(1)(c)(i) after a s. 85 rollover transaction. The [page1114] Court concluded that "it is implicit in the principles outlined in Bronfman Trust that the ability to deduct interest is not lost simply because the taxpayer sells the income-producing property, as long as the taxpayer reinvests in an eligible use property" (para. 20). The Court held at para. 25 that:

> As long as the taxpayer establishes a link between the current shares, the proceeds of disposition of the original shares, and the money that was borrowed to acquire the original eligible use property, it is in keeping with the interest deduction provision to permit the taxpayer to continue to deduct the interest payments for the full amount of the original loan, regardless of the value or cost of the newly acquired shares. Of course, where the taxpayer reinvests only a portion of the proceeds of disposition of the original eligible use property, then interest can only be deducted for the relevant portion of the loan.

Therefore, on the facts of this case, the appellant Ludco must establish a link between the Class B preferred shares and the interest-bearing note (the "current eligible use property"), the proceeds of disposition of the shares in the Companies (the "original eligible use property") and the money that was borrowed to acquire the shares in the Companies.

¶ 75 In this regard, Ludco's burden of establishing the necessary linkage between the original eligible use and the current eligible use is apparently complicated by the fact that the shares in the Companies were disposed of as part of a group of assets and, as consideration for this group of assets, Ludco received some income-producing and some non-income-producing assets. This Court in Bronfman Trust, supra, at pp. 45-46, indicated that as a general principle "[t]he onus is on the taxpayer to trace the borrowed funds to an identifiable use which triggers the deduction. Therefore, if the taxpayer commingles funds used for a variety of purposes only some of which are eligible he or she may be unable to claim the deduction." This general [page1115] principle was echoed in Tennant, supra, at para. 23, in the context of a s. 85 rollover transaction. In that case, the Court held that "[a]s long as the replacement property can be traced to the entire amount of the loan, then the entire amount of the interest payment may be deducted. If the replacement property can be traced to only a portion of the loan, then only a proportionate amount of the interest may be deducted."

¶ 76 However, nowhere in Tennant, supra, did the Court require a strict interpretation of tracing for the continuing entitlement to deduct interest after a rollover transaction. Instead, as noted above, the Court spoke in broader terms, referring to the need to "establish a link" between the original and current eligible use property (para. 18). Based upon this more flexible approach, I conclude that, although the shares in the Companies were commingled with other assets and disposed of as part of a group of assets, for the purposes of the interest

deductibility provision, the shares in the Companies can be traced to any of the specific assets received by Ludco as a result of the rollover. In this case, the taxpayer can trace the shares in the Companies to the income-producing assets. Therefore, the appellant Ludco has established the required link.

¶ 77 That the Class B shares were pledged by Ludco for an unrelated debt does not affect the fact that these shares were received as part of the consideration for the s. 85 rollover. In my view, the subsequent pledging of the Class B shares could only affect Ludco's continued ability to deduct the interest if the effect of the pledge was to give ownership of the shares to the parent company. However, the documentary evidence confirms that [page1116] Ludco continued to be the beneficial owner of the Class B shares.

¶ 78 In summary, although the appellant Ludco initially received a mix of income-earning and non-income-earning assets as consideration for the shares in the Companies, the value of the income-earning assets (or current eligible use property) exceeded the amount of the borrowed money. In these circumstances, the income-producing replacement property can be linked to the entire amount of the loan and it can be said that the interest charges were "wholly applicable" to the source of the income. Consequently the entire amount of the interest payment continued to be deductible after the rollover occurred.

E. Should Special Costs Be Awarded in This Case?

¶ 79 Pursuant to s. 47 of the Supreme Court Act, R.S.C. 1985, c. S-26, an order for costs is a discretionary matter for the Court. However, I agree with the respondent that this is not an appropriate case for an order for special costs. In general, special costs ought to be awarded only on the grounds of misconduct connected with the litigation or other exceptional circumstances. Here, although the Crown aggressively pressed its case against the appellants, there is no substance to the appellants' claims of abuse and misconduct and that the Crown otherwise acted improperly. I also do not find any other reasons why special costs should be awarded.

VII. Conclusion

¶ 80 Accordingly, I would allow the appeal with costs throughout, set aside the judgment of the Federal Court of Appeal and the reassessments for the appellants' 1981 to 1985 taxation years, and remit the matter back to Revenue Canada for reassessment in conformity with these reasons.

[page1117]

The following are the reasons delivered by

¶ 81 **LeBEL J.**:— Subject to my comments on the interpretation of tax statutes in the companion case of Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61, I agree with the disposition of the appeal proposed by Justice Iacobucci. The taxpayers' appeal is well founded.

¶ 82 As Iacobucci J. points out, there was undoubtedly a loophole in the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.). A well-crafted piece of tax planning took advantage of it, but remained clearly within the four walls of the statute. From the evidence, although the taxpayers intended to emphasize capital accumulation, they had also a purpose of gaining income. Hence, they could deduct the interest paid on loans obtained to acquire securities. The rollover that took place several years later did not change the situation. For these reasons, I would allow the appeal, quash the judgment of the Federal Court of Appeal ((1999), 240 N.R. 70), set aside the assessments and send the matter back to Revenue Canada for reassessment in accordance with the judgment of our Court.

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