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Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA.

Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: Where an individual borrows money from a financial institution and subsequently loans the borrowed funds to another party, is the interest expense incurred by that individual fully deductible for income tax purposes when the interest expense incurred exceeds the interest income earned.

POSITION: As noted in paragraph 10 of IT-533, income earned need not be in excess of interest paid, but draft legislation Income Tax Act should be considered.

REASONS: Until the Department of Finance's review of the October 2003 legislative proposals is complete, and the results are made available to the public, we cannot comment further on their impact on interest deductibility.

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2012-044377  
Andrea Boyle, CGA

October 2, 2012

Dear XXXXXXXXXXXX:

Re: Interest Deductibility

I am writing in reply to your letter dated April 4, 2012, in which you have asked whether interest expense incurred by individuals in a particular situation is deductible.

Specifically, a church is planning to ask individuals in its congregation to borrow funds which the individuals would subsequently loan to the church. The church will issue a one-year promissory note to each individual lender bearing interest at the same rate that the individual borrows from his/her own bank, capped at a rate of prime plus 3%. The church will issue T-5's to the individuals reporting the interest income. You have asked whether the individuals can deduct the interest expense on their loans and, if yes, whether, where an individual pays more than prime plus 3% to borrow the loan money, the interest expense in excess of the interest income is deductible.

Written confirmation of the tax implications inherent in particular transactions is given by this Directorate only where the transactions are proposed and are the subject matter of an advance income tax ruling request submitted in the manner set out in Information Circular 70-6R5, Advance Income Tax Rulings, dated May 17, 2002. We are, however, prepared to offer the following general comments, which may be of assistance.

All statutory references in this letter are references to the provisions of the Income Tax Act, R.S.C. 1985 (5th supp.) c. 1, as amended ("the Act").

Interest on borrowed money is deductible for income tax purposes if it meets all the requirements of paragraph 20(1)(c) of the Act. Paragraph 20(1)(c) states, among other things, that the borrowed money must be used for the purpose of earning income from a business or property. In *Bronfman* (87 DTC 5059), the court held that, "The interest deduction provision requires not only a characterization of the use of the 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." For a taxpayer to deduct interest under this provision the purpose of borrowing the money must have been to earn income and the borrowed money must have been used in an eligible manner to produce this income.

The Supreme Court's comments in *Ludco* (2001 SCC 62) are discussed in paragraph 10 of Interpretation Bulletin IT-533 Interest Deductibility and Related Issues:

The interpretation of the term income was addressed in *Ludco* as follows: "...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." The court also said, "The plain meaning of s. 20(1)(c)(i) does not support an interpretation of 'income' as the equivalent of 'profit' or 'net income' .... Therefore, absent a sham or window dressing or similar vitiating circumstances, courts should not be concerned with the sufficiency of the income expected or received."

Generally speaking, in a situation such as the one which you have described, if the promissory note pays interest, then the direct use and purpose tests required for interest to be deductible under paragraph 20(1)(c) would be met.

Notwithstanding the comments regarding *Ludco* in paragraph 10 of IT-533, in 2003 the Department of Finance proposed draft legislative amendments which, if enacted, would restrict the full deduction of interest expense in those cases where the underlying investment is not expected to generate net income (i.e. cases where, over the life of the investment, the interest expense incurred is expected to exceed the income generated). Many commentators expressed concerns about this draft legislation. As part of the 2005 Federal Budget, the Department of Finance stated that, after an extended period of public consultation, the Department "...has sought to respond by developing a more modest legislative initiative that would respond to those concerns while still achieving the Government's objective". No revised legislative amendments have been drafted since that time.

Until the Department of Finance's review of the October 2003 legislative proposals is complete, and the results are made available to the public, we cannot comment further on their impact on interest deductibility.

We trust that these comments will be of assistance.

Yours truly,

Doug Watson  
for Director  
Corporate Financing Division  
Income Tax Rulings Directorate  
Legislative Policy and Regulatory Affairs Branch