[OFFICIAL ENGLISH TRANSLATION]

2001-3871(IT)I

BETWEEN:

FRANÇOISE DESLAURIERS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on August 6, 2002, at Montréal, Quebec, by

the Honourable Judge Lucie Lamarre

Appearances

For the Appellant: The Appellant herself

Counsel for the Respondent: Julie David

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 1997, 1998 and 1999 taxation years are dismissed.

Signed at Ottawa, Canada, this 9th day of October 2002.

"Lucie Lamarre"

J.T.C.C.

Translation certified true
on this 23rd day of December 2003.

Sophie Debbané, Revisor

[OFFICIAL ENGLISH TRANSLATION]

Date: 20021009
Docket: 2001-3871(IT)I

BETWEEN:

FRANÇOISE DESLAURIERS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Lamarre, J.T.C.C.

[1] These are appeals under the informal procedure from assessments made by the Minister of National Revenue ("Minister") disallowing the appellant an interest expense deduction in computing her income for the 1997, 1998 and 1999 taxation year under paragraph 20(1)(*c*) of the *Income Tax Act* ("*Act*").

[2] Specifically, the deduction of the amounts of $9,718, $8,770 and $8,374 claimed by the appellant for those years respectively was disallowed. Those amounts corresponded to interest paid on a $125,000 loan taken out at the Caisse populaire Desjardins (Jean-Talon) in May 1994. The proceeds of that loan were used to repay debts that the appellant owed to her brother, Réjean DesLauriers ($56,000), and to another Caisse populaire Desjardins (St-Léopold) in the amount of $65,000 and to pay notary's fees ($4,000).

[3] The chronology of events is as follows. In 1987, the appellant and her spouse, Pierre Trudeau, still owed $27,000 on a mortgage on their residence (appellant's testimony). They renewed that mortgage in the amount of $70,000

(Exhibit A-6). The surplus borrowed was used to invest in an income property in co-ownership with other investors (Exhibit A-5).

[4] On March 31, 1988, the business corporation 2550-7724 Québec Inc. ("corporation"), of which the appellant owned 50 percent of the shares, the other 50 percent belonging to Francine Trudeau, acquired the convenience store called "Bidule" for $115,000 (Exhibit A-1). To make that acquisition, the two shareholders borrowed $55,000 personally and on behalf of the corporation from Edouard Beaudouin, Francine Trudeau's husband. That amount was used to pay a portion of an initial downpayment of $65,000. The vendor moreover kept an outstanding balance of $50,000 on the sale price (Exhibit A-4).

[5] In 1991, Francine Trudeau separated from Mr. Beaudouin, and Mr. Beaudouin demanded payment of his loan by the corporation that owned the Bidule convenience store. Since Francine Trudeau had declared personal bankruptcy at the time, the appellant personally had to repay the residual balance of the loan granted by Mr. Beaudouin.

[6] To do that, on June 6, 1991, the appellant personally borrowed the sum of $52,000 plus interest (Exhibit I-4) from her brother, Réjean DesLauriers, and repaid Mr. Beaudouin.

[7] On January 6, 1992, the appellant acquired all the shares that Francine Trudeau held in the corporation (subparagraph 7(b)(v) of the Reply to the Notice of Appeal, admitted by the appellant).

[8] On June 2, 1992, the income property jointly owned by Pierre Trudeau and the appellant was sold (Exhibit A-3), and they obtained an amount of $30,000 (appellant's testimony).

[9] On July 7, 1992, the appellant repaid the balance of the selling price of the Bidule convenience store (Exhibit A-2). To do that, she used the $30,000 received at the time of the sale of the income property and once again borrowed from her brother. Instead of granting her a second loan, the brother gave the appellant a discharge from the first loan of $52,000 (Exhibit I-3) and executed a new loan for a total amount of $59,620, without interest (Exhibit I-2). Those two documents were signed on July 7, 1992.

[10] The appellant then repaid the balance of the selling price of the Bidule convenience store. At that point, the appellant no longer owed money to anyone except to her brother, Réjean DesLauriers.

[11] On November 17, 1993, the corporation, of which the appellant was now the sole shareholder, sold the Bidule convenience store at a loss to another corporation for $34,285 in an arm's length transaction (Exhibit I-1).

[12] On June 6, 1994, the appellant and her spouse renewed the expiring mortgage on their house with the Caisse populaire Desjardins (Jean-Talon) for an amount of $125,000 (Exhibit I-6).

[13] The proceeds of that loan were used to repay the balance of $65,000 of the mortgage with the first Caisse populaire Desjardins (St-Léopold), $56,000 to the appellant's brother and $4,000 in notary's fees. It is the interest on this $125,000 loan that is in dispute (Reply to the Notice of Appeal, subparagraph 7(b)(x), admitted by the appellant).

[14] On June 14, 1994, Réjean DesLauriers gave the appellant a discharge (Reply to the Notice of Appeal, subparagraph 7(b)(xi), admitted by the appellant).

[15] At the corporation's fiscal year end on November 30, 1994, the financial statements showed an amount of $109,221 "owed to the director" (Exhibit I-5) and, for 1994, the director was allocated a business investment loss a portion of which she was able to carry over to 1992 and 1993 (Reply to the Notice of Appeal, subparagraphs 7(b)(xiii) and (xiv), admitted by the appellant).

[16] On May 24, 1995, the corporation was dissolved (Reply to the Notice of Appeal, subparagraph 7(b)(xv), admitted by the appellant).

[17] The respondent contends that the corporation was no longer carrying on an active business after its fiscal year ended on November 30, 1993.

[18] Counsel for the respondent considers that the amount of $125,000 borrowed in 1994 was not used for the purpose of earning income from a business or property within the meaning of paragraph 20(1)(*c*) of the *Act*.

[19] In her view, if the business was no longer operated at the time of the loan, the interest on that loan was no longer deductible since the use of that loan did not

constitute an eligible purpose. The borrowed money was not used to earn income (see *Bronfman Trust v. Canada*, [1987] 1 S.C.R. 32).

[20] The appellant considers that the loan was used to repay a debt incurred for the purpose of enabling her to earn income. In her view, although the income-bearing property no longer exists, the debt incurred in order to invest in that property still exists. She therefore believes that the interest should be deductible.

[21] Interest on borrowed money may be deducted in computing a taxpayer's income under subparagraph 20(1)(*c*)(i) of the *Act*, which reads as follows:

> **SECTION 20: Deductions permitted in computing income from business or property.**
>
> **(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*) Interest** – an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy).

[22] Four elements must be met for interest to be deductible under subparagraph 20(1)(*c*)(i). The Supreme Court of Canada referred to them in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, as follows at paragraph 28:

> ... 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.

[23] Only the third condition is in dispute here. The issue thus concerns only the question as to whether the borrowed amount of $125,000, for which an interest

expense was claimed, was used for the purpose of earning non-exempt income from a business or property.

[24] As Iacobucci J. stated in *Ludco Enterprises Ltd. v. Canada*, [2001] 2 S.C.R. 1082, at paragraph 44, Dickson C.J. of the Supreme Court of Canada, as he then was, closely analyzed the third element of interest deductibility in *Bronfman Trust*, *supra*. He classified the various possible uses of borrowed money as: eligible and ineligible, original and current, 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.]

[25] Thus, in analyzing the use made of borrowed money, Dickson C.J. endorsed the proposition that it is the current use rather than the original use of borrowed funds by the taxpayer which is relevant in assessing deductibility of interest payments. Dickson C.J. wrote as follows in paragraphs 23, 25 and 34 in *Bronfman Trust*, *supra*:

> ¶ 23 ... A taxpayer cannot continue to deduct interest payments merely because the original use of borrowed money was to purchase income-bearing assets, after he or she has sold those assets and put the proceeds of sale to an ineligible use.
>
> ...

> ¶ 25 ... A continuing obligation to make interest payments to the creditor therefore does not conclusively demonstrate that the borrowed money has a continuing use for the taxpayer.
>
> ...
>
> ¶ 34 ... As stated previously, however, the fact that the taxpayer continues to pay interest does not inevitably lead to the conclusion that the borrowed money is still being used by the taxpayer, let alone being used for an income-earning purpose. For example, an asset purchased with borrowed money may have been disposed of, while the debt incurred in its purchase remains unpaid.

[26] This is based on the principle that the deduction of interest payments, which would normally be prevented by paragraph 18(1)(*b*) of the *Act*, is permitted by paragraph 20(1)(*c*) in order to encourage the accumulation of taxable income-producing assets. (See *Tennant v. Canada*, [1996] 1 S.C.R. 305, at paragraph 16, which also refers to *Bronfman Trust, supra*.)

[27] Thus, if the taxable income-bearing asset is no longer owned by the taxpayer or has not been replaced by another taxable income-bearing asset, there is no longer any reason for the interest on a loan that was used to repay the initial loan (which was originally used for an eligible purpose) to be deductible.

[28] Iacobucci J. summed up the situation as follows in *Tennant, supra*, at paragraph 20:

> To repeat, 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.

[29] In *Emerson v. Canada*, [1985] F.C.J. No. 320 (Q.L.), affirmed by [1986] F.C.J. No. 160 (Q.L.), the taxpayer had borrowed a sum of money to repay an eligible initial bank loan, which had been used to purchase shares in business corporations. The second loan was taken out after the taxpayer had disposed of his shares. The proceeds of disposition of the shares were not reinvested in other eligible use property. Cullen J. of the Federal Court Trial Division refused to allow the deductibility of the interest on the second loan since the source of income from a business or property had disappeared. He wrote as follows at page 3:

> An essential requirement, therefore, of any deduction on account of interest pursuant to 20(1)(*c*) is the existence of the source to which the expense relates and if the source has been terminated, as is the case here, the interest

> expense is no longer deductible. The continuing obligation to meet the interest costs of an outstanding loan, after, the source has been extinguished, is not relevant.
>
> ...
>
> To sum up, as the Defendant does,
>
> In the case at bar, the interest expense in question, in the amount of $3,737.32, was charged on borrowed money used to replace a previous loan which had been used to finance the purchase of shares. However, at the time that the interest costs of $3,737.32 (interest being the cost of using someone else's money over time) were incurred by the Plaintiff, the shares were no longer owned by the Plaintiff. The shares used to be the source of income against which the interest expense on the original loan was deductible in the computation of income from that source. Upon the disposition of the shares, there no longer was a source of income, nor a computation of income, in which that interest on the original loan, had it not been repaid, and the interest on the replacement loan, in fact used to repay the original loan, would be deductible outlays. The only purpose of the refinancing was to repay the money previously borrowed which was a debt owing by the Plaintiff and there is no ground for finding that the borrowed money to which the $3,737.32 interest related, was used for the purpose of earning income from a property.

[30] In *Tennant*, Iacobucci J.—even though he distinguished the situation in *Emerson* from the situation in *Tennant*—implicitly approved of the Federal Court Trial Division's finding, which was affirmed by the Federal Court of Appeal in *Emerson*. Iacobucci J. wrote as follows at paragraphs 21 and 23:

> ¶ 21 ... In my view, the *Emerson* case is not of any application to these facts. *Emerson* is distinguishable as the proceeds of disposition in that case were not reinvested into a second eligible use property, unlike the case at hand.
>
> ...
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> ¶ 23 ... As 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.

[31] If all these comments are applied to the instant case, it becomes clear that, in computing her income, the appellant could not deduct the interest paid on the $125,000 loan contracted with the Caisse populaire Desjardins (Jean-Talon) in 1994. At the time the money was borrowed, the source of income had disappeared

since the Bidule convenience store, which constituted the corporation's sole source of income, had been sold in November 1993. The proceeds of disposition of the Bidule convenience store were not reinvested in income-bearing replacement property. The $125,000 loan was used solely to repay the initial loans, and the conclusion cannot be made that the purpose of that loan, to which the interest was related, was to earn income from a property or business.

[32] In the instant case, the interest that was paid on the $125,000 loan, and which is at issue here, could not be deducted by the appellant in computing her income for the 1997, 1998 and 1999 taxation years under paragraph 20(1)(*c*) of the *Act*.

[33] The appeals are therefore dismissed.

Signed at Ottawa, Canada, this 9th day of October 2002.

"Lucie Lamarre"

J.T.C.C.

Translation certified true
on this 23rd day of December 2003.

Sophie Debbané, Revisor