Docket: 2001-4291(IT)G

BETWEEN:

RÉAL BERNIER,

Appellant,

and

HER MAJESTY THE QUEEN

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on April 26 and 27, 2004, at Montréal, Quebec

Before: The Honourable Justice B. Paris

Appearances:

Counsel for the Appellant:	Gaétan Drolet
Counsel for the Respondent:	Anne Poirier

JUDGMENT

The appeal from the reassessment under the *Income Tax Act* for the 1998 taxation year is allowed, without costs, and the reassessment is referred back to the Minister of National Revenue to allow the Appellant additional capital losses of $10,385.92 and to cancel the penalties imposed further to the application of subsection 163(2).

Signed at Ottawa, Canada, this 30th day of July 2004.

"B. Paris"

Paris J.

Translation certified true
on this 26th day of January 2005.

Colette Dupuis-Beaulne, Translator

Citation: 2004TCC376
Date: 20040730
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Appellant,

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REASONS FOR JUDGMENT

Paris J.

[1] The Appellant is an insurance broker and consultant, and he is the sole shareholder of a number of companies. In 1998, he paid $29,755.33 in interest in connection with a line of credit, and he claimed an equivalent deduction in calculating his business income. The Minister of National Revenue disallowed the deduction, because the interest had not been paid in connection with a loan used for the purpose of earning income from a business or property. The Appellant also claimed capital losses on a repayment made to the line of credit in 1998. The line of credit was denominated in U.S. dollars, and the losses resulted from exchange rate fluctuations between the U.S. dollar and the Canadian dollar. The Minister disallowed the losses. Finally, penalties were imposed on the amounts disallowed, pursuant to subsection 163(2) of the *Income Tax Act* (the "Act").

[2] The issues at bar in this case are as follows:

> Was the loan for which the Appellant paid interest in 1998 used for the purpose of earning income from a business or property?

> Did the Appellant sustain losses in 1998 related to a foreign currency subject to subsection 39(2) of the Act? If so, what is the amount of these losses?
>
> Consequently, did the Appellant knowingly, or in circumstances amounting to gross negligence, make a false statement or omission in filing his income tax return for the 1998 taxation year?

Deduction of interest

The Act

[3] In order to claim a deduction for interest in the calculation of the income he earns from a business or property, a taxpayer must meet the requirements set out in paragraph 20(1)(*c*) of the Act, as follows:

> **20.** (1) Notwithstanding paragraphs 18(1)(*a*), 18(1)(*b*) and 18(1)(*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),
>
> [...]

[4] In order to justify a deduction under this provision, a taxpayer must be able to demonstrate that the money borrowed, on which the interest was paid, was used in an activity that can be identified as an income-earning activity. The taxpayer must demonstrate how the borrowed capital was used.[1]

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[1]*Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32, Dickson C.J., page 3.

[5] It is not possible to claim a deduction where the relationship between the borrowed funds and the eligible use is merely indirect. The interest is deductible only where a sufficiently direct relationship exists between the funds borrowed and the actual eligible use.[2] In this respect, the Federal Court of Appeal says the following:

> [...] Thus, even in cases where the borrowed funds are used for a purpose that has the indirect effect of enhancing the taxpayer's income-earning capacity, the interest payments remain non-deductible. The income-earning purpose is simply too remote. [3]

[6] It is necessary to determine, based on the evidence filed in this case, whether the Appellant has discharged his burden to demonstrate the existence of a direct relationship between the funds borrowed and an eligible use during the 1998 taxation year.

Evidence

[7] The evidence shows that, in 1992, the Appellant obtained a $375,000 line of credit denominated in U.S. dollars from Financial International Advisors Ltd. ("FIA"). The company's head office is located in the Bahamas, but its operations are based in Phoenix, Arizona. Any funds borrowed against the line of credit were to be repaid on November 30, 1996. The annual rate of interest was 7.5%.

[8] The Appellant testified that he arranged this funding for the purpose of investing the money and paying the legal fees incurred by the company, Agence J.W.E.R. Bernier Ltée ("Agence"), which was involved in legal action. Agence expected to be awarded a substantial amount in damages in the case. The Appellant stated that, without the line of credit, he would have been forced to sell some of his investments to pay the legal fees incurred by Agence.

[9] The Appellant stated that, in 1992, he borrowed $370,000 (less a 5% processing fee retained by FIA) against the line of credit. However, in his testimony, he also stated that he had left some of the money on deposit with the FIA until he needed it in 1994.

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[2] *Tennant v. The Queen* [1996] 1 S.C.R. 305 (S.C.C.); Iacobucci J., par. 18 to 20.

[3] *74712 Alberta Ltd. v. Minister of National Revenue*, [1997] 2 F.C. 471; Robertson C.J.

[10] When asked to explain how he had used the money, he indicated that he had loaned approximately $150,000 to Agence to enable the company to acquire the Argenteuil building, for which he already held a second mortgage. The first mortgagee had initiated foreclosure proceedings, and Agence was at risk of losing its investment, unless it acquired the first mortgagee's rights.

[11] Agence's financial statements show that the company acquired the Argenteuil building for $151,304.33 and that this property still carried a first mortgage of $149,431.64. These financial statements also show that Agence incurred $9,201.19 in interest charges on this mortgage during its 1993 taxation year. The evidence does not support the Appellant's claim whereby he provided Agence with a $150,000 advance to discharge the first mortgage and acquire the Argenteuil building in late 1992.

[12] Nevertheless, Agence's financial statements for the 1998 taxation year (including comparative data relating to the 1997 taxation year) reveal that Agence no longer owned the Argenteuil building, which had been disposed of prior to 1997.[4] Consequently, even where I was satisfied that, in 1992 or 1993, the Appellant used the funds from the line of credit to buy back the rights of the first mortgagee, the funds could not have been used for that purpose in 1998, because the Argenteuil building had been disposed of a year earlier.

[13] The Appellant also claimed that he invested $100,000 in a restaurant called Vert Blanc Rouge, and that he had received the related interest. The Appellant filed an excerpt of the working papers used by an Appeals Officer from the Canada Customs and Revenue Agency (CCRA), pertaining to a reassessment the Appellant received for the 1993 to 1995 taxation years. The deductibility of interest on an alleged investment of $100,000 in Vert Blanc Rouge was being contested. In this case, the deduction was allowed.

[14] In the documents before me, the only indication of this 1998 investment appears in Gestion's financial statements for the 1998 taxation year, in which reference is made to a $13,383 mortgage payable by Vert Blanc Rouge to Gestion.[5] No document relating to the Appellant's alleged loan, nor any evidence to corroborate the loan, was filed. Therefore, I have insufficient evidence to conclude

[4] Exhibit A-18, 1998, Part 1, Agence's financial statements; Statement of Assets.

[5] Exhibit A-18, Part 2, Gestion's financial statements, Note 1.

that, in 1998, the Appellant used a portion of the funds from the line of credit to invest personally in Vert Blanc Rouge, or that the restaurant owed money to the Appellant personally, rather than to one of his companies.

[15] The Appellant also claimed that an additional $168,000 drawdown was made from the line of credit to pay Agence's legal fees related to the litigation in 1994 and 1995. He considered these amounts to be advances that he had made to Agence.

[16] The evidence also shows that Agence was successful in this case, and it was awarded $366,864 in damages. The Appellant claimed that Agence received the money in 1995 and that it repaid FIA in 1996. In Agence's financial statements for the 1998[6] and 1999[7] taxation years, the only entries that can be identified as debts to the Appellant are the sums of $11,855 and $14,633 respectively, listed as directors' debts. All of Agence's other debts were payable to an "affiliated company" in 1998 and to a "private company" in 1999. It appears that all of the advances the Appellant made to Agence prior to 1996 have been repaid. It is not possible for me to conclude, based on the evidence before me, that the drawdowns from the line of credit with the FIA were invested in Agence by the Appellant after 1996.

[17] The Appellant also testified that he had invested money in another company for which he was the sole shareholder: Magazine l'agent de voyage Inc. ("Magazine"). He referred to Magazine's financial statements for the year ended July 31, 1997,[8] which show advances totalling $71,568 that the company owed to "third parties"; he also referred to the financial statements for the period ended July 31, 1999,[9] which show debts totalling $55,927 owed to an affiliated company. The Appellant claimed that he, himself, was the "affiliated company" and the "third parties" identified in the statements.

[18] However, the financial statements for Gestion, owned by the Appellant, show loans from Gestion to Magazine, whose outstanding debt totalled $58,159 on January 31, 1997, and $77,995 on January 31, 1998. Although the dates indicated

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[6] See Statement of Liabilities, Exhibit A-18.

[7] See Note 5 in Agence's financial statements for 1999, Exhibit A-24.

[8] Exhibit A-28, Liabilities.

[9] Exhibit A-29, Liabilities.

in Gestion's financial statements do not correspond exactly to those that appear in Magazine's financial statements, it is clear to me that during these years most, if not all, of Magazine's debts were owed to Gestion, rather than to the Appellant personally.

[19] The Appellant stated that he had made additional drawdowns to advance the sum of $244,000 to another one of his companies, Société de Gestion Réal Bernier Inc. ("Gestion"). Gestion was incorporated in 1994, and its financial statements for 1995 to 1998 taxation years were filed in evidence. These statements show that the funds advanced by the Appellant totalled $244,081.63, $245,776.41, $371,847, and $244,338 on January 31, 1995, 1996, 1997, and 1998, respectively.[10] The Appellant did not specify the dates on which the advances were made, and he did not document any relationship whatsoever between these advances of funds and the drawdowns from the line of credit.

Position of the parties

[20] Counsel for the Respondent did not challenge the Appellant's drawdown from the FIA line of credit to pay the interest owing in 1998, but she argued that it was not possible to determine that the funds borrowed had been used by the Appellant for income-generating activities.

[21] Counsel for the Appellant argued that a direct relationship exists between the Appellant's drawdowns from the line of credit and his investments. He added that, at any rate, the Act no longer requires that a direct relationship be strictly demonstrated between the funds borrowed and an income-generating activity or objective, such that the deduction of interest should be allowed, even where the Court concludes that the Appellant was not able to establish a specific relationship between the drawdowns and the use of the funds in 1998. He argued that, at the very least, there was evidence that the Appellant had used the borrowed money indirectly to generate income from his investments, which made him eligible for the deductions claimed. He also argued that the deduction should be allowed, because the Appellant had been authorized in the past to deduct the interest related to the line of credit.

[10] Exhibits A-25, 26, 27 and Exhibit A-18 (second set of financial statements).

Analysis

[22] It is my opinion that the evidence filed by the Appellant does not, in any way, account for the funds borrowed by the Appellant from the line of credit. Neither the drawdowns from nor the repayments to the line of credit have been documented.

[23] During cross-examination, the Appellant was asked, on a number of occasions, to provide details of the dates and amounts of the drawdowns he made from the line of credit between 1992 and 1998, and the use of the funds. The Appellant's responses were vague; very few of his claims regarding the use of the funds were corroborated by documentary evidence and none of them was corroborated by other witnesses. No bank statements were filed to show the transfer of funds drawn from the line of credit to other accounts. No transaction dates were specified, and the years in which the Appellant claims he made various investments remain unclear. Only one statement relating to the FIA line of credit[11] was filed, even though the evidence showed that statements were sent to the Appellant every six months, beginning in 1992. Moreover, there are a number of contradictions between the Appellant's testimony and the documents filed. Overall, I am not satisfied that the evidence provided by the Appellant with respect to the use of the funds is credible.

[24] It is my opinion that the Appellant cannot establish a relationship between the drawdowns and their specific use, let alone a direct and eligible use. The fact that he invested money at the same time as he became indebted to the FIA by way of his line of credit is not sufficient. In the absence of credible evidence to establish a relationship between the funds borrowed and specific investments or specific sources of income from a business or property, I am ruling that the Appellant has not shown that he was entitled to deduct any of the interest claimed.

[25] Finally, the authorization he received to deduct interest in past taxation years does not automatically entitle him to receive the same treatment for subsequent years. The law is clear that the Minister is not bound by assessments he may have issued in the past.[12]

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[11] Exhibit A-31, November 1997 to November 1998.

[12] *Schumaker v. R.*, [2002] 3 C.T.C. 2206.

Capital losses

[26] The claim for capital losses is also related to the loan with the FIA. The loan was made in the form of a line of credit denominated in U.S. currency. In 1998, when the Appellant repaid $65,000 to the FIA, the value of the Canadian dollar in U.S. currency was lower than it was at the time he received the loan. The Appellant calculated his loss resulting from exchange rate fluctuations to be $36,042.50.

[27] Again, the Respondent is not challenging the repayment of US$65,000 made by the Appellant to the FIA in 1998 or the losses sustained by the Appellant at the time of the transaction, owing to the currency fluctuation. However, the Respondent argues that the losses do not constitute capital losses because they result from the discharge of a debt that was not incurred for the purpose of earning income from a business or property. Alternatively, the Respondent argues that the calculations made by the Appellant in assessing the losses contain mathematical errors and that the losses are smaller than the amount claimed.

[28] Losses resulting from exchange rate fluctuations are covered at subsection 39(2) of the Act, as follows:

> (2) Notwithstanding subsection 39(1), where, by virtue of any fluctuation after 1971 in the value of the currency or currencies of one or more countries other than Canada relative to Canadian currency, a taxpayer has made a gain or sustained a loss in a taxation year, the following rules apply:
>
> (*a*) the amount, if any, by which
>
> (i) the total of all such gains made by the taxpayer in the year (to the extent of the amounts thereof that would not, if section 3 were read in the manner described in paragraph (1)(*a*) of this section, be included in computing the taxpayer's income for the year or any other taxation year)
>
> exceeds
>
> (ii) the total of all such losses sustained by the taxpayer in the year (to the extent of the amounts thereof that would not, if section 3 were read in the manner described in paragraph (1)(*a*) of this section,

be deductible in computing the taxpayer's income for the year or any other taxation year), and

(iii) if the taxpayer is an individual, $200,

shall be deemed to be a capital gain of the taxpayer for the year from the disposition of currency of a country other than Canada, the amount of which capital gain is the amount determined under this paragraph; and

(*b*) the amount, if any, by which

(i) the total determined under subparagraph 39(2)(*a*)(ii),

exceeds

(ii) the total determined under subparagraph 39(2)(*a*)(i), and

(iii) if the taxpayer is an individual, $200,

shall be deemed to be a capital loss of the taxpayer for the year from the disposition of currency of a country other than Canada, the amount of which capital loss is the amount determined under this paragraph.

[29] Subsection 39(2) recognizes that the gains or losses resulting from *any* foreign exchange transaction constitute capital gains or losses, except for transactions in respect of income and gains or losses less than $200. Subsection 39(2) constitutes an exception to the rules normally applicable to the calculation of capital gains and losses in the application of the provisions of division B, sub-division C of the Act.[13] Consequently, the limitation provided for at subparagraph 40(2)(*g*)(ii) of the Act, which assumes that any losses resulting from the disposition of a debt that was not acquired for the purpose of earning income from a business or property are nil, does not prevent the recognition of capital losses on foreign currency at the time such a debt is repaid.

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[13] Susbection 39(2) is applicable notwithstanding subsection 39(1) of the Act.

[30] The Canada Customs and Revenue Agency recognizes that the gains and losses resulting from personal transactions on foreign currency constitute capital gains and losses under subsection 39(2) of the Act. Interpretation Bulletin IT-95R says the following at paragraph 5:

> 5. Sundry dispositions of foreign currency by individuals, such as a conversion of traveller's cheques in foreign funds to Canadian dollars on return from a vacation, are considered to be on account of capital. Foreign exchange losses sustained on the repayment of a debt which was given to acquire a personal-use property are also considered to be capital losses under subsection 39(2).
>
> (Emphasis mine.)

[31] Consequently, because the fact that the Appellant sustained losses resulting from foreign exchange transactions in the repayment made to the FIA in 1998 is not being challenged, the Appellant is entitled to consider them to be capital losses under subsection 39(2).

[32] However, the calculation of losses made by the Appellant contains errors. It is necessary to adjust the amount of the losses, taking into consideration the specific exchange rate between the U.S. and the Canadian dollar in effect in 1992, at the time of the drawdown from the line of credit. The evidence shows that, at that time, the exchange rate was C$1.239 per U.S. dollar. This was the rate used by the Appellant's accountant to calculate the losses in the calculation sheet,[14] yet the figure was not transcribed properly on the Appellant's income tax return. The exchange rate for 1998, as accepted by the parties, was C$1.5545 per U.S. dollar, which resulted in capital losses for the Appellant totalling $20,472.92, calculated as follows:

Amount of repayment in Canadian dollars:	$65,000 x 1.5545 =	$101,042.50
Proceeds from the initial loan in Canadian dollars:	$65,000 x 1.239 =	$80,569.58
Difference:		$20,472.92

[33] The Respondent raised an additional issue regarding the calculations made by the Appellant with respect to capital gains and losses for his 1998 taxation year.[15] The Respondent alleges that the Notice of Reassessment contained an

[14] Exhibit A-8, p. 2.

[15] Paragraphs 5(m) and 6 of the amended Reply.

error: only a portion of the capital loss deduction that was disallowed was added at the time of the Appellant's total capital gains calculation for this year. Consequently, the Appellant was reassessed, because his capital gains for the year at issue totalled $64,680 rather than $74,768, as would have been the case had the total amount of the disallowed capital loss deduction been added. Given that I have concluded that the Appellant is entitled to capital losses of $20,472.92, the Respondent would like to deduct $10,087 from this amount, which is equivalent to the error noted above. In other words, the Respondent maintains that, because of the error, a portion of the capital losses has already been deducted and that I should add only the difference to the total eligible losses.

[34] The Appeals Officer was called as a witness. He filed a table[16] containing the Appellant's capital gains calculations for the 1998 taxation year. Included in this table are the amount of the initial assessment, the amounts admitted to make the reassessment, and the resulting calculation error. The Appeals Officer's evidence in this matter was not challenged during cross-examination, and I admit that, because of the error made in the reassessment, a portion of the capital losses has already been allowed. Consequently, the amount for net capital losses to which the Appellant is entitled is $10,385.92 (given the calculation error made in the reassessment).

Penalties

[35] It is the Respondent's burden to prove that the Appellant knowingly, or in circumstances amounting to gross negligence, made a false statement or omission in his income tax return for the 1998 taxation year.

[36] In this case, I am not satisfied that the Respondent has discharged this burden.

[37] The Appellant's claim for capital losses was allowed in part, and the claim for the deduction of interest is based on amounts that he has, in fact, paid as interest. There is no evidence to enable me to conclude that the Appellant was grossly negligent in claiming these deductions. It appears that the penalties were imposed because the Appellant refused to provide documents or make representations to justify his claims at the time of the audit. The auditor concluded that the claims were not founded and that they constituted false statements.

[16] Exhibit I-8.

[38] The Appellant explained to the Court that he chose not to provide documents to the auditor, because he felt that all of the relevant data had been gathered during the audit of prior years, and he believed that the CCRA still had them in its possession. He was apparently told that the data provided to the auditor at the time of the previous audit was not sufficient, and he refused to accept this reply. The relationship between the Appellant and the auditor deteriorated, and the Appellant did not provide the auditor with additional documents to support his claims. However, given the evidence and the documents filed in Court during the appeal hearing, the Appellant clearly had grounds, to some extent, for claiming the deductions, and he genuinely believed that he was entitled to do so. It is not appropriate to impose penalties in these circumstances.

Conclusion

[39] Consequently, the appeal is allowed in part, without costs. The reassessment will be referred back to the Minister to allow the Appellant additional capital losses totalling $10,385.92 and to cancel the penalties imposed under subsection 163(2).

Signed at Ottawa, Canada, this 30th day of July 2004.

"B. Paris"

Paris J.

Translation certified true
on this 26th day of January 2005.

Colette Dupuis-Beaulne, Translator

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APPEARANCES:

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For the Respondent:	Anne Poirier

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