Docket: 2007-4612(IT)I

BETWEEN:

GÉRARD GOULET,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on October 3, 2008, at Québec, Quebec

Before: The Honourable Justice Paul Bédard

Appearances:

Agent for the appellant:	Gail Pilon
Counsel for the respondent:	Valérie Tardif

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2003 taxation year is dismissed in accordance with the attached reasons for judgment.

Signed at Ottawa, Canada, this 19th day of May 2009.

"Paul Bédard"

Bédard J.

Translation certified true
on this 30th day of June 2009
Margarita Gorbounova, Translator

Citation: 2009 TCC 127
Date: 20090519
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REASONS FOR JUDGMENT

Bédard J.

[1] In 2002 and 2003, the appellant purchased notes and commercial papers (debt obligations) at a discount on the secondary market.[1] The appellant held these debt obligations for periods ranging from 27 to 90 days. The debt obligations did not accumulate interest. However, the rate of return for each obligation was clearly established,[2] thus enabling the appellant to know his rate of return. I note right away that the appellant did not demonstrate that the rate of return was higher than the market rate. The debt obligations were repaid by their issuers on time in 2003. In his income tax return for the 2003 taxation year, the appellant treated the difference between the redemption prices of the debt obligations and their purchase prices (in this case, $30,164) as capital gain. The Minister of National Revenue (the Minister) reassessed the appellant's return for the 2003 taxation year concluding that the difference between the redemption prices of the debt obligations and their purchase prices constituted interest instead. That is the reason for this appeal.

Respondent's position

[2] The respondent basically maintains that the return on the debt obligations must be treated as interest income pursuant to subsections 12(4) and 12(9) of the *Income*

1 See Exhibits I-1, I-2 and I-3.
2 See Exhibit I-2.

Tax Act (the Act) and subsections 7000(1) and 7000(2) of the *Income Tax Regulations* (the Regulations).

Appellant's position

[3] The relevant parts of the appellant's written submissions merit citing.

> START OF WRITTEN ARGUMENT
>
> [TRANSLATION]
> Your Honour:
>
> The respondent cannot base himself on paragraph 7000(1)(*a*) or on subsection 12(9) of the *Income Tax Act*, because they do no apply in the commercial paper context. Subsection 12(4) mentioned in Ms. Tardif's argument does not apply either, since it is related to subsection 12(9) and only gives more details on applying it.
>
> The provisions that apply are rather the following:
>
> (a) Division B: Computation of Income, Subdivision c: Taxable Capital Gains and Allowable Capital Losses;
>
> (b) section 38: meaning of taxable capital gains and allowable capital losses;
>
> (c) paragraph 39(1)(*a*): meaning of capital gain and capital loss;
>
> (d) subsection 39(3): gain in respect of purchase of bonds, etc., by issuer;
>
> > (a) the amount, if any, by which the amount for which the obligation was issued by the taxpayer exceeds the purchase price paid or agreed to be paid by the taxpayer for the obligation shall be deemed to be a capital gain of the taxpayer for the taxation year from the disposition of a capital property, and
> >
> > (b) the amount, if any, by which the purchase price paid or agreed to be paid by the taxpayer for the obligation exceeds the greater of the principal amount of the obligation and the amount for which it was issued by the taxpayer shall be deemed to be a capital loss of the taxpayer for the taxation year from the disposition of a capital property,
>
> (e) subsection 39(6): Definition of "Canadian security".

It is true that, for a taxpayer, it is not easy to determine the tax treatment of these obligations. Interpretation Bulletin IT-114 2.1.4, enclosed in Appendix 1, mentions this fact.

> [TRANSLATION]
> The *Income Tax Act* has few provisions concerning the tax treatment of discounts and premiums on debt obligations.

What should we be referring to in situations like this, Your Honour?

I believe that the appellant did well to base himself on the information he had received from the Canada Revenue Agency staff. It was based on this information that the income was treated as capital gain, especially since the financial institution did not issue an information slip (T5 or other).

Even the Canada Revenue Agency was unable to confirm in its draft assessment what provision of the Act the appellant could refer to, stating only that the appellant must apply the generally accepted accounting principles. Moreover, Danielle Cloutier, the reviewing officer, admitted to the Court in her testimony that she had no training in taxation.

In addition, the appellant considers the fact that he has been using the same tax treatment or practice from year to year to be a method accepted by the Department. Interpretation Bulletin IT-479R, paragraph 25(*c*), enclosed in Appendix 2, states that

> . . . the Department will accept reporting of gains and losses on capital account provided this practice is followed consistently from year to year.

It is very important to also consider the riskiness of these investments, which results in a higher rate of return. Taking into account that the obligations are unsecured, we cannot consider the discount as being the same as interest. I refer you to the test established by Lord Greene in *Lomax v. Dixon & Son, Ltd* (Appendix 3):

> . . . the high rate of interest is in part attributable to the capital risk.

Interpretation Bulletin IT-114 2.1.4.3 (Appendix 1) states the following:

> [TRANSLATION]
> Thus, in the context of an obligation being issued on the secondary market, if it is admitted that there was no discount at the time the obligation was first issued and if it does not comply with regulatory provisions, the discount will not be treated as interest, but rather as income of a business or capital gain depending on whether or not the buyer is an investor.

With respect to law, Valérie Tardif found no case law on subsection 12(9), and in the one case that does refer to it, *O'Neil v. Minister of National Revenue*

(Appendix 4), Justice Lamarre Proulx found that subsection 12(9) and section 7000 do not apply to short-term debt obligations, which is the case that concerns us:

> Subsection 12(9) and Regulation 7000 invoked by counsel for the Respondent in the Reply, though not of application here, as these sections would apply for an investment instrument of a long duration and here the instrument had a six-month life, confirm however that instruments with no stated interest are deemed to be carrying on a yearly interest calculated in a prescribed manner.

As for Justice Dussault's decision in *Gestion Guy Ménard*, which Ms. Tardif refers to, regretfully, it does not discuss the same kind of obligation at all. Commercial papers cannot be compared with Treasury bills or banker's acceptances.

> A Treasury bill of the Government of Canada is a debt obligation issued by the Canadian government that offers a high level of security with respect to capital and income.
>
> A banker's acceptance is a bill issued to a client, the capital and interest of which is guaranteed by the bank.
>
> A commercial paper is a short-term unsecured obligation issued by financial or non-financial institutions, usually at a discount.

Furthermore, the appellant is quite familiar with Treasury bills and banker's acceptances and has always declared the income from those as interest.

Ms. Tardif is also referring us to McCarthy Tétrault's comments, but that document cannot be accepted because it does not apply to this case pursuant to the *Income Tax Act*.

I would also submit to you, Your Honour, a document enclosed in Appendix 5 taken from the Collection fiscale du Québec in October 2006, using the search terms: *gain en capital – intérêts* [capital gain – interest]. In section 2.3.2.4 of this document, *Escompte ou prime sur l'achat d'une obligation* [discount or premium on the purchase of an obligation], paragraph (3), [TRANSLATION] "the Revenue Canada test" is proposed as the method for determining the nature of the discount or premium on a debt obligation. If we apply that test to this case, we would notice that we cannot answer "yes" to the questions in (b) and (c). Based on this, we can conclude that a discount must be treated as capital gain.

Your Honour, I would also cite a comment you made during Ms. Tardif's argument. I consider it very important for deciding on the tax treatment of an obligation when the issuing company goes bankrupt and the taxpayer collects nothing.

> [TRANSLATION]
> How would you have treated the loss?

Of course this would result in capital loss. The Department does not permit that this loss be deducted from other income at 100%. Should we not then consider the treatment of losses when assessing the opposite case? I think so. In the acts and regulations, the Department recognizes that debt or other kinds of obligations treated as capital gain must also be treated as capital loss.

If we also look at the current subprime lending crisis, it clearly demonstrates the fragility of these investments, which are completely unsecured and can be considered as capital losses.

In support of my argument, I enclose in Appendix 6 a letter of compliance from the Ministère du revenu du Québec from a related case. It informed the respondent that her tax returns for the years concerned were in compliance with the tax legislation in effect.

Your Honour, I do not believe that the respondent has **clearly** demonstrated that the return on the unsecured debt obligations should be added to the appellant's income in the form of interest. There were several hesitations and suppositions in Ms. Tardif's argument:

> [TRANSLATION]
> Yes, subsection 12(4) applies somewhat, so to speak.
>
> I found no case law on subsection 12(9) and section 7000, but for those . . . in those, what is at issue are not debt obligations.

The Court must instead base its decision on section 38, paragraphs 39(1)(*a*), 39(3)(*a*) and 39(3)(*b*) and subsection 39(6) of the *Income Tax Act*.

Consequently, I believe that the appellant was justified in treating his return as capital gain for the above reasons and because of the reasonable doubt created by the documents, bulletins and case law.

Statutory provisions

[4] The relevant provisions of the Act and Regulations are as follows:

Income Tax Act

12. (1) Income inclusions – There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:

. . .

> **(*c*) Interest** – subject to subsections (3) and (4.1), any amount received or receivable by the taxpayer in the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income) as, on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer's income for a preceding taxation year;

(4) Interest from investment contract – Subject to subsection 12(4.1), where in a taxation year a taxpayer (other than a taxpayer to whom subsection 12(3) applies) holds an interest in an investment contract on any anniversary day of the contract, there shall be included in computing the taxpayer's income for the year the interest that accrued to the taxpayer to the end of that day with respect to the investment contract, to the extent that the interest was not otherwise included in computing the taxpayer's income for the year or any preceding taxation year.

(9) Deemed accrual – For the purposes of subsections 12(3), 12(4) and 12(11) and 20(14) and 20(21), where a taxpayer acquires an interest in a prescribed debt obligation, an amount determined in prescribed manner shall be deemed to accrue to the taxpayer as interest on the obligation in each taxation year during which the taxpayer holds the interest in the obligation.

(11) Definitions – In this section,

"anniversary day" of an investment contract means

> (*a*) the day that is one year after the day immediately preceding the date of issue of the contract,
>
> (*b*) the day that occurs at every successive one year interval from the day determined under paragraph (*a*), and
>
> (*c*) the day on which the contract was disposed of;

"investment contract", in relation to a taxpayer, means any debt obligation other than

(*a*) a salary deferral arrangement or a plan or arrangement that, but for any of paragraphs (*a*), (*b*) and (*d*) to (*l*) of the definition "salary deferral arrangement" in subsection 248(1), would be a salary deferral arrangement,

(*b*) a retirement compensation arrangement or a plan or arrangement that, but for any of paragraphs (*a*), (*b*), (*d*) and (*f*) to (*n*) of the definition "retirement compensation arrangement" in subsection 248(1), would be a retirement compensation arrangement,

(*c*) an employee benefit plan or a plan or arrangement that, but for any of paragraphs (*a*) to (*e*) of the definition "employee benefit plan" in subsection 248(1), would be an employee benefit plan,

(*d*) a foreign retirement arrangement,

(*e*) an income bond,

(*f*) an income debenture,

(*g*) a small business development bond,

(*h*) a small business bond,

(*i*) an obligation in respect of which the taxpayer has (otherwise than because of subsection 12(4)) at periodic intervals of not more than one year, included, in computing the taxpayer's income throughout the period in which the taxpayer held an interest in the obligation, the income accrued thereon for such intervals,

(*j*) an obligation in respect of a net income stabilization account,

(*k*) an indexed debt obligation, and

(*l*) a prescribed contract.

Income Tax Regulations

7000. (1) [prescribed debt obligation] – For the purpose of subsection 12(9) of the Act, each of the following debt obligations (other than a debt obligation that is an indexed debt obligation) in respect of which a taxpayer has at any time acquired an interest is a prescribed debt obligation:

> (*a*) a particular debt obligation in respect of which no interest is stipulated to be payable in respect of its principal amount,
>
> . . .
>
> and, for the purposes of this subsection, a debt obligation includes, for greater certainty, all of the issuer's obligations to pay principal and interest under that obligation.
>
> **(2) [interest on a prescribed debt obligation]** – For the purposes of subsection 12(9) of the Act, the amount determined in prescribed manner that is deemed to accrue to a taxpayer as interest on a prescribed debt obligation in each taxation year during which he holds an interest in the obligation is,
>
> > (*a*) in the case of a prescribed debt obligation described in paragraph (1)(*a*), the amount of interest that would be determined in respect thereof if interest thereon for that year were computed on a compound interest basis using the maximum of all rates each of which is a rate computed
> >
> > > (i) in respect of each possible circumstance under which an interest of the taxpayer in the obligation could mature or be surrendered or retracted, and
> > >
> > > (ii) using assumptions concerning the interest rate and compounding period that will result in a present value, at the date of purchase of the interest, of all the maximum payments thereunder, equal to the cost thereof to the taxpayer;
>
> . . .
>
> **(5) [computation of interest]** – For the purposes of making the computations referred to in paragraphs (2)(*a*), (*b*), (*c*) and (*c*.1), the compounding period shall not exceed one year and any interest rate used shall be constant from the time of acquisition or issue, as the case may be, until the time of maturity, surrender or retraction.

Analysis and conclusion

[5] Based on the above statutory provisions, a taxpayer who holds a prescribed debt obligation as set out in subsection 7000(1) of the Regulations must compute the interest accrued in the manner prescribed in subsection 7000(2) of the Regulations and include this interest in computing his annual income pursuant to subsection 12(4) of the Act.

[6] Subsection 12(9) of the Act sets out that, when a taxpayer acquires an interest in a prescribed debt obligation, an amount determined in the prescribed manner is deemed to accrue to the taxpayer as interest on the obligation in each taxation year during which the taxpayer holds the interest in the obligation. The prescribed debt obligations described in subsection 12(9) of the Act include "a particular debt obligation in respect of which no interest is stipulated to be payable in respect of its principal amount". Subsection 7000(2) of the Regulations sets out the method for computing the interest accrued on prescribed debt obligations for the purposes of subsection 12(9) of the Act. More specifically, paragraph 7000(2)(*a*) of the Regulations sets out the method for computing the presumed interest on "a particular debt obligation in respect of which no interest is stipulated to be payable in respect of its principal amount" for the purposes of subsection 12(9) of the Act. The method for computing the interest accrued set out in paragraph 7000(2)(*a*) of the Regulations makes it possible to compute the interest accrued daily during the time that the taxpayer holds an interest in a particular debt obligation in respect of which no interest is stipulated to be payable in respect of its principal amount. Consequently, in my view, it is wrong to be claiming that the provisions in subsections 12(4) and 12(9) of the Act apply only to long-term prescribed debt obligations. I note right away that subsections 12(9) of the Act and 7000(2) of the Regulations do not stipulate that their provisions apply only to taxpayers who hold prescribed debt obligations that were acquired at the time of their issue. In other words, I am of the opinion that subsections 12(9) of the Act and 7000(2) of the Regulations also apply to taxpayers holding prescribed debt obligations acquired on the secondary market. Moreover, the following comments from the Canada Tax Service on the application of subsection 12(9) of the Act to prescribed debt obligations acquired on the secondary market are very convincing:

> Where such an instrument is purchased by a second or subsequent purchaser in a secondary market transaction, the amount of the original issue discount itself is disregarded and the rule operates so as to accrue over the period until maturity the difference between the price paid for the instrument and its value at maturity, again on the basis of an effective interest calculation utilizing annual or more frequent compounding.[3]

[7] In addition, subsection 12(4) of the Act obligates a taxpayer who holds an interest in an "investment contract" (defined in subsection 12(11) of the Act) on any "anniversary day" of the contract (also defined in subsection 12(11) of the Act) to include in computing his income for the year the interest that accrued to him pursuant

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[3] Analysis/Commentary – Canada Tax Service – McCarthy Tétrault Analysis, 12(3)–(9.1), p. 12, August 25, 1999.

to subsection 12(9) of the Act to the end of that day. According to subsection 12(11) of the Act, an "investment contract" is any debt obligation other than those set out in that subsection. Furthermore, subsection 12(11) of the Act defines "anniversary day" of an investment contract as any of the following days:

> (*a*) the day that is one year after the day immediately preceding the date of issue of the contract,
>
> (*b*) the day that occurs at every successive one year interval from the day determined under paragraph (*a*), and
>
> (*c*) the day on which the contract was disposed of.

[8] In this case, the debt obligations at issue are prescribed debt obligations because they are particular debt obligations in respect of which no interest is stipulated to be payable in respect of their principal amount. They are also "investment contracts" under subsection 12(11) of the Act, since they are not one of the exempted obligations set out in that subsection. Consequently, the Minister was correct to treat the return on these debt obligations ($30,164 in this case) as interest pursuant to subsections 12(4) and 12(9) of the Act and 7000(1) and 7000(2) of the Regulations.

[9] The fact that debt obligations are riskier investments does not, in my opinion, change the application of or override subsections 12(4) and 12(9) of the Act and 7000(1) and 7000(2) of the Regulations. I note that the appellant did not establish that the rate of return for the debt obligations at issue was higher than the market rate. As a result, Lord Greene's comments in *Lomax*[4] do not apply to this case. As for Interpretation Bulletin IT-114, which the appellant referred to several times, not only do interpretation bulletins not have the force of law, but also that particular bulletin was cancelled on June 10, 1994.

[10] In conclusion, even if subsections 12(4) and 12(9) of the Act and subsections 7000(1) and 7000(2) of the Regulations did not apply to the debt obligations at issue, in my view, based on the case law[5] dealing with interest, the return on the obligations (in this case $30,164) should be included in computing the appellant's income for the 2003 taxation year in the form of interest in accordance with paragraph 12(1)(*c*) of the Act.

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4 *Lomax v. Dixon & Son, Ltd.* (1943), 25 T.C. 353.

5 *Lord Howard de Waldens v. Beck* (1940), 23 T.C. 384; *Hall v. M.N.R.* (1970), 70 D.T.C. 6333; *National Provident Institution v. Brown*, [1921] 2 A.C. 222; *Lomax v. Dixon & Son, Ltd., supra.*

[11] For these reasons, the appeal is dismissed.

Signed at Ottawa, Canada, on this 19th day of May 2009.

"Paul Bédard"

Bédard J.

Translation certified true
On this 30th day of June 2009
Margarita Gorbounova, Translator

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