Docket: 2008-3801(IT)I

BETWEEN:

NINA SHERLE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on June 9, 2009 at Vancouver, British Columbia

Before: The Honourable Justice J.E. Hershfield

Appearances:

For the Appellant:	The Appellant herself
Counsel for the Respondent:	Whitney Dunn

JUDGMENT

The appeal from the reassessments made under the *Income Tax Act* for the 2004 and 2005 taxation years are dismissed, without costs.

Signed at Ottawa, Canada, this 24th day of July 2009.

"J.E. Hershfield"

Hershfield J.

Citation: 2009TCC377
Date: 20090724
Docket: 2008-3801(IT)I

BETWEEN:

NINA SHERLE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Hershfield J.

Background and Issues

[1] This appeal deals with the deductibility of interest paid by the Appellant in her 2004 and 2005 taxation years on a loan secured by a mortgage on a home which she co-owned with her husband ("Alan").[1]

[2] The evidence, together with unchallenged assumptions of fact made by the Minister, can be summarized as follows:

(a) The Appellant and Alan owned a property located on Joyce Street in Vancouver ("the Joyce Property");

(b) The Appellant and Alan purchased the Joyce Property in 1985 and used it as their principal residence until 1994;

(c) The Appellant and Alan owned a property located on Ewart Street in Burnaby (the "Ewart Property");

[1] While the co-ownership was not disputed, it was never addressed at the trial. The appeal was presented as if the Appellant was the sole owner of the properties discussed in this appeal.

(d) The Appellant and Alan purchased the Ewart Property in 1993 and used it as a rental property until the middle of 1994;

(e) The Ewart property was rented to an arm's length tenant;

(f) During 1994, the Appellant converted the Joyce Property from their principal residence to a rental property;

(g) During 1994, the Appellant converted the Ewart Property from a rental property to their principal residence;

(h) In April, 1994, the Appellant and Alan took out a mortgage on the Joyce Property in the amount of $180,000 (prior to that the Joyce Property was owned free and clear of any debt encumbrance);

(i) In April, 1994, the Appellant and Alan used the amount of $180,000 to pay the mortgage on the Ewart Property (placed on the Ewart Property to secure a loan used on its purchase);

(j) In December, 1994, the Appellant and Alan took out a new loan and credit line secured by a mortgage on the Ewart Property in the amount of $73,966;

(k) The loan and credit line secured by the Ewart Property mortgage was unrelated to the change in use of either of the two properties. The proceeds of the loan were largely used to make payments on unrelated loans from relatives and for minor renovations to the Ewart Property after it had become a principal residence;

(l) On January 15, 1995, the Appellant rented the Joyce Property to an arm's length tenant.

[3] Having listened to the Appellant's testimony, I am satisfied that these facts are consistent with the Appellant's presentation of them, summarized as follows:

- a rental property was owned and interest payable in respect of that property was deductible;
- a personal residence was owned free and clear of any loans;
- the Appellant wanted to switch properties; that is, live in the rental property and rent out the personal residence;
- she did not want the switch to alter her financing goal which was to continue being in a personal residence that was unencumbered by a mortgage;

- to effect this, she mortgaged the residence she was leaving to pay off the loan on the rental property which was to be her new residence;
- this resulted in her having interest payments due on a loan secured by a mortgage on the Joyce property which was the rental property after the switch;
- the whole change in use undertaking was conditional on realization of her objective to maintain her equity in her personal residence;
- that she later took out a mortgage on her new residence (the Ewart Property), as circumstances required, should not be relevant in considering the true purpose of the loan secured by the mortgage on the new rental property (the Joyce Property);
- that purpose was to finance the holding of an income producing asset.

Arguments

[4] The Appellant argues that the purpose of borrowing on the security of her former residence was to enable the switch of properties and to thereby *enable* the desired change of use of the Joyce Property to a rental property. Without such financing, the "switch" would not have been acceptable. The Joyce Property loan was therefore required to effect the change of use which led to that property becoming an income-producing one. The Appellant relies on subparagraph 20(1)(c)(i) of the *Income Tax Act* (the "*Act*") which sets out the requirement that for interest on borrowed funds to be deductible, the borrowed funds must be used for the purpose of gaining or producing income.

[5] The Respondent argues that the *actual use* of the monies borrowed was to pay off a mortgage on the Appellant's new personal residence and that therefore the borrowed money cannot be viewed as giving rise to interest incurred to gain or produce income. The Respondent relies on case law authorities to the effect that the deductibility of interest under subparagraph 20(1)(c)(i) of the *Act* is governed solely by the actual, direct use of the borrowed funds, and that the use of the loan proceeds indirectly enabled or resulted in the Appellant having a new income producing property is not relevant.

Analysis

[6] The requirements for interest to be deductible are set out in section 20 of the *Act* which reads in its relevant parts as follows:

> **20(1) Deductions permitted in computing income from business or property** -- 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 upon 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),
>
> (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),
>
> […]
>
> or a reasonable amount in respect thereof, whichever is the lesser;
>
> (Emphasis added.)

[7] As noted, subparagraph 20(1)(c)(i) permits the deduction of interest on borrowed money only if the borrowed funds are used for the purpose of gaining or producing income.

[8] The Respondent relies on *Singleton v. Canada*, [2001] 2 S.C.R. 1046 ("*Singleton*") and *Lipson v. Canada*, [2009] 1 S.C.R. 3 ("*Lipson*") as confirming that the direct and immediate use of borrowed money is the only factor to be considered in ascertaining the purpose of the loan.

[9] In *Singleton*, a taxpayer refinanced his partnership interest (an income-producing asset) with a loan reflected largely by book entries, thereby permitting a tax free withdrawal of funds from that partnership. That is, his former capital investment in the firm was taken out and replaced with borrowed money. The funds so withdrawn were used to buy a home. It was clear from the facts that the ultimate purpose of the loan was to permit the purchase of a home; however, the direct use of the borrowed monies was to refinance an income producing asset by making a capital contribution to the partnership.

[10] Justice Bowman of this Court (as he then was) found that the true purpose of the loan was to finance the purchase of a home, and so he denied the interest deduction. In his decision[2] he remarked as follows:

> 12 On any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purpose cannot be altered by the shuffle of cheques that took place on October 27, 1988.
>
> […]
>
> 14 <u>The true purpose of the use of the borrowed funds subsumed the subordinate and incidental links in the chain.</u> Theoretically one might, in a connected series of events leading to a predetermined conclusion, postulate as the purpose of each event in the sequence the achievement of the result that immediately follows but in determining the "purpose" of the use of borrowed funds within the meaning of paragraph 20(1)(c) the court is faced with practical considerations with which the pure theorist is not concerned.
>
> (Emphasis added.)

[11] Under this view, the Appellant would have a better chance to succeed in her appeal. Her true purpose was to refinance her holdings, by borrowing funds, in order to permit her to earn rental income from a property that had not, prior to the borrowing, produced any income. As an income producing property, the Joyce Property was, in effect, newly acquired. Indirectly, the borrowed money was used for the overall purpose of producing income from a newly acquired property. However, this view as to the proper construction of the purpose test in paragraph 20(1)(c) did not prevail.

[12] The case went from this Court to the Federal Court of Appeal and finally to the Supreme Court of Canada and was heard, in that process, by a total of 11 judges. Four such judges found, in effect, that the only *bona fide* purpose of the loan was to finance the purchase of the house and that the interest on the loan was not deductible. At the end of the road however, 5 of 7 Supreme Court judges found the overall purpose of the loan was not the governing factor in applying paragraph 20(1)(c). Justice Major, who authored the decision of the majority at the Supreme Court, reasoned as follows:

> 26 […] The *Shell* case [*Shell Canada Ltd. v. Canada,* [1999] 3 S.C.R. 622] confirmed that <u>the focus of the inquiry is not on the purpose of the borrowing *per se*,</u>

[2] 96 D.T.C. 1850.

> but is on the taxpayer's purpose in using the money. McLachlin J. agreed with Dickson C.J. in *Bronfman Trust* that the inquiry must be centred on the use to which the taxpayer put the borrowed funds. McLachlin J. made it clear that the deduction is not available where the link between the borrowed money and the eligible use is indirect. However, she made it equally clear that "[i]f a direct link can be drawn between the borrowed money and an eligible use" this third element is satisfied (para. 33).
>
> […]
>
> 29 It is now plain from the reasoning in *Shell* that the issue to be determined is the direct use to which the borrowed funds were put. […]
>
> (Emphasis added.)

[13] In the context of the present appeal then, the overall purpose of the Appellant's loan, namely to have a financing arrangement enabling the change in use of a personal use property to an income-producing property, is not the governing factor. The relevant question is: to what direct use were the borrowed funds put?

[14] The Appellant has admitted that the proceeds of the loan secured by the Joyce Property were used to pay down the mortgage on the Ewart Property. This property was converted by the Appellant into their principal residence in 1994. Since this change resulted in the Ewart Property becoming incapable of producing income, the direct use of the funds does not fit within the requirements of subparagraph 20(1)(c)(i), as that provision has been interpreted by the Courts. Therefore, the Appellant is not entitled to the interest deduction she seeks.

[15] I also point out in support of this conclusion that the Appellant's focus as to "why" she borrowed the money is itself misdirected given the Court's construction of the requirements of subparagraph 20(1)(c)(i). There is no dispute as to why she used the loan proceeds as she did: namely, it was to maintain in her new residence the same equity she had in her former residence. She wanted to change the use of a property from a non-income producing asset to an income producing asset without negatively impacting her financial situation *vis-à-vis* her equity in her residence. This required her to use the loan proceeds to increase her equity in her new residence. However, the law is clear that "why" funds are borrowed is irrelevant to the analysis under subparagraph 20(1)(c)(i).[3] It is the use of the funds that governs.

---

[3] *Shell Canada Ltd. v. Canada* at para. 47: "[…] It is irrelevant why the borrowing arrangement was structured the way that it was or, indeed, why the funds were borrowed at all." (*Shell* is cited at paragraph 12 of these Reasons.)

In the present case, the required link between the use of the proceeds and the income producing property is just not there.

[16] While this conclusion does not sit easily with my reading of the subject provision, the authorities that bind me are clear. Distinguishing these authorities and resurrecting this Court's decision in *Singleton* would make the administration of the subject provision more difficult than it already appears to be. The law relies on the consistent application of the principles developed by the higher Courts and I am bound to follow them.

[17] Before concluding, there are a few additional matters that I would like to address.

[18] Firstly, in addition to relying on subparagraph 20(1)(c)(i), the Appellant wanted me to address her interest deduction claim under subparagraph 20(1)(c)(ii) given that, pursuant to section 45 of the *Act*, a deemed acquisition of the Joyce Property occurred due to the change in its use.

[19] In responding to this, it is helpful to look at the two provisions together:

> **20(1)** […] there may be deducted […]
>
> (c) **interest** -- an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on
>
> (i) […]
>
> (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),
>
> […]
>
> (Emphasis added.)
>
> **45(1) Property with more than one use [change in use]** -- For the purposes of this subdivision the following rules apply:
>
> (a) where a taxpayer,
>
> (i) having acquired property for some other purpose, has commenced at a later time to use it for the purpose of gaining or producing income, or
>
> (ii) having acquired property for the purpose of gaining or producing income, has commenced at a later time to use it for some other purpose,
>
> the taxpayer shall be deemed to have

> (iii) disposed of it at that later time for proceeds equal to its fair market value at that later time, and
> (iv)<u> immediately thereafter reacquired it at a cost equal to that fair market value</u>;
>
> (Emphasis added.)

[20] These provisions read together do not assist the Appellant in this case. Subparagraph 20(1)(c)(ii) allows interest to be deducted if it is paid "*on an amount payable for property acquired*". That is, it allows interest to be deducted in respect of an obligation arising as payment for (as part of) the purchase price of the property acquired. The deemed acquisition of the income-producing property, in this case, does not give rise to a principal amount payable. Therefore, the interest paid by the Appellant cannot relate to such a non-existent amount. It relates to the loan used to pay off the mortgage on the Ewart Property - a property that is not income-producing. That the deemed acquisition might not have occurred but for the refinancing employed cannot make the actual loan obligation amount an amount "*payable for property acquired*".

[21] Secondly, it should be noted that the nature of the security given for a loan is not relevant in determining whether interest payments in respect of that loan are deductible from income. In the present case, the fact that the security given for the loan was an income-producing rental property is not sufficient to meet the requirements of subparagraph 20(1)(c)(i). Giving the rental property as security for a loan does not attach (connect) the interest payment on the loan to the income stream from that rental property. The nature of the security for the loan is not merely a tenuous link to the use of the loan proceeds - it is simply not relevant in considering how the loan proceeds are used.

[22] Thirdly, I note that the Appellant has effectively underlined an unsettling ironic twist to the Respondent's position. I would not be doing her justice unless I recognized her point. The twist is that what was of concern in *Singleton* was that the series of steps adopted obscured reality; they obscured the real *bona fide* purpose of the loan. In the case at bar, doing what Singleton did would not disguise the real purpose of the loan but would rather ensure recognition of it. Namely, a *Singleton*-type series of contrived and purely legalistic steps would ensure that her underlying purpose would be recognized under paragraph 20(1)(c). Such a connected series of steps would not be subordinate, incidental links that are subsumed by the true purpose. They would be insurance that the true purpose would be recognized.

[23] Indeed, the Appellant argued, without particular knowledge of the plan in *Singleton*, that she could have sold the residence to a friend and bought it back and achieved the desired result. For example, with the necessary legal advice, the Appellant might have done something along the following lines:

- On day 1 she sells her residence, the Joyce Property, to her friend Ms. A. The purchase price is paid by issuing a Promissory Note;
- On day 2 she takes a bank loan to discharge the mortgage on the Ewart Property (the first loan). While the loan might only be a daylight-bookkeeping entry, there is adequate security for it given that a collateral charge will be immediately available on the Ewart Property upon the payout of the former charge against it;
- Also on day 2, she buys back the Joyce Property (her new rental property), and finances this acquisition by borrowing money from the bank, which loan is secured by a mortgage on the re-acquired property (the second loan);
- The proceeds of the latter mortgage are paid to her friend Ms. A as consideration for this buy-back and Ms. A uses the proceeds to pay off the Promissory Note she issued on the purchase of the property the day before;
- The proceeds from the Promissory Note are used by the Appellant to pay off the first bank loan;
- The only remaining loan is the second loan taken to acquire a rental property;
- Everything is done at fair market value without tax consequence, and actual transfers of land need never be registered.

[24] Since in this hypothetical scenario the direct use of the borrowed funds would be to buy the rental property, applying the *Singleton* test of direct use would most likely result in the interest on such borrowing being deductible. In light of *Singleton*, it would be difficult to suggest that this series of transactions would be considered artificial or lacking commercial reality in some fatal way. Considering the Supreme Court decision in *Lipson* it would be difficult to even suggest that this hypothetical series of transactions could be found to be offside the General Anti-Avoidance Rule in section 245 of the *Act*.

[25] The result then is that had the Appellant engaged in this type of tax planning, applying the direct use test would give the same result as that which could have

been achieved without such a plan if the construction of subparagraph 20(1)(c)(i) recognized the ultimate or true purpose of the loan.

[26] A further irony in this situation lies in one of the rationales of the majority in *Singleton* that allowed the interest deduction in that case. That rationale is found at paragraphs 37 and 38 of Justice Major's majority decision:

> 37 In *Bronfman Trust*, it was stated that "[f]airness requires that the same legal principles must apply to all taxpayers, irrespective of their status as natural or artificial persons, unless the Act specifically provides otherwise" (p. 46). As indicated by this statement, if a corporation can refinance equity with debt and deduct the interest on the associated debt, so too should the respondent be entitled to refinance his partnership equity with debt and deduct the interest.
>
> 38 If the respondent was not allowed to do this we would end up with the inconsistency identified by Rothstein J.A. That is, the interest would be deductible where a partner's initial capital investment was financed with borrowed funds. As well, it would continue to be deductible with a subsequent refinancing of debt. However, a partner who originally financed with his own money and later withdraws that money for personal use and refinances with debt would be denied the deduction.

[27] Based on this horizontal equity justification of respecting legal form, one might have thought a similar justification could allow for the recognition of the true purpose of a loan in a case such as the one at bar. Indeed, the Appellant's plea is that I recognize that she is being put in a worse economic position than someone who had debt financed a rental property when it was first acquired, and that, like in *Singleton*, I should resolve that inequity. In effect, her plea is that the proper construction of the subject provisions be informed, on the facts of her case, by a fundamental principle of our taxation system: two persons in similar circumstances should be subject to the same burden of taxation. She asks that I recognize her ultimate economic picture as the means by which I can do that.

[28] However, that option is not open to me. Both the Supreme Court decisions in *Shell* and *Singleton* make it clear that the focus for the application of the subject provision is on the direct "use" of the borrowed money as opposed to the "purpose" for borrowing it or the ultimate economic result of borrowing it.

[29] In assessing the use of borrowed money, it is not open to the Court to re-characterize a taxpayer's *bone fide* legal relationships so as to allow the "economic realities" of that taxpayer's situation, objectively or subjectively determined, to govern the analysis. Absent a specific provision of the *Act* to the contrary or a

finding that the transactions that were carried out were a sham, a taxpayer's legal relationships will be respected in tax cases.[4]

[30] At the end of the day, a taxpayer is not able to simply argue that the economic substance of their situation is identical to that of another taxpayer and thereby claim to be entitled to a tax treatment similar to that enjoyed by that other taxpayer. This was most recently illustrated in *Scragg v. Canada*, [2009] F.C.J. No. 710, 2009 FCA 180. In that case, the taxpayer borrowed $150,000 from a business associate and claimed the money was to fund his companies. At trial, it was determined that there was insufficient evidence to demonstrate that the funds had actually been used for this purpose. In affirming the decision below, Justice Noël reasoned as follows at paragraph 12:

> 12 The appellant compared his case to that of *Singleton v. Canada*, 2001 SCC 61, [2001] 2 S.C.R. 1046 in which a taxpayer who used borrowed funds to replace equity taken from his law firm to purchase a house was allowed the interest deduction on the borrowed funds. The comparison is not apt because in *Singleton*, the taxpayer was clearly able to trace the borrowed fund to an eligible use. <u>The appellant's argument is that the only difference between his case and *Singleton* is that he did not bother with the formalities, that is, he did not withdraw his equity from his companies and replace it with borrowed money, but in substance his transaction achieves the same result. With respect, it does not. A taxpayer cannot deduct interest on borrowed money unless the money is actually used to produce income. It is not enough to say that it could have been, as the appellant says here.</u>
>
> (Emphasis added.)

[31] Similarly, Justice McLachlin stated in *Shell*, at paragraph 45:

> 45 […] Unless the *Act* provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, […].

[32] As well, I note that to widen the scope of subparagraph 20(1)(c)(i) to allow claims on the basis of either legal form and ultimate purpose would be to develop a

[4] *Shell* at para. 39. *Shell* recognizes that Courts must be sensitive to the economic realities of a situation but it also recognizes limitations. As noted, one limitation is that economic realities cannot be used to re-characterize *bone fide* legal relationships. Although I was not presented with loan agreements or related documents, there is no suggestion in the case at bar that the legal relationships relating to the application the loan proceeds were anything other than as portrayed in the assumptions of facts as admitted to by the Appellant. The *bone fide* legal relationships would be re-cast if the outcome of this appeal was governed by the Appellant's view of the economic realities of her case. That would offend the limitation dictated in *Shell*. See also *Singleton* where, in overturning the Federal Court of Appeal, Major J. said at para. 31: "[…] This Court must simply apply s. 20(1)(c)(i) rather than search for the economic realities of the transaction."

rule that would permit attribution of all debt firstly to income producing assets and secondly to personal assets. There is no suggestion in the *Act* that Parliament intended such a regime even if the Courts have recognized that steps can be taken by a taxpayer to ensure that result. Those steps however must be taken.

[33] Lastly, as alluded to earlier in these Reasons, I note that while the conclusion I have come to in this case does not sit easily, distinguishing the authorities would utterly confuse the administration of the subject provisions and their consistent application.

[34] For all these reasons, the appeal is dismissed, without costs.

Signed at Ottawa, Canada this 24th day of July 2009.

"J.E. Hershfield"

Hershfield J.

CITATION:	2009TCC377
COURT FILE NO.:	2008-3801(IT)I
STYLE OF CAUSE:	NINA SHERLE AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Vancouver, British Columbia
DATE OF HEARING:	June 9, 2009
REASONS FOR JUDGMENT BY:	The Honourable Justice J.E. Hershfield
DATE OF JUDGMENT:	July 24, 2009

APPEARANCES:

For the Appellant:	The Appellant herself
Counsel for the Respondent:	Whitney Dunn

COUNSEL OF RECORD:

For the Appellant:

Name:

Firm:

For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada