



# Supreme Court Rules on Interest Expense

Financial planners and tax practitioners across the country are breathing a sigh of relief after the Supreme Court of Canada released its long-awaited decision on Friday, September 28, 2001 in the Singleton case in favour of the taxpayer. The case involved a lawyer, Mr. Singleton, who was a partner in a law firm. He withdrew \$300,000 from the capital account of his law firm and he used the money to purchase a home. He then went to a bank and borrowed \$300,000 and used that money to repay his capital account at the law firm. Since borrowing for the purpose of earning business income from the partnership is tax deductible (ie. the loan to fund the capital account contribution), whereas mortgage interest on a home is not, Mr. Singleton was able to convert non-deductible interest into deductible interest.

## Singleton's plan

Mr. Singleton originally deducted interest of about \$3,700 in 1988 and \$27,000 in 1989 on his tax returns for those years. Canada Customs and Revenue Agency (CCRA) reassessed Mr. Singleton denying his interest deduction for each of those years. He appealed to the Tax Court of Canada, which dismissed his appeal. However, Mr. Singleton appealed to the Federal Court of Appeal, which allowed the appeal and set aside the lower court judge's ruling that the interest was not deductible. The CCRA pursued this case even further to the Supreme Court, which heard the case in March 2001, but only released its judgment on Friday, September 28, 2001.

## Tax Court of Canada

The Tax Court of Canada originally found that the money was not borrowed for business purposes as the true purpose of the use of the borrowed funds was to buy a home. The Court held that all the transactions that Mr. Singleton undertook were related and therefore should be considered as one transaction – the purchase of the home – for which interest is not tax deductible.

## Federal Court of Appeal

However, the Federal Court of Appeal disagreed and found that the interest was deductible because the direct use of the funds was to refinance his capital account in the partnership and was therefore a valid business expense. The Court stated “the issue was whether the separate transactions undertaken by (Mr. Singleton) should be treated as independent transactions or as one transaction.” The Court held that the transactions should be considered independently. Therefore, Mr. Singleton was entitled to deduct his interest expense because he could clearly trace the borrowed funds to a business-earning purpose (i.e. the refinancing of his partnership capital account.)



## Supreme Court of Canada

The Supreme Court of Canada sided with the Appeal Court's reasoning and stated: "While courts must be sensitive to the economic realities of a transaction and to the general object and spirit of the provision, where the provision at issue is clear and unambiguous, as in this case, its terms must simply be applied.... In this case, a direct link can be drawn between the borrowed money and an eligible use, so (Singleton) was entitled to deduct from his income the relevant interest payments. The transactions in question are properly viewed independently."

## Implications for advisors

The facts in Singleton are very similar to the advice many Canadians receive from their financial planners before buying a home. The strategy often suggested by professional advisors is to liquidate any non-registered investments (stocks, bonds, mutual funds, etc.) and use the cash received upon their disposition to either fully purchase their home or at least to reduce the amount of mortgage otherwise required. The new homeowner would then acquire an "investment loan" and repurchase the securities previously disposed of with the favourable result that what would have been non-deductible interest expense on the mortgage has now become tax deductible. As a result of the favourable decision in Singleton, Canadians can sleep better at night knowing their interest claims won't be challenged – that is, unless the government responds by changing the law....

## Have a tax or estate planning question?

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