

**Federal Court of Appeal**



**Cour d'appel fédérale**

**Date: 20160304**

**Docket: A-169-15**

**Citation: 2016 FCA 67**

**CORAM: DAWSON J.A.  
NEAR J.A.  
BOIVIN J.A.**

**BETWEEN:**

**THE TDL GROUP CO.**

**Appellant**

**and**

**HER MAJESTY THE QUEEN**

**Respondent**

Heard at Toronto, Ontario, on February 4, 2016.

Judgment delivered at Ottawa, Ontario, on March 4, 2016.

**REASONS FOR JUDGMENT BY:**

**DAWSON J.A.**

**CONCURRED IN BY:**

**NEAR J.A.  
BOIVIN J.A.**

**Federal Court of Appeal**



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**REASONS FOR JUDGMENT**

**DAWSON J.A.**

[1] The principal issue raised on this appeal is whether money borrowed by the appellant was “used for the purpose of earning income” within the meaning of subparagraph 20(1)(c)(i) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5<sup>th</sup> Supp.) (Act). If so, a subsidiary issue must be addressed: was the amount of interest paid on the borrowed money reasonable?

[2] For reasons cited as 2015 TCC 60, the Tax Court of Canada found the borrowed money was used by the taxpayer solely to facilitate an interest-free loan to the taxpayer's parent corporation, while creating an interest deduction for the taxpayer. In consequence, the taxpayer's appeal from a reassessment under the Act was dismissed.

[3] This is an appeal from the judgment of the Tax Court. For the reasons that follow, I conclude that the Tax Court erred in law in its application of subparagraph 20(1)(c)(i) of the Act, such that I would allow the appeal and vacate the assessment at issue.

I. The Facts

[4] As the Tax Court noted, most of the relevant facts are not in dispute. A series of transactions began when Wendy's International Inc. (Wendy's), the ultimate parent corporation of the Wendy's group of corporations, lent \$234 million (Cdn) to a U.S. subsidiary, Delcan Inc., at a rate of interest not to exceed 7%. The same day, Delcan Inc. lent the full amount to the appellant taxpayer, at an interest rate of 7.125%. Next, the appellant used the full amount of the loan to purchase additional common shares in its wholly-owned U.S. subsidiary Tim Donut U.S. Limited, Inc. (Tim's U.S.). The next day, March 27, 2002, Tim's U.S. lent the monies received on account of the appellant's share subscription to Wendy's on an interest-free basis, evidenced by a promissory note.

[5] Counsel for the appellant accurately characterized this to be another "money in a circle case". Thus, money that originated from Wendy's, and was lent out by it at a 7% rate of return, wended its way back to Wendy's on an interest-free basis.

[6] Of relevance, in my view, is that the loan to Wendy's was originally intended to be on an interest bearing basis, although no rate of interest was specified. Concerns arose, however, with respect to the impact an interest bearing note would have on state taxes in the U.S. and on the Thin Capitalization and Foreign Accrual Property Income Rules in Canada. As a result, it was decided the loan would be advanced on an interest-free basis until these concerns could be addressed.

[7] Subsequently, a revised plan was put forward in May 2002, approximately two months later. Pursuant to the revised plan, Tim's U.S. incorporated a new U.S. subsidiary, Buzz Co., and assigned Wendy's promissory note to Buzz Co. as payment for its acquisition of Buzz Co.'s shares. Ultimately, pursuant to the promissory note, Buzz Co. demanded repayment of the loan from Wendy's. Wendy's repaid the promissory note in full by issuing a new promissory note to Buzz Co. on November 4, 2002 for the same full amount, bearing interest at the rate of 4.75%.

[8] The Tax Court found the delay from May 2002 to November 2002 was explained by "the group's preoccupation with other matters", including the repurchase of the shares of one of the founders of the Tim Horton's group. The Tax Court found the evidence explaining the delay in implementing the revised plan suggested that the funds were intended to be lent interest-free to Wendy's for an even shorter period of time.

[9] The Tax Court also noted that the Minister of National Revenue denied the appellant the deduction of interest during the period that Tim's U.S. lent the subscription proceeds back to

Wendy's on an interest-free basis. Once the loan to Wendy's was effectively repaid and replaced with an interest bearing loan, the Minister allowed interest to be deducted by the appellant.

## II. The Decision of the Tax Court

[10] At the outset of its reasons, the Tax Court clarified that the interest claimed by the taxpayer, and disallowed by the Minister, was interest paid during the period from March 28, 2002 until November 3, 2002. The Minister disallowed the interest deduction pursuant to subparagraph 20(1)(c)(i) of the Act on the basis that the borrowed monies were not used for the purpose of earning income from a business or property (reasons, paragraph 1).

[11] The Tax Court began its analysis by noting that there was no dispute about the direct use of the borrowed funds. Thus, the only question to be answered was whether the common shares the appellant acquired using the borrowed funds were acquired for the purpose of earning non-exempt income as required by subparagraph 20(1)(c)(i) of the Act.

[12] The Tax Court then reviewed the appropriate test to determine the taxpayer's purpose when using the borrowed funds to subscribe for common shares, as set out in *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, [2001] 2 S.C.R. 1082. In *Ludco*, at paragraph 54, the Supreme Court described the requisite test to be "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made".

[13] In the Tax Court's view, the requirement that consideration be given to "all the circumstances" allowed it to look at Tim's U.S. use of the monies received as a result of the

appellant's subscription of its shares and to also look to "any series of transactions related to the direct investment" (reasons, paragraph 26).

[14] The Tax Court then reviewed the evidence that led it to conclude that the appellant had no reasonable expectation of income at the time it acquired the additional shares in Tim's U.S. (reasons, paragraph 31).

### III. Standard of Review

[15] The Tax Court's findings of fact and inferences of fact may only be set aside if a palpable and overriding error is identified. However, the proper application of the test articulated in *Ludco* is a question of law, reviewable on the standard of correctness (*Ludco*, paragraph 34).

[16] I reject the notion advanced by counsel for the respondent that on this point *Ludco* has been overtaken by *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235. The two decisions are consistent with one another. Any error in the proper application of the legal test is an extricable error of law, reviewable on the correctness standard.

### IV. Application of the Standard of Review

[17] Since *Ludco*, it is settled-law that the taxpayer's purpose when using borrowed monies is to be assessed at the time the monies are used; in this case, the required inquiry is what was the appellant's purpose at the time it subscribed for the additional shares in Tim's U.S.?

[18] Given that the appellant's purpose is to be assessed at that one point in time, an unanswered paradox runs through the reasons of the Tax Court: how is it that there was no income earning purpose during the first seven months the additional common shares were owned by the appellant, but an income earning purpose thereafter?

[19] In my respectful view, this paradox stems from two legal errors on the part of the Tax Court.

[20] The first error resulted from the Court importing into subparagraph 20(1)(c)(i) a requirement that the appellant have a reasonable expectation of receiving income on account of the newly acquired shares within the first seven months of ownership of those shares. Without importing this requirement, one cannot explain how thereafter the shares carried an income earning purpose.

[21] The second legal error flows from the Tax Court's concern with tax avoidance, hence its conclusion that for the seven month period in question (a period the Tax Court found was intended to be shorter) the "sole purpose of the borrowed funds [was] to facilitate an interest free loan to Wendy's while creating an interest deduction for the Appellant".

[22] In *Shell Canada Limited v. Canada*, [1999] 3 S.C.R. 622, the Supreme Court concluded, at paragraph 47, that this Court's "overriding concern with tax avoidance not only coloured its general approach to the case, but may also have led it to misread the clear and unambiguous

terms of s. 20(1)(c)(i) itself'. In my view, the same error led the Tax Court to its conclusion with respect to the purpose for which the borrowed monies were used.

V. The Reasonableness of the Amount of Interest

[23] The Tax Court did not address the fourth element relevant to the issue of interest deductibility because, given its conclusion about the purpose to which the borrowed monies were put, it was not necessary to consider this final element.

[24] The respondent argues that for the initial seven month period the interest charged upon the borrowed funds was not reasonable in view of the fact that the same amount was immediately lent back to Wendy's interest-free.

[25] In *Shell*, at paragraph 28, the Supreme Court observed that the reasonableness of the amount paid must be assessed by reference to the first three requirements of interest deductibility. That is, the reasonableness must be assessed by reference to the terms upon which the monies were lent and the purpose for which the borrower used the money.

[26] I have found that the temporary use of the subscription proceeds by Tim's U.S. did not detract from the appellant's income earning purpose behind its acquisition of additional shares in Tim's U.S. The Minister accepted that the rate of interest on the loan from Delcan Inc. was reasonable after the interest-free loan was replaced with an interest bearing loan. On that basis, I accept that the interest paid during the period at issue was also reasonable.

VI. Conclusion

[27] For these reasons, I would allow the appeal and set aside the judgment of the Tax Court. Pronouncing the judgment that should have been made, I would allow the appeal of the reassessment and vacate the reassessment dated November 11, 2008 for the taxation year ending December 29, 2002. I would also award to the appellant costs both here and in the Tax Court.

“Eleanor R. Dawson”

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J.A.

“I agree.

D. G. Near J.A.”

“I agree.

Richard Boivin J.A.”

**FEDERAL COURT OF APPEAL**

**NAMES OF COUNSEL AND SOLICITORS OF RECORD**

**DOCKET:** A-169-15

**STYLE OF CAUSE:** THE TDL GROUP CO. v. HER  
MAJESTY THE QUEEN

**PLACE OF HEARING:** TORONTO, ONTARIO

**DATE OF HEARING:** FEBRUARY 4, 2016

**REASONS FOR JUDGMENT BY:** DAWSON J.A.

**CONCURRED IN BY:** NEAR J.A.  
BOIVIN J.A.

**DATED:** MARCH 4, 2016

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