Federal Court of Appeal		Cour d'appel fédérale

Date: 20100114

Docket: A-81-09
A-82-09

Citation: 2010 FCA 12

CORAM: **BLAIS C.J.**
SHARLOW J.A.
PELLETIER J.A.

Docket: A-81-09

BETWEEN:

FLEURETTE COLLINS

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Docket: A-82-09

BETWEEN:

EUGENE COLLINS

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Calgary, Alberta, on January 12, 2010.

Judgment delivered at Calgary, Alberta, on January 14, 2010.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: BLAIS C.J.
PELLETIER J.A.

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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] This is an appeal of two judgments of Justice V. Miller of the Tax Court of Canada disposing of income tax appeals of the appellants Fleurette and Eugene Collins for the years 1993, 1994, 1995 and 1996. The reasons for judgment are reported as *Collins v. Canada*, 2009 TCC 56. The income tax appeals succeeded in respect of issues conceded by the Crown, but were otherwise

dismissed. Mr. and Mrs. Collins are now appealing to this Court on the one issue on which they did not succeed in the Tax Court.

[2] The one issue remaining in dispute relates to the deductibility of interest on a particular debt for 1994, 1995 and 1996. It is undisputed that the appellants were jointly liable for the principal amount of the debt in the amount of approximately $1.5 million. They each claimed deductions of $77,186 for 1994, $80,127 for 1995 and $84,391 for 1996, representing 50% of the interest accrued in those years at the rate of 10%. The Minister reduced each of those deductions to $10,000 based on his conclusion that, according to the contractual terms governing the debt, the appellants' joint legal obligation in each 1994, 1995 and 1996 was to pay interest of $20,000 but no more.

[3] The relevant statutory provision is paragraph 20(1)(*c*) of the *Income Tax Act*, R.S.C. 1985, 1 (5th. Supp.) c.1, which reads in relevant part as follows:

20. (1) [. . .] 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	**20.** (1) [. . .] sont déductibles dans le calcul du revenu tiré par un contribuable d'une entreprise ou d'un bien pour une année d'imposition celles des sommes suivantes qui se rapportent entièrement à cette source de revenus ou la partie des sommes suivantes qu'il est raisonnable de considérer comme s'y rapportant :
[. . .]	[. . .]
(*c*) 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	*c*) la moins élevée d'une somme payée au cours de l'année ou payable pour l'année (suivant la méthode habituellement utilisée par le contribuable dans le calcul de son revenu) et d'une somme raisonnable à cet égard, en exécution d'une obligation

pay interest on (i) borrowed money used for the purpose of earning income from a business or property [. . .], or a reasonable amount in respect thereof, whichever is the lesser [. . .].	légale de verser des intérêts sur : (i) de l'argent emprunté et utilisé en vue de tirer un revenu d'une entreprise ou d'un bien [. . .].

[4] The facts are fully set out in the reasons for the judgment under appeal. For the purposes of this appeal only a summary is necessary. The facts are undisputed except for one point, which is mentioned below.

[5] In the early 1980s the appellants, as equal partners, borrowed approximately $1.8 million from an Alberta crown corporation for the purpose of constructing an apartment building to be made available to low income tenants. The loan was secured by a mortgage on the property. The terms of the loan stipulated an interest rate of 8.75% and required monthly payments of $13,368.32. Between 1984 and 1991, amounts of interest were capitalized or deferred pursuant to various formal and informal arrangements.

[6] In 1991, the Alberta government decided to terminate the program under which the loan had been made. From 1991 to 1993, the appellants negotiated with an Alberta government agency to restructure the financing. By the time an agreement was reached, the amount of the loan (including capitalized interest) had increased to almost $2.7 million.

[7] Under an agreement entitled “Loan Agreement and Mortgage Amending Agreement” dated July 22, 1993 (referred to in the reason for judgment as the “Amending Agreement”), an Alberta government agency lent the appellants $1.2 million to be applied against the original debt, leaving a balance of approximately $1.5 million. The new $1.2 million loan was secured by a new mortgage ranking ahead of the previous mortgage. No tax issue arises in relation to that new loan.

[8] The contractual terms of the mortgage agreement governing the original loan were amended by the Amending Agreement. Paragraphs 13 and 14 of the Amending Agreement provide that it does not constitute an accord and satisfaction with respect to the existing debt, or a novation.

[9] Paragraph 6 of the Amending Agreement sets out the amended terms relating to interest and payments on the debt. It reads in relevant part as follows (Appeal Book, page 230):

i)	TERM:	20 years from AUGUST 1, 1993;
(ii)	INTEREST:	10% simple interest to be calculated and paid annually on AUGUST 1st of each year subject to the payment provision below for the first 15 years of the term;
(iii)	PAYMENTS:	Minimum annual interest payments of $20,000.00 for each of the first 15 years of the amended term due on or before AUGUST 1st of each year. At the end of the 16th year of the term, any remaining unpaid accrued interest is immediately due and payable and thereafter, interest shall be paid in accordance with subparagraph (ii) above. The principal sum outstanding shall be paid on or before JULY 31, 2013;
(iv)	EARLY PAYOUT:	The Borrower may at its option, at any time, up to JULY 31, 2008, pay all interest and principal monies outstanding upon payment of the sum of $100,000.00 plus payment of all the FIFTEEN (15) minimum $20,000.00 annual interest payments unpaid which total payment shall be applied firstly to all outstanding interest due to the date of early payment and secondly to principal.

[10] The parties do not agree on how to interpret paragraph 6 of the Amending Agreement. The Judge adopted the Crown's interpretation, discussed later in these reasons.

[11] The appellants report their income on the accrual basis. As mentioned above, when filing their income tax returns for 1994, 1995 and 1996, the appellants each claimed 50% of the full amount of interest accrued on the loan at 10%, the rate stipulated in paragraph 6 of the Amending Agreement.

[12] The Minister took the position that the appellants had no legal obligation, in the years under appeal, to pay interest on the loan in excess of the $20,000 stipulated in subparagraph 6(iii) of the Amending Agreement. On that basis, he limited the interest deductions for each of those years to $10,000 for Mr. Collins and $10,000 for Ms. Collins. The appellants objected and appealed to the Tax Court. The Judge agreed with the Minister and dismissed their appeal on that point.

[13] The Tax Court trial was held in April of 2008. Mr. Collins testified that, as of that time, the appellants had made all of the annual $20,000 payments except the last one, which was due on August 1, 2008, and that they intended to exercise the subparagraph 6(iv) option (which I will refer to as the "settlement option"). Mr. Collins also testified that, because the rental market had improved in the preceding four years, he thought they would have the money to exercise the settlement option by July 31, 2008.

[14] It is useful at this point to mention the one fact that is in dispute. The appellants argue that the Judge made a palpable and overriding factual error at paragraph 17 of her reasons, where she indicates that the appellants agreed at the trial that the interest to which subparagraph 6(ii) of the Amending Agreement refers was not paid and that it would never be paid. The appellants say that this statement is not an accurate reflection of the evidence of Mr. Collins, which is summarized above. I agree. However, in my view nothing turns on this factual error. It is irrelevant to the issues in dispute in this case whether and when the appellants formed the intention to exercise the settlement option, or whether they had the means to do so at any point in time.

Interpretation of paragraph 6 of the Amending Agreement

[15] The interpretation of a contract is a question of law: see *MacNeil v. Canada (Employment Insurance Commission*, 2009 FCA 306 at paragraph 26, and the cases cited in that paragraph. For that reason, this issue must be reviewed on the standard of correctness.

[16] The interpretation proposed by the Crown is that the only legal obligation of the appellants during the first fifteen years of the term of the amended loan agreement was to pay $20,000 on August 1 of each year on account of interest accrued during that year. Any obligation to pay interest in excess of $20,000 per year would arise only after July 31, 2008, and then only if the appellants failed to exercise the settlement option by paying $400,000 less the total of the $20,000 annual payments previously made.

[17] The Judge accepted the interpretation proposed by the Crown. In my respectful view, she erred in law in doing so because that interpretation is not consistent with the language of paragraph 6 of the Amending Agreement and with the agreement as a whole.

[18] In substance, the Crown's argument is that during the first 15 years of the term, the appellants' obligation to pay the excess amount was only a contingent obligation that would become an absolute obligation only if, by July 31, 2008, the appellants failed to exercise the settlement option. However, reading paragraph 6 in its entirety, it is apparent that the provisions governing the due date for payment of interest and principal are the same, in that the principal and all unpaid interest is stated to be due on a future date subject to the exercise of the settlement option requiring payments totalling $400,000 for all principal and interest. In my view, the Crown has mistaken what is contingent. It is not the appellants'obligation to pay the interest that is contingent, but the appellants' right to exercise the settlement option.

[19] It follows that, in each of the years under appeal (1994, 1995 and 1996) and indeed for each of the first 15 years of the term of the Amending Agreement, the appellants had a non-contingent obligation to pay interest accrued on the approximately $1.5 million principal amount of the debt at the rate of 10% as stipulated in subparagraph 6(ii) of the Amending Agreement.

Interpretation of paragraph 20(1)(*c*) of the *Income Tax Act*

[20] The next question is whether the appellants had a legal obligation during the years under appeal to pay the full amount of the interest accrued during those years, even though the due date did not occur in those years and would not occur if the appellants exercised the settlement option. The Judge determined this question in the Crown's favour on the basis that a taxpayer cannot be said to have a legal obligation that is "payable" in a particular year if the due date of the obligation falls in a subsequent year. In my view, that conclusion is based on an incorrect understanding of meaning of "payable" as used in paragraph 20(1)(*c*) in the phrase "payable in respect of the year".

[21] The interpretation of the opening words of paragraph 20(1)(*c*) has been settled for many years. It has long been accepted that if a taxpayer borrows money for the purpose of earning non-exempt income from a business or property and has, as in this case, a non-contingent legal obligation to pay interest on that debt, the taxpayer may deduct the interest.

[22] It is also well settled that the timing of the deduction depends upon whether the taxpayer computes income on the cash basis or the accrual basis. If the taxpayer computes income on the cash basis, the permissible deduction in a particular year is the amount of interest paid in that year. If the taxpayer computes income on the accrual basis, the permissible deduction in a particular year is the amount of interest accrued in respect of that year, whether or not the interest was paid or fell due in that year. The law on this point is correctly summarized in paragraphs 5 and 6 of Interpretation Bulletin IT-533, *Interest Deductibility and Related Issues,* dated October 31, 2003.

[23] It is very common, for example, for a commercial debt to require interest accrued in one year to be paid in a later year. If the borrower is an accrual basis taxpayer, the interest deduction is properly made in the year of accrual. Indeed, if the deduction is not made in that year it can never be made; see *M.N.R. v. Mid-West Abrasive Company of Canada Ltd.*, 73 D.T.C. 5429 (F.C.T.D.).

[24] In this case the appellants are accrual basis taxpayers. Therefore, they are entitled to deduct interest as it accrues, regardless of the date on which payment is due. The appellants correctly claimed deductions for interest accrued at the rate of 10% per year as stipulated in paragraph 6(ii) of the Amending Agreement. They are entitled to that deduction even though they were not obliged to pay the full amount of the interest in the year of accrual, and even though the lender would be obliged, if the appellants exercised the settlement option, to forgive most of the obligation to pay principal and interest.

[25] The situation is analogous to that of a limited recourse mortgage loan, where the right of the lender to recover the principal and interest is limited to the proceeds of sale of the mortgaged property at the end of the term. Even if it is absolutely certain that the value of the property will not cover the mortgage debt, the full amount of the debt remains a legal obligation of the borrower unless and until the mortgaged property is sold (see, for example, *Canada v. McLarty*, [2008] 2 S.C.R. 79, 2008 SCC 26).

The reasonableness test in paragraph 20(1)(c) of the *Income Tax Act*

[26] The Judge agreed with the Crown that the amount of the interest deductible under paragraph 20(1)(*c*) must be limited to $20,000 because to permit any greater deduction would not be reasonable. That conclusion is intended to be an application of the words of paragraph 20(1)(*c*) that limit any interest deduction to the interest payable or "a reasonable amount in respect thereof", whichever is less.

[27] The Crown's pleadings put the appellants on notice that they would be required to establish that the interest in question met the requirements of paragraph 20(1)(*c*), but only in relation to the question of whether the appellants had a legal obligation, in the years under appeal, to pay interest at the rate stipulated in paragraph 6 of the Amending Agreement. The Crown did not plead the issue of reasonableness and did not mention the issue of reasonableness until closing arguments at trial.

[28] In *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at paragraph 28, Chief Justice McLachlin, writing for the Court, explained that one of the elements of paragraph 20(1)(*c*) is that the amount of the deduction claimed must be reasonable, as assessed by reference to the first three requirements. In that regard, she explained at paragraph 34 that an interest rate established in a market of lenders and borrowers acting at arms' length is generally a reasonable rate. This suggests that, in determining the reasonableness of an interest deduction, it is relevant to consider evidence of external factors such as market conditions and market rates for comparable transactions.

[29] When the Crown failed to plead reasonableness and raised that issue for the first time in closing argument at trial, the appellants were unfairly prejudiced because they could not have known, until after the evidence was presented, that evidence relating to the reasonableness of the interest rate could be relevant. The appellants argued at trial that the reasonableness argument should not be entertained, but the Judge rejected that argument. In my view, she erred in law in doing so because of the resulting prejudice to the appellants.

[30] Even if the Tax Court Judge had been correct to permit the reasonableness test to be argued, she did not apply the test correctly. At paragraph 38, she explains her view that the deduction of interest is unreasonable if the interest was not paid in the year under appeal and did not have to be paid in the year under appeal. That is not only inconsistent with the comments in *Shell* relating to the reasonableness test, it renders most of paragraph 20(1)(*c*) redundant.

Conclusion

[31] For these reasons, I would allow the appeal, set aside the judgments of the Tax Court and, making the judgments that should have been made, I would allow the taxpayers' appeals and refer the reassessments back to the Minister for reassessment on the basis that the appellants are entitled to deduct all interest accrued on the loans in the amounts they originally claimed.

Costs

[32] The appellants have asked for costs in this Court and in the Tax Court. They have also asked for costs on an increased scale because of the Crown's improper attempt to raise a new issue for the first time in argument at trial.

[33] The request for increased costs was not mentioned in the appellants' memorandum of fact and law, but was raised for the first time only in argument at the appeal, thus taking the Crown by surprise. The appellants should have indicated in the memorandum that they were seeking costs on an increased scale, or alternatively indicated at the hearing of the appeal that if successful, they would bring a motion under Rule 400 for a direction that costs be awarded on an increased scale.

[34] In any event, I am not persuaded that an award on a higher than normal scale is justified in this case. The reasonableness argument failed on its merits and so no actual prejudice resulted.

[35] I would award the appellants their costs in this Court on the ordinary scale, and their costs in the Tax Court.

"K. Sharlow"

J.A.

"I agree.
Pierre Blais C.J."

"I agree.
Pelletier J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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DATED:	January 14, 2010

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