

Interest Deductibility Uncertainty

2007

Issue

Taxpayers have been operating without any clear legislation on the deductibility of interest expense incurred to earn income since October 31, 2003.

Background

As a result of Supreme Court of Canada decisions in 2002 regarding the deductibility of interest expense, the Department of Finance proposed legislation on October 31, 2003, to be effective for taxation years beginning after 2004.

The Supreme Court basically ruled that interest will be deductible unless there is a personal benefit component to the use of the borrowed funds (for example, money borrowed to acquire a cottage that is used personally and rented out for profit). If there is a personal nature to the use of the borrowed funds then the interest will only be deductible if the taxpayer is operating in a sufficiently commercial manner.

The Department of Finance reacted to the Supreme Courts decision by proposing legislation to severely curtail a taxpayer's ability to deduct interest. Essentially, a taxpayer must show in every year of a venture that there is a reasonable expectation of profit from the venture in order for the interest to be deductible. The legislation clearly states that profit does not include capital gains. For example, in year 1 a taxpayer borrows money to invest in what they hope is a profitable venture. In year 3 it becomes apparent that the venture will likely not be successful. Any interest expense in year 3 on the borrowed funds will be denied as a deduction for tax purposes.

Currently the proposed legislation is under review by the Department of Finance because of its potentially far-reaching adverse effects. It has been 3 ½ years since the proposed legislation has been released and there is still no clear timeline for when this issue will be resolved or what the final form of the legislation will be.

Recommendation

That the federal government scrap the proposed legislation and in the furtherance of the objective of obtaining clarity, acceptance and certainty in legislation on the deductibility of interest expense, consult with key stakeholders by turning the matter over to the Tax Competitiveness Committee