THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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December 23, 2003

DELIVERED AND SENT BY FAX

The Honourable Ralph Goodale, P.C., M.P.
Minister of Finance
L'Esplanade Laurier
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Minister:

Re: Legislation Regarding the Deductibility of Interest and Other Expenses

I am writing to express the opposition of the Investment Funds Institute of Canada to the draft legislation released on October 31, 2003 regarding the deductibility of interest and other expenses. The reasons for our opposition are as follows:

- The measure represents a new and unnecessary limitation on the deductibility of interest and other expenses, notwithstanding the claims in the Finance press release that the measure is intended to result in "continuity".
- The measure will limit the deductibility of interest on money borrowed to purchase securities (including mutual fund securities), and thus will have a negative impact on Canada's capital markets and the Canadian economy, and will diminish Canada's global economic competitiveness.
- Finance officials have stated to a number of persons that they do not intend the CCRA to administer the law as proposed. This is clearly unacceptable and likely unworkable under our legal system.
- The measure will have an unintended and adverse effect upon the deductibility of expenses by mutual funds which will limit their attractiveness as investment and savings vehicles for ordinary Canadians.

The remainder of this letter details our concerns and suggests an alternative proposal.

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Legislation Will Result In A New Regime

The effect of the legislation will be to move the test for the deductibility of interest on money borrowed to purchase securities (including mutual fund securities) from one of possibility of profit to one of probability of profit. Prior to the decision of the Supreme Court in *Ludco*, the CCRA had repeatedly stated that the test was as follows:

> "Normally the Department considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that the potential return to the common shareholder ***may*** exceed his borrowing costs." (*emphasis added*)

In contrast to the old test, the proposed test is that there must be a reasonable expectation that the taxpayer "***will***" realize a "cumulative profit". At the least, this is a "more likely than not" test. It may even require a higher standard to be met. Thus, it is a completely new test.

Notwithstanding the foregoing, the Finance press release claims that the measures will "provide continuity in this important area of the law" and states that:

> "These measures will reaffirm many current practices that support the deductibility of interest, including those relating to the deductibility of interest on money borrowed to purchase common shares."

This assertion is not supportable. If Finance had wished to achieve this result, it should have proposed the addition of the following very simple parenthetical wording after the word "income" in subparagraphs 20(1)(c)(i) and (ii):

> "(as defined in section 9)"

Fundamentally, the draft legislation is not a return to the past. Rather, it will result in a more onerous test than prior to *Ludco* and thus will have a negative impact upon the ability of Canadian companies to raise capital. The reality is that many investments are highly speculative, especially in the case of start-up companies and companies engaged in high risk businesses, and the probability of a cumulative profit (even if capital gains are taken into account) is quite low.

The Finance press release claims that the release of the draft legislation together with a CCRA interpretation bulletin was "a coordinated Government response on the deductibility of interest and other expenses". However, the CCRA interpretation bulletin is at odds with this claim. The CCRA interpretation bulletin very clearly states on page 2:

> "This bulletin does not take into account proposed amendments to the law."

It is difficult to understand how an interpretation bulletin which does not take into account the draft legislation can have any relevance to the draft legislation.

The Department of Finance has, in our view, failed to explain why a new approach to the deductibility of expenses is necessary. In theory, one can speculate that the decision of the Supreme Court in *Ludco* to only require an expectation of gross revenue in order to be able to deduct interest could lead to inappropriate results. However, we believe that the actual likelihood of inappropriate results is severely limited by other provisions in the law. Firstly, the addition of section 94.1 in 1984 was targeted specifically at *Ludco* and would have made uneconomic an investment in the shares purchased with borrowed money by the taxpayer in that case. Secondly, the proposed changes currently before Parliament with respect to non-resident trusts and foreign investment entities further ensure that there will be no repetition of the *Ludco* fact pattern. Thirdly, the requirement that an expense must not be incurred for a personal purpose if it is to be deductible is a very significant limitation on the inappropriate deduction of interest and other expenses. Lastly, the general anti-avoidance rule exists to limit abusive deductions. Having regard to the foregoing, the intended purpose of the draft legislation is not at all clear to IFIC, although its likely effect is all too clear.

Legislation Will Have Adverse Effect On Capital Markets

The technical impact of the draft legislation on capital market transactions is described in the following paragraphs. Proposed subsection 3.1 of the draft legislation provides as follows:

> "3.1 (1) Limit on loss - A taxpayer has a loss for a taxation year from a source that is a business or property only if, in the year, *it is reasonable to expect that the taxpayer* ***will*** *realize a cumulative profit* from that business or property *for the period in which the taxpayer* has carried on, and can reasonably be expected to carry on, that business or has held, and *can reasonably be expected to hold, that property.*
>
> (2) Determination of profit – For the purpose of subsection (1), *profit is determined without reference to the capital gains or capital losses.*" *(emphasis added)*

There is considerable data available regarding dividend yields on stock and the normal length of the hold period for stock. Some of this data was submitted as part of the pleadings in *Ludco* and thus is available in the court file. IFIC would be pleased to provide data of this sort in any reasonable form requested by the Department of Finance to facilitate the analysis of the Department of this matter. However, the data really comes down to two key facts.

Firstly, there are virtually no common shares of Canadian corporations (and none in the TSX 300) which pay a regular dividend anywhere close to the lowest borrowing cost available to an investor (e.g., the prime rate, which is the lowest borrowing rate typically available to individuals, is currently around 4.25%). Secondly, the normal hold period of investors is actually quite short (on average, probably less than 5 years, although this number will vary significantly according to the type of investor and the risk profile of the stock). Thus, it is generally not reasonable to expect that the average taxpayer will realize a "cumulative profit" from purchasing and holding stock "for the period in which the taxpayer … can reasonably be expected to hold" the stock. The following table illustrates the necessary length of holding period before a taxpayer with a 4.25% funding cost has a "cumulative profit" under certain assumptions.

Required Holding Period in Years to Realize Cumulative Profit

		Stock Price Growth Rate				
		1.00%	**3.00%**	**5.00%**	**7.00%**	**9.00%**
Dividend Rate	**0.50%**	342	116	70	51	40
	1.00%	245	83	51	37	29
	1.70%	164	56	34	25	20
	2.00%	138	47	29	21	17
	2.50%	101	35	22	16	13

The following table illustrates the necessary increase in the price of stock as a multiple of its initial price before the taxpayer has a "cumulative profit" under the same assumptions as in the previous table. Clearly, most taxpayers are likely to dispose of stock long before it has increased by the price multiples shown in the following table.

Required Price Multiple Increase to Realize Cumulative Profit

		Stock Price Growth Rate				
		1.00%	**3.00%**	**5.00%**	**7.00%**	**9.00%**
Dividend Rate	**0.50%**	30.1	30.5	30.9	31.4	31.8
	1.00%	11.4	11.6	11.8	12.0	12.2
	1.70%	5.1	5.2	5.3	5.5	5.6
	2.00%	3.9	4.0	4.1	4.3	4.4
	2.50%	2.7	2.8	2.9	3.0	3.1

We note that the Department's position is that the proposed test is an objective test. The technical notes that accompanied the draft legislation state as follows:

> "By requiring that the profit expectation be reasonable, it is intended that the determination be made on an objective, and not a subjective basis . . . Where a taxpayer has – or purports to have – expectations of profit that are objectively unreasonable, subjective expectations will not suffice."

Unfortunately, the data analyzed above would clearly support the conclusion that most persons who purchase stock using borrowed money do not have an objective expectation of a "cumulative profit" as defined by the Department of Finance. The response of the Supreme Court of Canada to this fact (and, in particular, to the very clear wording of existing subsection 9(3)) was to conclude that the measure of income for purposes of the profit test should be gross revenue. This conclusion maintained the integrity of the capital markets and was therefore clearly correct from a broad policy point of view.

In contrast, the draft legislation will not maintain the integrity of the capital markets. In the future Canadians who borrow to make investments will be penalized and thus it will become more difficult and more expensive for Canadian companies to raise capital. We do not believe that there is any other country in the world with mature capital markets which discourages investment in this way. This result is also inequitable. It means persons with accumulated capital can continue to generate returns from the investment of their capital. In contrast, those persons without accumulated capital and who use borrowed money to make investments will be disadvantaged.

The CCRA Cannot Ignore Legislation Under Canadian Legal System

As noted above, the release of the draft legislation was accompanied by the release of a CCRA interpretation bulletin. Finance officials have suggested that the intended effect of these two documents is to communicate to taxpayers that the CCRA does not intend to administer the draft legislation in the form proposed. They refer to their comments in the Finance press release regarding "continuity" and "reaffirming many current practices that support the deductibility of interest". Finance officials clearly realise that Canada's capital markets should not be brought to their knees. However, the statements by the Finance officials and the Finance press release are difficult to reconcile with the statement of the CCRA that the interpretation bulletin "does not take into account proposed amendments to the law".

Moreover, the idea of releasing draft legislation and then indicating that the government does not intend to administer and enforce it is clearly unacceptable and likely unworkable under our legal system. There is very limited discretion in the application of the *Income Tax Act* (Canada). The Minister responsible for the CCRA and the officials of the CCRA are required to administer the law as enacted by Parliament**.** Both CCRA and Finance officials are well aware that one of the responsibilities of the Auditor General is to report to Parliament on the extent to which the law is not being administered as enacted.

Legislation Will Have Unintended Effect On Mutual Funds

The draft legislation will impose a new and unintended limitation on the deduction of expenses by mutual funds. The expenses of a mutual fund are typically between 1.0% and 2.5% of the fair market value of the investments of the mutual fund. As the value of the investments increases, the expenses generally increase. Mutual funds holding primarily equities typically offset their expenses firstly against any incidental interest income, secondly against dividends, and thereafter against taxable capital gains realized in either the current year or in future years in accordance with the rules governing the use of non-capital losses. However, because of the relationship between the expenses of a mutual fund and the fair market value of its assets and because the dividend yield on most portfolios is quite modest (e.g., the portfolio comprising the TSX 300 currently has an average dividend yield of 1.7%), many mutual funds will not be able to deduct all of their expenses. This is clearly an inappropriate result and was not the case under the law affirmed by the Supreme Court in the *Stewart* and *Walls* cases. It will discourage ordinary Canadians from investing in mutual funds which invest in the equity markets. The net result will be an increase in the cost of capital in Canadian companies and a decrease in Canada's global economic competitiveness. Moreover, the absence of any carry forward or carry back provisions in the draft legislation for disallowed expenses is, in our view, a clear and serious technical defect of the legislation.

An Alternative Test

If, notwithstanding the foregoing, the Department of Finance feels compelled to advance a new test for the deductibility of expenses, such as interest, in the view of IFIC, the test should be whether there is an expectation of a net profit on a before tax or cash basis. In measuring net profit for purposes of this test, capital gains should be taken into account. This type of test will accord with normal economic behaviour in the marketplace. Taxpayers obviously take into account the potential for gains in making investment decisions, even if the realization of such gains is not the primary purpose for the investment. In effect, IFIC believes that the test should be based on how taxpayers would behave if tax considerations were not an issue. In other words, the test must be based on the reality of how investors behave, not on some assumptions which investors can rarely satisfy.

It may be that the Department of Finance will object to the idea of allowing a full deduction for an expense when a portion of the related income is only half taxable. In our view there is no validity to this objection since it is a fundamental policy of the *Income Tax Act* (Canada) to tax capital gains on a preferential basis. This policy has several objectives, including the creation of capital and compensating for inflation. If this policy is to be effective, it should not result, in normal circumstances, in any limitation on the deduction of related expenses. We note that many other countries similarly regard the preferential treatment of gains in most circumstances as appropriate tax policy.

We also note that a policy of taking capital gains into account will be largely parallel to the policy of taking dividends into account. Dividends, like capital gains, are taxed on a preferential basis. There are obviously important policy objectives of this preferential treatment, principally, in order to avoid the double taxation of income. Parliament has not undermined these policy objectives by limiting the deduction of expenses incurred to earn dividends. Moreover, the *Income Tax Act* (Canada) is a long way from the 1960s when capital gains were tax exempt. As with dividends, capital gains are now subject to significant, but preferential, taxation. Thus, in the same way that expenses incurred to earn dividends are fully deductible, expenses incurred to earn capital gains should also be fully deductible.

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The continued deductibility of interest and other expenses is obviously of fundamental importance to the Canadian economy. Accordingly, IFIC and its technical advisors would like to meet with you or your officials at any convenient time to discuss our concerns. We look forward to your response.

Yours very truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

ORIGINAL SIGNED BY THOMAS A. HOCKIN

Hon. Thomas A. Hockin
President and Chief Executive Officer

cc: Kevin Lynch, Deputy Minister Finance