

Singleton v. Canada, [2001] 2 S.C.R. 1046, 2001 SCC 61

Her Majesty The Queen

Appellant

v.

John R. Singleton

Respondent

Indexed as: Singleton v. Canada

Neutral citation: 2001 SCC 61.

File No.: 27477.

2001: March 19; 2001: September 28.

Present: Gonthier, Iacobucci, Major, Bastarache, Binnie, Arbour and LeBel JJ.

on appeal from the federal court of appeal

Income tax – Deductions – Interest – Taxpayer using equity in law firm to purchase house then refinancing law firm equity with borrowed money – Whether interest payments made on borrowed money deductible – Whether borrowed money “used for the purpose of earning income from a business” — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 20(1)(c)(i).

The respondent used \$300,000 of equity in his law firm to purchase a house. He refinanced his law firm equity with borrowed money. All of the relevant

cheques were deposited and honoured. The respondent paid interest of \$3,688 in 1988 and \$27,415 in 1989. He deducted the interest on his tax return for those years, pursuant to s. 20(1)(c)(i) of the *Income Tax Act* claiming that the borrowed money now represented his investment in the law firm. The Minister of National Revenue reassessed and denied the interest deduction on the grounds that the borrowed money was used to finance the purchase of the house and not as a business investment. The Tax Court of Canada dismissed the respondent's appeal. The majority of the Federal Court of Appeal allowed the respondent's appeal.

Held (Bastarache and LeBel JJ. dissenting): The appeal should be dismissed. The interest payments were deductible under s. 20(1)(c)(i) of the *Income Tax Act*.

Per Gonthier, Iacobucci, Major, Binnie and Arbour JJ.: 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. Furthermore, absent a sham, window-dressing or other vitiating circumstances, none of which was alleged in this case, the respondent does not have to demonstrate a *bona fide* purpose.

In this case, a direct link can be drawn between the borrowed money and an eligible use, so the respondent was entitled to deduct from his income the relevant interest payments. The transactions in question are properly viewed independently. Regardless of the sequence of the cheques, the respondent used the borrowed funds for the purpose of refinancing his partnership capital account with debt. Viewing the transactions as one simultaneous transaction, thereby treating the borrowed funds as used for financing the purchase of the home, ignores what the respondent actually did:

he used the borrowed funds to replace the funds required for his capital account at the firm. Taxpayers are entitled to structure their transactions in a manner that reduces taxes; the fact that the structures may be complex arrangements does not remove the right to do so. The respondent engaged in a legal transaction to which the Court must give effect. It is irrelevant that he used the money he withdrew from the firm to purchase a house, that the transactions occurred on the same day, and that the respondent structured the transaction for tax purposes.

The \$300,000 invested in the law firm was not frozen for all time in the form of its original investment. Corporations can refinance equity with debt and deduct the interest on the associated debt. Since fairness requires that the same legal principles must apply to all taxpayers, irrespective of their status as natural or artificial persons, unless the Act specifically provides otherwise, the respondent should be entitled to refinance his partnership equity with debt and deduct the interest. Similarly, if a partner's initial capital investment was financed with borrowed funds, the interest on the original loan and on subsequent refinancing of debt is deductible. It would be inconsistent if a partner who originally financed with his own money and later refinanced with debt could not deduct the interest.

Per Bastarache and LeBel JJ. (dissenting): This case does not involve a pure question of law. It turns on the purpose for which the borrowed money was used, and determining the taxpayer's purpose in undertaking the transactions at issue requires an examination of the surrounding facts. Since the Tax Court Judge heard all the evidence relevant to determining the taxpayer's purpose, deference should be given to his understanding of the facts.

Although *Shell Canada* weakens the “economic realities” jurisprudence, it does not reject it wholesale. Courts are still required to look beyond the legal instruments used by the taxpayer in those cases where the legal relations were not created *bona fide*. The economic realities of the situation, however, do not grant a court licence to ignore clear statutory language. In order to ensure that clear statutory language is not overlooked, the words-in-total-context approach should be applied in this case.

The interest paid should not be claimed as a deduction from taxable income. Upon considering the economic realities in this case, it is clear that a series of transactions like the one at bar does not constitute a set of *bona fide* legal relations. The respondent funnelled money through his law firm simply to secure a tax advantage; his borrowing was not made with the *bona fide* purpose of generating income from his business. A contextual reading of s. 20(1)(c)(i) of the *Income Tax Act*, leads to the same conclusion. First, the section is an exception to the general rule against deductibility. Second, the purpose of s. 20(1)(c)(i) is to encourage the accumulation of capital which would produce taxable income. Since the deduction is being claimed for a use of borrowed capital that will lead to the purchase of personal property rather than the production of income, the deduction should be denied. Whether the transactions are considered separately or together does not affect the legal relations created by the taxpayer.

It is not unfair to deny a deduction to the respondent even though a corporation which refinances equity with debt would be allowed the interest deduction. By definition, any money borrowed by a corporation will relate to the business, but money borrowed by an individual may relate to the business or, as in this case, to personal matters. Similarly, a partner who originally financed the partnership with his

own money will only continue to get the interest deduction on any subsequently borrowed money if that money is related to the business. He will not get the deduction for personal spending. The Act requires that the court consider the actual purpose for which the borrowed money was used. The question to be asked in order to ascertain that purpose is, “What was changed by these transactions?” Here it was the acquisition of a house. The financing of the law firm remained the same. Lastly, the “direct link” analysis in *Shell Canada* does not suggest that, under s. 20(1)(c)(i), a taxpayer can deduct the interest he paid on money he borrowed for a purpose completely unrelated to his business.

Cases Cited

By Major J.

Referred to: *Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32; *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622; *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 D.T.C. 6351; *Ludco Enterprises Ltd. v. Canada*, [2001] 2 S.C.R. 1082, 2001 SCC 62.

By LeBel J. (dissenting)

Shell Canada Ltd. v. Canada, [1999] 3 S.C.R. 622; *Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32; *Tennant v. M.N.R.*, [1996] 1 S.C.R. 305; *Mark Resources Inc. v. Canada*, 93 D.T.C. 1004; *Backman v. Canada*, [2001] 1 S.C.R. 367, 2001 SCC 10; *Dunn v. M.N.R.*, 74 D.T.C. 1121; *Stubart Investments Ltd v. The Queen*, [1984] 1 S.C.R. 536; *Harris Steel Group Inc. v. M.N.R.*, 85 D.T.C. 5140; *The Queen v. Golden*,

[1986] 1 S.C.R. 209; *Symes v. Canada*, [1993] 4 S.C.R. 695; *Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours*, [1994] 3 S.C.R. 3; *Friesen v. Canada*, [1995] 3 S.C.R. 103; *Alberta (Treasury Branches) v. M.N.R.*, [1996] 1 S.C.R. 963; *Canada Safeway Ltd. v. Minister of National Revenue*, [1957] S.C.R. 717; *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 D.T.C. 6351; *Sternthal v. The Queen*, 74 D.T.C. 6646.

Statutes and Regulations Cited

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 20(1)(c)(i).

Authors Cited

Duff, David G. “Interpreting the *Income Tax Act* — Part 2: Toward a Pragmatic Approach” (1999), 47 *Can. Tax J.* 741.

APPEAL from a judgment of the Federal Court of Appeal, [1999] 4 F.C. 484, 177 D.L.R. (4th) 461, 243 N.R. 110, 99 D.T.C. 5362, [1999] F.C.J. No. 864 (QL), setting aside a judgment of the Tax Court of Canada, [1996] 3 C.T.C. 2873, 96 D.T.C. 1850, [1996] T.C.J. No. 1101 (QL), affirming the Minister’s reassessment disallowing the respondent’s interest deduction. Appeal dismissed, Bastarache and LeBel JJ. dissenting.

Donald G. Gibson and Deen C. Olsen, for the appellant.

John H. Saunders, for the respondent.

The judgment of Gonthier, Iacobucci, Major, Binnie and Arbour JJ. was delivered by

1 MAJOR J. — This appeal raises the issue of whether borrowed money was
“used for the purpose of earning income” within the meaning of s. 20(1)(c)(i) of the
Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) (the “Act”). The respondent had at least
\$300,000 of equity in his law firm. He decided to use this money to purchase a house
and to refinance his law firm equity with borrowed money. The respondent then
deducted the interest payments made on the borrowed money pursuant to s. 20(1)(c)(i)
of the Act, claiming that the borrowed money now represented his investment in the
law firm. The Minister of National Revenue denied the deduction on the grounds that
the borrowed money was used to finance the purchase of the house and not as a
business investment.

2 The question is whether the borrowed money was used for the purpose of
earning income from the law firm or for the purpose of financing the purchase of his
house. If the former, the interest is deductible; if the latter, it is not.

3 I conclude that the borrowed money was used for the purpose of earning
income from the law firm. As such, the interest is deductible pursuant to s. 20(1)(c)(i)
of the Act. Accordingly, the appeal is dismissed.

I. Facts

4 The respondent is a partner in the law firm Singleton Urquhart. On October
27, 1988 the amount in the respondent’s capital account at the law firm was at least
\$300,000. The respondent’s original capital contributions had not been financed with

borrowed funds. On October 27, 1988 the respondent wanted to do a number of things. He wanted to use \$300,000 of his equity in the law firm to assist in the purchase of a house. He then wanted to borrow that same amount and use it to refinance his partnership capital account.

5 There is less than full agreement on how the respondent achieved these results and the record is unclear as to the sequence of the transactions that occurred on October 27, 1988. While not central to this appeal, the transactions occurred in one of two possible ways.

6 One way was that found by the Tax Court Judge, that is that \$298,750 of money borrowed from the Bank of British Columbia, along with \$1,250 of the respondent's own money, went into the firm trust account. A cheque for \$300,000 was then paid into the partnership general account and credited to the respondent's capital account. The partnership then paid \$300,000 by cheque to the respondent, who deposited this money into his personal bank account. The respondent then issued a cheque drawn on his personal bank account, payable to the firm, for \$300,000. This amount was deposited into a client trust account. The respondent's spouse deposited \$147,901 into the same account. The firm issued a cheque for \$440,451 drawn on the client trust account and payable to the solicitors for the vendors of the house.

7 The other way as found by the Court of Appeal, was that on October 27, 1988, the firm paid the respondent Singleton \$300,000 from his capital account. He used the \$300,000 to assist in the purchase of a house registered in his wife's name. Later that same day, the respondent borrowed \$400,000 from the Bank of British Columbia, only \$298,750 of which is relevant to this appeal, and together with \$1,250 of his own money, paid \$300,000 back into his capital account at the law firm.

8 Counsel for the respondent conceded that the record is unclear as to whether the \$300,000 came out of the firm before the money was borrowed. However, it is undisputed that the respondent had at least \$300,000 in his capital account on October 27, 1988. Furthermore, all of the relevant cheques were deposited and honoured.

9 The respondent paid interest of \$3,688.52 in 1988 and \$27,415.46 in 1989 and deducted the interest on his tax return for those years, pursuant to s. 20(1)(c)(i) of the Act. The Minister reassessed and denied the interest deduction on the grounds that the borrowed money was used to finance the purchase of the house. The Tax Court of Canada dismissed the respondent's appeal. The majority of the Federal Court of Appeal allowed the respondent's appeal.

II. Statutory Provisions

10 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.)

20. (1) Notwithstanding paragraphs 18(1)(a), (b) and (h), 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:

...

(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 pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),

...

or a reasonable amount in respect thereof, whichever is the lesser;

III. Judicial History

A. *Tax Court of Canada*, [1996] 3 C.T.C. 2873

11 This case was originally heard by Kempo J.T.C.C., who retired before she rendered judgment. As a result, Bowman J.T.C.C. decided this case relying on the transcript and submissions made before him.

12 Bowman J.T.C.C. began his analysis of whether the interest was deductible with an examination of what the borrowed money was used for. He concluded that, on October 27, 1988, the borrowed money was channelled through the firm and immediately went to the respondent for the purchase of the house. He observed that “[w]ithout suggesting that there was a sham or dissimulation, that is the reality of the situation” (p. 2876). He concluded, at p. 2876:

On any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purpose cannot be altered by the shuffle of cheques that took place on October 27, 1988.

13 Bowman J.T.C.C. concluded that the borrowed money was used as a “matter of economic reality” (p. 2877) for the purpose of buying the house. He added that the steps of the transaction were “conterminous and interdependent” (p. 2877). He stated that even if the legal validity of the steps was accepted and the tax motivation treated as irrelevant, “one is still left with the inescapable factual determination that

the true economic purpose for which the borrowed money was used was the purchase of a house, not the enhancement of the firm's income earning potential by a contribution of capital" (pp. 2878-79). He dismissed the appeal.

B. *Federal Court of Appeal*, [1999] 4 F.C. 484

(1) Rothstein J.A. for the Majority

14 Rothstein J.A. first considered the proper standard of review to apply in this case. He noted that the Tax Court judge used the term "inescapable factual determination" in referring to the "true economic purpose for which the borrowed money was used" (para. 41 (emphasis added by Rothstein J.A.)). Rothstein J.A. stated that what was at issue was how to treat the transaction for the purpose of s. 20(1)(c)(i). He held that this raised a question of law and it was appropriate for the Court of Appeal to re-examine the conclusion of the Tax Court judge.

15 Rothstein J.A. then considered whether the transactions should be treated independently or as a series of connected activities. He thought the transactions should be treated independently in order to reflect the reality of what occurred: the respondent had his own funds in his capital account which he withdrew and used to purchase a house and he used the borrowed funds to replenish his capital account. Therefore, the borrowed funds were used for the purpose of refinancing the respondent's capital investment in the law firm. He concluded that s. 20(1)(c)(i) does not exclude borrowed funds used for this purpose.

16 Rothstein J.A. said that two requirements for interest deductibility set out in *Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32, are relevant here. The first is

tracing, which the Minister conceded was not at issue. The second is the direct use of the borrowed funds, which he concluded was to refinance the capital account. Rothstein J.A. held that in accordance with *Bronfman Trust*, this direct use could not be ignored.

17 Rothstein J.A. relied on *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298, *per* Bastarache J., who wrote for the Court on this point, in stating that there are three important principles of law relevant to this appeal (at para. 58):

First, a taxpayer who complies with the provisions of the *Income Tax Act* should not be denied the benefit of such provisions simply because the transaction was motivated for tax planning purposes. Second, in the absence of evidence that the transaction was a sham or abuse . . . and where the words of the Act are clear, it is not the role of the Court to decide . . . whether the taxpayer is deserving of the deduction. Third, it is an error for the Court to ignore the legal and commercial reality of a transaction.

18 Rothstein J.A. concluded that the absence of the phrase “series of transactions” from s. 20(1)(c)(i) implies that the legislature did not intend that the series test be applied to transactions such as the one at issue.

19 The majority of the Federal Court of Appeal allowed the appeal and set aside the judgment of the Tax Court and the Minister’s reassessment.

(2) Linden J.A. in dissent

20 Linden J.A. noted that the focus of the case was whether the borrowed funds were used for the purpose of earning income. He concluded that the Tax Court judge was correct in deciding that the interest was not properly deductible under s. 20(1)(c)(i). He gave three reasons for this conclusion (at para. 4):

1. The determination of the purpose for which borrowed money was used is primarily a factual determination which should not be interfered with.
2. Past cases have, without exception, denied deductibility of interest in transactions such as these.
3. The task of the Court under paragraph 20(1)(c) of the Act is to examine the commercial and economic realities underlying the transaction to determine if the borrowed funds were “used for the purpose of earning income,” which, in my view, they were not.

IV. Issue

21 Was the borrowed money “used for the purpose of earning income from a business” such that the interest is deductible pursuant to s. 20(1)(c)(i) of the Act?

V. Analysis

A. *Standard of Review*

22 Bowman J.T.C.C. concluded that it was an “inescapable factual determination that the true economic purpose for which the borrowed money was used was the purchase of a house” (p. 2878). Linden J.A., in dissent, held that this was a factual determination which should not be interfered with. I respectfully disagree. I adopt the conclusion of Rothstein J.A. That is, this appeal raises the issue of what is the proper legal test under s. 20(1)(c)(i). That is a question of law. For the reasons outlined, the Tax Court Judge, in searching for the “true economic purpose”, applied the wrong legal test.

23 To the extent that the Tax Court judge’s characterization of the sequence
of the transactions differed from that of the Court of Appeal, it is of no material
consequence in the determination of this appeal.

B. The Legal Principles to be Applied in this Case

24 The law with regard to s. 20(1)(c)(i) was recently clarified in *Shell Canada
Ltd. v. Canada*, [1999] 3 S.C.R. 622. The decision in *Shell* is determinative of the issue
in this case. The key principles from that case bear repeating.

25 In *Shell, supra*, McLachlin J. (later Chief Justice), writing for the Court,
confirmed that s. 20(1)(c)(i) contains four elements (at para. 28):

(1) the amount must be paid in the year or be payable in the year in which
it is sought to be deducted; (2) the amount must be paid pursuant to a legal
obligation to pay interest on borrowed money; (3) the borrowed money
must be used for the purpose of earning non-exempt income from a
business or property; and (4) the amount must be reasonable, as assessed
by reference to the first three requirements. [Emphasis added.]

26 Only the third element is at issue in this appeal: the borrowed money must
be used for the purpose of earning non-exempt income from a business. The *Shell* case
confirmed that the focus of the inquiry is not on the purpose of the borrowing *per se*,
but is on the taxpayer’s purpose in using the money. McLachlin J. agreed with Dickson
C.J. in *Bronfman Trust* that the inquiry must be centred on the use to which the
taxpayer put the borrowed funds. McLachlin J. made it clear that the deduction is not
available where the link between the borrowed money and the eligible use is indirect.
However, she made it equally clear that “[i]f a direct link can be drawn between the
borrowed money and an eligible use” this third element is satisfied (para. 33).

27 In examining the Minister’s argument about the need to consider the economic realities of a transaction rather than being bound to its strict legal effects, McLachlin J. recognized that the courts must be sensitive to the economic realities of a transaction. However, she stated that (at paras. 39-40):

. . . this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer’s *bona fide* relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer’s legal relationships must be respected in tax cases. . . .

Second, it is well established in this Court’s tax jurisprudence that a searching inquiry for either the “economic realities” of a particular transaction or the general object and spirit of the provision at issue can never supplant a court’s duty to apply an unambiguous provision of the Act to a taxpayer’s transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied. [References omitted.]

28 The Court in *Shell* emphasized that taxpayers are entitled to structure their transactions in a manner that reduces taxes (see for example paras. 45 and 46). The fact that the structures may be complex arrangements does not remove the right to do so.

29 It is now plain from the reasoning in *Shell* that the issue to be determined is the direct use to which the borrowed funds were put. “It is irrelevant why the borrowing arrangement was structured the way it was or, indeed, why the funds were borrowed at all” (*Shell, supra*, para. 47).

C. Application to the Facts in the Case at Bar

30 The appellant, the Minister in Right of the Crown, relied on the reasons of the Tax Court Judge and Linden J.A., in dissent, and urged the Court to examine the

“economic realities” of the taxpayer’s transactions in determining whether the requirements of s. 20(1)(c)(i) had been met.

31 Applying *Shell*, I decline to do so. This Court must simply apply s. 20(1)(c)(i) rather than search for the economic realities of the transaction.

32 In applying s. 20(1)(c)(i) here, the relevant question is: to what use were the borrowed funds put? The Tax Court Judge found that the purpose in using the money was to purchase a house and that this purpose could not be altered by the “shuffle of cheques” that occurred on October 27, 1988. I respectfully disagree. It is this “shuffle of cheques” that defines the legal relationship which must be given effect. The respondent had at least \$300,000 of his own money in the law firm. Surely it follows that the \$300,000 invested in the law firm was not frozen for all time in the form of its original investment. The respondent was free to change his mind and decide whether to use his own money or borrowed money to finance the business of his law firm. In reviewing what the respondent did, it is clear that the relevant cheques were deposited and honoured. There is no suggestion that the transaction was a sham. Giving effect to the legal relationships in this case, it is clear that the respondent used the borrowed funds to refinance his capital account.

33 This characterization of the use of the funds is not altered by the fact that the respondent used the money he withdrew from the firm to purchase a house. Nor is it altered by the fact that the transactions occurred on the same day.

34 In my respectful opinion, it is an error to treat this as one simultaneous transaction. In order to give effect to the legal relationships, the transactions must be viewed independently. When viewed that way, on either version of the facts (i.e.

regardless of the sequence), what the respondent did in this case was use the borrowed funds for the purpose of refinancing his partnership capital account with debt. This is the legal transaction to which the Court must give effect. In this regard, I adopt the following reasons of Rothstein J.A. (at para. 54):

In the case at bar, the direct use of the borrowed funds was to refinance the appellant's capital account at the firm. Treating the borrowed funds as used for financing the purchase of the home ignores what the appellant actually did, i.e. used the borrowed funds to replace the funds required for his capital account at the firm. As stated by Dickson C.J. in *Bronfman Trust*, the Court cannot ignore the direct use to which the appellant put the borrowed money.

35 The fact that the money was borrowed in order to allow the respondent to use his own money to purchase the house is of no moment. The *Shell* decision decided that why the money was borrowed is irrelevant. The fact that money was transferred from the firm to the respondent for the purchase of a residential property has no impact on the application of s. 20(1)(c)(i) to the interest incurred on borrowed money which was used directly for the purpose of refinancing the capital, and as such used for the purpose of earning income from the law firm.

36 As the borrowed money was used to refinance the respondent's capital account in his law firm, the issue arises as to whether such refinancing is a direct, eligible use of the funds within s. 20(1)(c)(i) of the Act. Relevant to this is the Exchequer Court of Canada decision in *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 D.T.C. 6351. This case involved a corporate taxpayer refinancing equity with debt. In *Trans-Prairie*, the corporate taxpayer's issued capital consisted of redeemable preferred shares with a par value of \$700,000 and common shares. The company borrowed \$700,000 and used \$400,000 of this amount, plus \$300,000 obtained by issuing additional common shares, to redeem the preferred

shares. In effect, the taxpayer refinanced share equity with debt and deducted the interest on the money borrowed to refinance. In allowing the deduction, the court reasoned that prior to the transaction the taxpayer's capital consisted in part of the \$700,000 subscribed by preferred shareholders and "as a practical matter of business common sense, [the \$700,000 of borrowed money] went to fill the hole left by the redemption of the \$700,000 preferred [shares]" (p. 6354).

37 In *Bronfman Trust, supra*, it was stated that "[f]airness requires that the same legal principles must apply to all taxpayers, irrespective of their status as natural or artificial persons, unless the Act specifically provides otherwise" (p. 46). As indicated by this statement, if a corporation can refinance equity with debt and deduct the interest on the associated debt, so too should the respondent be entitled to refinance his partnership equity with debt and deduct the interest.

38 If the respondent was not allowed to do this we would end up with the inconsistency identified by Rothstein J.A. That is, the interest would be deductible where a partner's initial capital investment was financed with borrowed funds. As well, it would continue to be deductible with a subsequent refinancing of debt. However, a partner who originally financed with his own money and later withdraws that money for personal use and refinances with debt would be denied the deduction.

39 If a direct link can be drawn between the borrowed money and an eligible use, then the money was used for the purpose of earning income from a business or property. That is clearly the case in this appeal. The respondent was entitled to deduct the relevant interest payments from his income.

40 The appellant submitted that even if there is a direct link between the borrowed funds and an eligible use, the respondent must still demonstrate that his *bona fide* purpose in using the funds was to earn income. However, as explained in *Ludco Enterprises Ltd. v. Canada*, [2001] 2 S.C.R. 000, 2001 SCC 62, the appellant's overriding concern for determining the respondent's *bona fide* purpose in using the funds is not consistent with the express wording of s. 20(1)(c)(i). Absent a sham or window-dressing or other vitiating circumstances, none of which was alleged in this case, the respondent does not have to demonstrate a *bona fide* purpose.

41 The appellant also relied upon the following *obiter dicta* statement in *Bronfman Trust* to support the position that even if there is a direct eligible use, the interest is not deductible (at pp. 54-55):

Before concluding, I wish to address one final argument raised by counsel for the Trust. It was submitted – and the Crown generously conceded – that the Trust would have obtained an interest deduction if it had sold assets to make the capital allocation and borrowed to replace them. Accordingly, it is argued, the Trust ought not to be precluded from an interest deduction merely because it achieved the same effect without the formalities of a sale and repurchase of assets. It would be sufficient answer to this submission to point to the principle that the courts must deal with what the taxpayer actually did, and not what he might have done. . . . In any event, I admit to some doubt about the premise conceded by the Crown. If, for example, the Trust had sold a particular income-producing asset, made the capital allocation to the beneficiary and repurchased the same asset, all within a brief interval of time, the courts might well consider the sale and repurchase to constitute a formality or a sham designed to conceal the essence of the transaction, namely that money was borrowed and used to fund a capital allocation to the beneficiary. In this regard, see *Zwaig v. Minister of National Revenue*, [1974] C.T.C. 2172 (T.R.B.), in which the taxpayer sold securities and used the proceeds to buy a life insurance policy. He then borrowed on the policy to repurchase the securities. Under s. 20(1)(c)(i) the use of borrowed money to purchase a life insurance policy is not a use entitling the taxpayer to an interest deduction. The Tax Review Board rightly disallowed the deduction sought for interest payments, notwithstanding that the form of the taxpayer's transactions created an aura of compliance with the requirements of the interest deduction provision. The characterization of taxpayers' transactions according to their true commercial and practical nature does not always favour the taxpayer. The taxpayer Trust in this appeal asks the

Court for the benefit of a characterization based on the alleged commercial and practical nature of its transactions. At the same time, however, it seeks to have the commercial and practical nature of its transactions determined by reference to a hypothetical characterization which reflects the epitome of formalism. I cannot accept that it should be allowed to succeed.

42 The appellant has over-stated the importance of this statement. It is clear that Dickson C.J. was simply responding to a hypothetical question in a somewhat tentative way. This was more musing than jurisprudence. As well, it is noteworthy that in the *Shell* decision the Court, although invited to, declined to follow other *obiter dicta* statements from *Bronfman Trust* that similarly suggested that sophisticated transactions designed to minimize tax liability should not be given effect.

43 In summary, it is irrelevant that by his own admission the respondent structured the transaction for tax purposes. Courts cannot search for the “economic reality” or the “*bona fide*” purpose of the transaction in this case. In giving effect to the legal relationships underlying the transactions here, it is obvious that the borrowed money was used directly to refinance the respondent’s capital account. This is a direct, eligible use within the meaning of s. 20(1)(c)(i) of the Act. The respondent was entitled to deduct the interest expenses.

VI. Disposition

44 For the foregoing reasons, I would dismiss the appeal with costs to the respondent throughout.

The reasons of Bastarache and LeBel JJ. were delivered by

45 LEBEL J. (dissenting) — I have had the opportunity of reading the reasons of Justice Major. I respectfully disagree with his characterization of the findings of the trial judge, as well as with his analysis both of the appropriate standard of appellate review and of the requirements of s. 20(1)(c)(i) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). Accordingly, I would allow this appeal and restore the judgment of the trial judge in this case.

1. Facts

46 The facts of this case can be summarized quickly. On October 27, 1988, the respondent borrowed roughly \$300,000 and deposited it with his law firm. On that very same day, he put almost exactly that same amount toward the purchase of a new house for himself and his wife. There is some disagreement as to the order in which these transactions were carried out but there is no disagreement that on that day, the amount of respondent's investment in his law firm did not change. The only change in his financial position was that he had a new house, a new loan of \$300,000 and a mortgage on his home.

2. Standard of Review

47 In his reasons (at para. 22), Major J. endorses Rothstein J.A.'s view that the taxpayer's purpose in using the borrowed money is a question of law, subject to full review by an appellate court. In so doing, of course, he also rejects Bowman J.T.C.C. and Linden J.A.'s view that the taxpayer's purpose in using the borrowed money is a question of fact, best left up to the trial judge.

48 I adopt a different approach to this question. Although I agree that this case turns on the purpose for which the borrowed money was used, I take the view that, the determination of this issue requires us to examine the surrounding facts in order to determine the taxpayer's purpose in undertaking these transactions, as did Linden J.A. and Bowman J.T.C.C. Since it was the trial judge who heard all the evidence that would be relevant to determining the taxpayer's purpose (concerning the surrounding circumstances, etc.), deference should be given to his understanding of the facts. The issue may not be then characterized as a pure question of law just because the determination of the purpose of the taxpayer in his use of borrowed money is determinative of the application of s. 20(1)(c)(i). On this basis, I will now turn to my substantive analysis.

3. Economic Realities

49 As I have already mentioned, I do not believe that it is necessary to reconsider the trial judge's analysis at this stage because his conclusion substantially rests on determinations of facts, where he should be given significant deference. However, given the disagreement on this issue, I will examine the merits of the trial judge's conclusions on the question of the economic realities of the transaction that occurred.

a. *Shell Canada*

50 Major J. cites McLachlin J.'s (as she then was) unanimous decision in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at para. 40, for the proposition that "a searching inquiry for . . . the 'economic realities' of a particular transaction . . . can never supplant a court's duty to apply an unambiguous provision of the Act to a

taxpayer's transaction". He interprets this quotation to mean that "taxpayers are entitled to structure their transactions in a manner that reduces taxes. The fact that the structures may be complex arrangements does not remove the right to do so" (para. 28). This is too broad a conclusion to draw from McLachlin J.'s comments in *Shell Canada*. Some structures will attract deductions and others will not. The question at issue in this appeal is precisely which "complex arrangements" generate tax deduction and which do not.

51 It is of course true that in *Shell Canada* this Court qualified the "economic realities" jurisprudence it had spent many years constructing. In a long history of cases at this Court, from *Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32, through *Tennant v. M.N.R.*, [1996] 1 S.C.R. 305, as well as in a number of important cases in the courts below such as *Mark Resources Inc. v. Canada*, 93 D.T.C. 1004 (T.C.C.), it had come to be accepted as part of the jurisprudence that, in tax cases, courts should look to the economic realities of the situation and not merely to the legal technique adopted by the taxpayer. In *Shell Canada, supra*, at paras. 39-40, this Court carved out two caveats to this general principle which can be summarized as follows:

- (1) economic realities cannot be used to re-characterize *bona fide* legal relationships; and
- (2) an inquiry concerning economic realities cannot supplant a court's duty to apply clear and unambiguous statutory terms.

52 Although these two caveats can be considered a weakening of the "economic realities" jurisprudence of this Court, they do not amount to a wholesale rejection of it. The first caveat simply turns one difficult normative question into

another. Rather than asking what the economic realities are, McLachlin J. says that we should ask whether the legal relations created by the taxpayer were *bona fide*. This, of course, still requires courts to look beyond the legal instruments used by the taxpayer. It limits such inquiries to those cases where the legal relations were not created *bona fide*, for instance where transactions simply amount to window dressing as in *Backman v. Canada*, [2001] 1 S.C.R. 367, 2001 SCC 10. Since it is still very much in question whether the legal relations in the case at bar were created *bona fide*, this is an important consideration.

53 The second caveat presented by McLachlin J. is that, whatever the economic realities of the situation might be, they can never grant a court license to ignore clear statutory language. As I shall argue at greater length in the next section (on statutory interpretation), however, it is not at all clear that the statutory language itself requires us to consider two transactions in isolation from one another. This is precisely the difficult question of statutory interpretation which is involved in this appeal. With respect, it begs the question to argue that the clear meaning of the section is that the transactions must be considered separately.

b. *“Economic Realities” Jurisprudence*

54 As I have said, *Shell Canada* did not overrule the economic realities rule. This general rule was adopted by Dickson C.J. in *Bronfman Trust*, *supra*, at p. 53, as follows:

Assessment of taxpayers’ transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer’s sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.

55 In that case, Dickson C.J. argued, at p. 55, that a situation such as the very one at bar would likely be rejected, possibly as a sham, but also on other grounds:

If, for example, the Trust had sold a particular income-producing asset, made the capital allocation to the beneficiary and repurchased the same asset, all within a brief interval of time, the courts might well consider the sale and repurchase to constitute a formality or a sham designed to conceal the essence of the transaction, namely that money was borrowed and used to fund a capital allocation to the beneficiary.

Dickson C.J.'s reasons are precisely on point and should not be dismissed as mere *obiter dicta* on an hypothetical issue. It appears that the then Chief Justice put his mind precisely to this scenario and found that the economic reality of the situation was that the two transactions should be understood as one.

56 Indeed, Linden J.A. makes clear, at [1999] 4 F.C. 484, at paras. 11 *et seq.*, in his thoughtful and well-reasoned dissenting judgment in this case in the Federal Court of Appeal that Dickson C.J.'s comments should be construed as rejecting such a scenario not simply as a sham, but on other grounds, as well. Moreover, such a scenario was rejected by the Tax Review Board in *Dunn v. M.N.R.*, 74 D.T.C. 1121, not on the grounds that it was a sham, but simply that, looking at the substance of the transaction, such money was not used for the purpose of earning income.

57 Later, in *Tennant*, Iacobucci J. examined the economic realities of the situation – this time to favour the taxpayer. He found that the taxpayer could deduct the full amount of interest payable on a loan of \$1,000,000 even though he had exchanged the original investment for one with a market value of only \$1,000. The reason for this was that, although at the time of assessment the taxpayer was only using \$1,000 for the purposes of earning income from property, the “economic reality”

of the situation was that he had originally borrowed \$1,000,000 for the purpose of investment. The legal form of the transaction, therefore, did not accord with the economic reality.

58 Since, as we have seen above, *Shell Canada* does not overrule this Court’s “economic realities” jurisprudence, these decisions should still be regarded as good law. Dickson C.J.’s analysis can be reconciled with McLachlin J.’s first caveat: he is simply arguing that the legal relationships in the *Bronfman Trust* hypothetical were not created *bona fide*. Accordingly, it is still appropriate to consider the two steps as part of a single transaction for the purposes of tax assessment. As for the second caveat in *Shell Canada*, it applies to the construction of statutory terms. Let us now proceed to that stage of the analysis.

4. Statutory Interpretation

a. *The Words-in-Total-Context Approach*

59 In *Stuart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536, this Court articulated a new method of statutory interpretation appropriate to the *Income Tax Act*, dubbed the “words-in-total-context approach” by MacGuigan J.A. in *Harris Steel Group Inc. v. M.N.R.*, 85 D.T.C. 5140 (F.C.A.). In *Stuart*, at p. 578, citing *Construction of Statutes* (2nd ed. 1983), at p. 87, Estey J. endorsed the rule of statutory interpretation from E. A. Driedger that this Court had already adopted for other statutes, *viz.*, that “the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament”.

60 Since *Stuart*, this Court has taken such an approach in a number of other decisions, such as *The Queen v. Golden*, [1986] 1 S.C.R. 209, at p. 214, *per* Estey J., and *Symes v. The Queen*, [1993] 4 S.C.R. 695, at p. 744, *per* Iacobucci J., and at p. 806, *per* L’Heureux-Dubé J. Even cases such as *Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours*, [1994] 3 S.C.R. 3, at p. 15 (advocating the teleological approach), and *Friesen v. Canada*, [1995] 3 S.C.R. 103, at para. 10, *per* Major J. (advocating the “plain meaning” approach), still refer to *Stuart* as the foundational modern Canadian case for statutory interpretation.

61 The words-in-total-context approach steers a middle course between the pure teleological method of Gonthier J. in *Corp. Notre-Dame de Bon-Secours* and Major J.’s focus on the “plain meaning” of the statute in *Friesen*. As Professor Duff points out in his article “Interpreting the *Income Tax Act*” (1999), 47 *Can. Tax J.* 741, at p. 787, “[i]n rejecting the extremes of purposive interpretation on the one hand and the plain meaning rule on the other, the words-in-total-context approach affirms a more ‘open-textured’ approach to statutory interpretation . . .”.

62 It is important to keep in mind that McLachlin J.’s second caveat in *Shell Canada* does not require a simplified “plain meaning” rule of statutory interpretation. The words-in-total-context approach ensures that clear statutory language is not overlooked in order to carry out a broad statutory purpose more effectively. It is the approach that should be applied here.

b. *The Teleological Approach*

63 This Court unanimously endorsed a “teleological approach” to the interpretation of the tax legislation in its 1994 decision *Corp. Notre-Dame de Bon-*

Secours. According to Gonthier J.'s view, at p. 18, courts should look first to the legislature's purpose in order to determine legislative intent. Once this intent has been determined, then courts can identify the sorts of presumptions to be applied to a particular section:

. . . it is the teleological interpretation that will be the means of identifying the purpose underlying a specific legislative provision and the Act as a whole; and it is the purpose in question which will dictate in each case whether a strict or a liberal interpretation is appropriate or whether it is the tax department or the taxpayer which will be favoured. [Emphasis added.]

64 This approach, however, cannot be mechanically applied for it may raise the first of Dickson C.J.'s worries concerning statutory interpretation in *Bronfman Trust* (which is the same in substance as McLachlin J.'s first *caveat* in *Shell Canada*), i.e. losing sight of the fact that an appreciation of the context of legislation is helpful "provided it is consistent with the text . . . of the taxation statute" (p. 53). If we begin by considering the purposes of the statute we run the risk of obscuring the meaning of the particular statutory language in our enthusiasm to forward the general statutory purpose. Careful attention must always be taken to give effect to the particular language Parliament chose to use.

c. *The Plain Meaning Approach*

65 The reaction to the teleological approach emphasises the particular statutory language and is often referred to as the "plain meaning" approach. This Court has not dealt consistently with what, precisely, this approach entails. Some cases, such as Major J.'s majority decision in *Friesen* (at pp. 113-114, citing P. W. Hogg and J. E. Magee, *Principles of Canadian Income Tax Law* (1995), section 22.3(c), "Strict and purposive interpretation", at pp. 453-54) take a hard line, as follows:

. . . “object and purpose” can play only a limited role in the interpretation of a statute that is as precise and detailed as the Income Tax Act. When a provision is couched in specific language that admits of no doubt or ambiguity in its application to the facts, then the provision must be applied regardless of its object and purpose.

66 Other cases, such as Cory J.’s majority decision in *Alberta (Treasury Branches) v. M.N.R.*, [1996] 1 S.C.R. 963, however, have understood the test differently, so much so that it is often difficult to distinguish from the words-in-total-context approach. In that case, Cory J. held, at para. 15, that “in order to determine the clear and plain meaning of the statute it is always appropriate to consider the ‘scheme of the Act, the object of the Act, and the intention of Parliament’”.

67 Cory J.’s understanding of the “plain meaning” approach in *Alberta (Treasury Branches)* is peculiar but telling. By turning to the total context of the statute in order to determine the “plain meaning” of statutory language, he shows that the meaning of statutory language is at times clear only in a particular context. It is a basic axiom of all textual interpretation that meaning is context-dependent. Some statutory language might appear to be obvious in its meaning independent of context. This is not, however, because context plays no part in interpreting the words used. Rather, it is simply because the context is so predictable that we need not pay it any special attention. Nevertheless, it plays a central role in our understanding of the words used.

68 If the “plain meaning” approach is to make any sense at all, it surely cannot mean that we are always to ignore context when interpreting statutory language. Rather, it must be understood to say that although context is always important, sweeping considerations of general statutory purpose cannot outweigh the

specific statutory language chosen by Parliament. It is an acknowledgement that Parliament's purposes can be complex. Rather than finding a single purpose for the Act as a whole and using it to interpret the clear language of specific provisions, we should use such broad purposes only as a context to help elucidate the meaning of the specific statutory language. Understood in this way, it is not inconsistent with the basic thrust of the words-in-total-context approach.

5. Application to the Case at Bar

69 The foregoing discussion, I believe, provides the necessary background for a proper disposition of this case. Although, as I mentioned above, we need not review the merits of the trial judge's analysis of the case (since it turns on an understanding of the purpose for which the borrowed money was used, which is substantially a question of fact best left up to him), a careful analysis reveals that his decision is entirely correct, all the same. In order to show this, I will apply the principles discussed above to the facts of the case.

a. *Economic Realities*

70 In *Shell Canada*, McLachlin J. never excluded the recharacterization of all legal relationships created by the taxpayer; she only protected *bona fide* legal relations. Thus, she invites a normative inquiry into whether or not such relations are created *bona fide* in order to meet the requirements of the statute.

71 Dickson C.J.'s decision in *Bronfman Trust* makes clear that a situation such as the one t bar is suspect. Whether or not such a series of transactions constitutes a sham, they clearly do not constitute a set of *bona fide* legal relations. It is an

undisputed finding of fact that the respondent funnelled money through his law firm simply to secure a tax advantage; his borrowing was not made with the *bona fide* purpose of generating income from his business.

b. *Section 20(1)(c)(i) in Total Context*

72 As mentioned earlier, we must proceed with a contextual reading of s. 20(1)(c)(i). Following Dickson C.J.'s *obiter dictum* from *Bronfman Trust*, I would hold that the legal relations created by the taxpayer have not been created *bona fide*.

73 The total context of s. 20(1)(c)(i) includes a number of factors. First, I would note that this section is an exception to the general rule (outlined in s. 18(1)(b) (formerly s. 6(1)(b)) as interpreted in *Canada Safeway Ltd. v. Minister of National Revenue*, [1957] S.C.R. 717, at pp. 722-23, *per* Kerwin C.J., and at p. 727, *per* Rand J.) against the deductibility of capital outlays. Although the general default rule against the taxpayer in exempting provisions is no longer good law, there is certainly no default in his favour, either.

74 Second, I turn to the purpose of the particular provision. According to *Bronfman Trust, supra*, at p. 45, "Parliament created s. 20(1)(c)(i), and made it operate notwithstanding s. 18(1)(b), in order to encourage the accumulation of capital which would produce taxable income" (emphasis added). Thus, insofar as the deduction is being claimed for a use of borrowed capital that will not lead to the production of income (but, instead will simply fund the purchase of personal property), I would be disinclined to grant such a deduction.

75 c. *Considering the Transactions Together*

The argument was made in this appeal that it was an error of law to treat the successive transactions as one and that they should be viewed independently. With respect, I do not agree. As Linden J.A. states, at para. 27, in his dissenting judgment in the Federal Court of Appeal:

There is no rigid rule which demands that complex transactions be viewed as separate steps or as one transaction. The task at hand is to discover the economic and commercial reality of the transaction in order to discover whether the borrowed money was used for the purpose of earning income.

Whether or not we consider the two transactions separately or together does not affect the legal relations created by the taxpayer. Of course, if we examine the two together, we will discover that the individual transactions were not created *bona fide* and that the overt attempt to meet the requirements of s. 20(1)(c)(i) was legally ineffective. Although the taxpayer did put roughly \$300,000 of borrowed money into his law firm, this does not mean that borrowed money was used for the purpose of earning income. Rather, understood in context, it was used to shore up a shortfall incurred as a result of his purchase of a home with his firm's funds.

d. *Equities*

76

The respondent contended that it would be inequitable not to allow a deduction to the taxpayer in this case because, as my colleague put it, "if a corporation can refinance equity with debt and deduct the interest on the associated debt, so too should the respondent be entitled to refinance his partnership equity with debt and deduct the interest" (para. 37). Major J. supports this claim by pointing out that fairness requires that no distinction be made between natural and artificial persons.

77 I do not think it follows that, just because a corporation can refinance equity with debt and obtain a deduction on the interest, the respondent should be entitled to refinance his partnership equity with debt and deduct the interest. Allowing the deduction for the corporation but not for the respondent does not rest on the difference between natural and artificial persons with differing treatment giving rise to a claim of unfairness. The point is that when the corporation borrows money, this is money that will relate to the business by definition or default, whereas in the case of a person with an ownership interest in a business (i.e., a partner in a partnership), the borrowed money may or may not relate to the business. Here it does not. In other words, if the deduction is denied to the respondent in the circumstances, it is not denied to him because he is a natural person; rather he is denied the deduction because, being an individual, the money he borrows may or may not relate to the business and here the “shuffle of checks” is insufficient to make it so given the personal use of the borrowed money.

78 Hence, the present situation is not analogous to that of *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*, 70 D.T.C. 6351 (C. de l'É.). In that case, the shortfall that the taxpayer corporation made up with borrowed funds was created by an indisputably business-related expense, viz., paying off a business debt to preferred shareholders. In the present case, the taxpayer has no such business purpose. The situation is much closer to that in *Sternthal v. The Queen*, 74 D.T.C. 6646 (F.C.T.D.), where the taxpayer had a large corporate shortfall because he had given large income-free loans to his children. In that case, the deduction was not allowed.

79 In para. 38, Major J. agrees with Rothstein J.A. that an inconsistency would arise if the deduction were to be denied to a partner who originally financed the partnership with his own money, withdraws that money for personal use and refinances this with debt, whereas a partner whose initial investment was financed with borrowed funds would get a deduction of interest and any subsequent refinancing with debt would also have a deductible interest. I think this comparison is misleading and the unfairness it is meant to point to is more apparent than real.

80 A partner whose initial investment was financed with borrowed money will only continue to get the interest deduction on any subsequently borrowed money if that money is related to the business. He will not get the deduction for personal spending. Hence, he compares favourably with someone in the respondent's position, i.e. a partner who originally finances the partnership with his own money. Access to the deduction does not turn on whether or not the initial investment is with borrowed money, but what the borrowed money is used for – personal use means no deduction regardless of when the borrowing started. As a consequence, there is no difference or differential treatment giving rise to potential unfairness. We must view access to the deduction in consideration of the use of the borrowed funds, as the provision directs us to; there is then no worry about an inconsistency. Where the borrowed money is used for personal purchases, there is no deduction in either case. Otherwise, a different kind of unfairness would be created, namely that partners in partnerships would be given access to a way to finance the purchase of their homes by virtue of a shuffle through the capital accounts of their law firms.

81 The unfavourable comparison between a partner who need not borrow money to invest in the partnership but who does so and as a result benefits from both the interest deduction and is left with capital that could be used for personal

consumption and a partner who uses his or her own money for investment in the law firm and as a result does not have that capital available for personal consumption is a comparison seems too hypothetical to me and requires assuming that things happened differently than they did in this case. If Singleton had borrowed rather than used his own money to finance the firm when he first joined it, theoretically, he could have used that money to buy a house. But that is not what he did. He used his money to invest in the partnership and the money he borrowed was used to finance the house, not to finance the partnership (he only returns it to the partnership because he took it from the partnership). We cannot attribute to him tax treatment because of something he could have done. We must look at what he did. As Linden J.A. states, at p. 501, in his dissent in the Federal Court of Appeal, “[w]e must examine what the taxpayer actually did, not what he could have or should have done”.

82 There is no inconsistency in saying that if a taxpayer does something one way, certain tax consequences follow, but things, if done another way, would be treated differently. He should not get the benefit of an interpretation which attributes to him the benefits of a possible way to arrange his affairs; he is to be taxed on how those affairs were actually arranged. In other words, we cannot say that he should obtain the deduction because he could have obtained the deduction by another different arrangement of his affairs. The Act requires that the court consider the actual purpose for which the borrowed money was used. The question to be asked in order to ascertain that purpose is rather simple in my view: what was changed by these transactions? Here it was the acquisition of a house. The financing of the law firm remained the same.

83 Moreover, the idea that a partner who has originally invested money in a law firm that he could have used for personal consumption should be given the same

tax benefit as the partner who borrows for that initial investment and then removes equity from the firm later in order to make a personal purchase does not result in a standard of “equal treatment” that is practicable. Suppose the respondent had borrowed in order to buy his part of the partnership, obtaining as he should deduction on the interest of the debt. Imagine that in five years he had repaid the borrowed money. Now suppose that the respondent did what he did here, i.e. took out his equity in the law firm, bought the house and borrowed to replace the money he took out of the capital account. If the deduction on the interest of the second loan is allowed, this means that the fictitious purpose is dominant in all cases as a result, a taxpayer can effectively continue to obtain deductions for personal consumption at will. This clearly cannot be what is intended by the legislation, which calls for a deduction only when the *bona fide* use of the borrowed funds is to produce income.

e. “Direct Link” analysis from *Shell Canada*

84 It was also submitted that there is a direct link between the taxpayer’s borrowing of the funds in question and an eligible use. According to *Shell Canada, supra*, the interest paid on that money should therefore be deductible. With respect for the opposite view, I do not agree with this reading of *Shell Canada*.

85 In *Shell Canada*, McLachlin J. did, in fact, use the language of “direct link.” She stated, at para. 32 as follows:

Here, Shell borrowed NZ\$150 million from the foreign lenders and immediately exchanged it for approximately US\$100 million before applying it to its business. This exchange did not alter the basic character of the funds as “borrowed money”. Money is fungible. The US\$100 million was simply the NZ\$150 million transformed into a different

currency which, although it changed its legal form and its relative value, did not change its substance. It remained money. [. . .] Viewed thus, it is apparent that all of the NZ\$150 million that Shell borrowed from the foreign lenders was borrowed money currently and directly used for the purpose of producing income from Shell's business. The direct link between the borrowed money and the activity calculated to produce income can hardly be compared to the indirect use at issue in *Bronfman Trust*. . . .

86 From this passage, it appears that McLachlin J. was not dealing with a situation at all similar to the one at bar. Rather, she was concerned to answer the argument that because the borrowed money was denominated in New Zealand dollars, it should not be deductible since it was immediately converted into U.S. dollars. She points out that money is fungible, however, so the denominations are immaterial to the analysis. In the present case, we are concerned with two possible uses of the borrowed funds: one is to invest in the law firm in order to generate income and the other is to purchase a home. In *Shell Canada*, by contrast, all the uses to which the money might be put are business-related. The only concern is whether a legal formality (that the funds were borrowed in New Zealand currency but were invested in U.S. currency) should prevent the taxpayer from being able to deduct interest on borrowed funds that clearly went toward its business.

87 Reading McLachlin J.'s decision in *Shell Canada* as a whole leads to the conclusion that she does not mean to suggest that a taxpayer can deduct the interest he paid on money he borrowed for a purpose totally unrelated to his business. Rather, she simply held that *bona fide* legal relationships should not be disregarded by the courts in analysing such transactions. Since, as McLachlin J. points out, money is fungible, the denominations in which it is calculated are irrelevant to understanding the essence of the transaction. Since she maintains that it is only *bona fide* legal relationships that are to be given deference by the courts, there must be some legal relationships that

courts still consider not to be *bona fide*. The facts in the present case surely present as strong a case of legal relations created without *bona fide* as one could imagine. A loan was obtained to finance the purchase of a private home. Interest paid in respect of such a loan should not be claimed as a deduction from taxable income.

6. Conclusion

88 For the reasons stated above, I would grant the appeal and restore the judgment of Bowman J.T.C.C.

Appeal dismissed with costs, BASTARACHE and LEBEL JJ. dissenting.

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