



Supreme Court of Canada Denies Deduction of Foreign Exchange Losses on Debt Repayments

In a recent decision of the Supreme Court of Canada ("SCC"), Imperial Oil and Inco Ltd. were denied deductions for foreign exchange losses that arose from the repayment of U.S. dollar denominated debentures. Each company had claimed a deduction under s. 20(1)(f) of the *Income Tax Act* (Canada) ("ITA"), a provision which is typically associated with debt obligations that are issued at a discount. The decision could have an impact beyond foreign exchange losses and affect the Canada Revenue Agency's ("CRA") long standing administrative positions with respect to exchangeable, convertible and commodity-based debt.

The Facts

In 1989, Imperial Oil issued debentures in U.S. dollars and later redeemed a portion of those debentures in 1999. The U.S. dollar had appreciated against the Canadian dollar during that period and Imperial Oil suffered a foreign exchange loss of almost C\$28 million.

As the foreign exchange loss arose in relation to a borrowing on capital account, the loss would only be deductible against regular income (as opposed to capital gains) under a specific provision of the ITA. Imperial Oil took the position that the full amount of the foreign exchange loss was deductible under s. 20(1)(f)(i) of the ITA. In the alternative, it took the view that it was entitled to a 75% deduction under s. 20(1)(f)(ii) and a capital loss for the remaining 25%. The CRA reassessed on the basis that the foreign exchange loss was a capital loss (which is only deductible against capital gains).

The facts in Inco were similar except that Inco repurchased its debentures in the market with U.S. dollars that it had available on hand.

In each case, the Tax Court of Canada held against the taxpayer and treated the foreign exchange losses as capital losses. However, on appeal, the Federal Court of Appeal found that each company was entitled to a deduction for 75% of the foreign exchange loss. The Crown appealed.

Principal Issues

Paragraph 20(1)(f) of the ITA allows for a full or partial deduction from income (depending on the magnitude of the discount) when an amount is paid in satisfaction of the taxpayer's debt obligations. Typically, paragraph 20(1)(f) is associated with providing for a deduction against income for original issue discounts.

The dispute with the tax authorities in the *Imperial Oil* and

Inco decisions was whether paragraph 20(1)(f) could also be applied to foreign exchange losses realized on the satisfaction of a debt obligation (*i.e.* the excess not attributable to the original issue discount that arises because the foreign currency in which the debt is denominated appreciates relative to the Canadian dollar).

The formula for determining the deduction available under s. 20(1)(f) is as follows:

$$X = [\text{lesser of A or B}] - [C]$$

where

X is the amount of the *deduction*;

A is the *principal amount* of the obligation;

B is *all amounts paid* in the year or in any preceding year in satisfaction of the principal amount; and

C is the amount for which the obligation was *issued*.

If the obligation was issued for an amount that was not less than 97% of its principal amount, a full deduction for **X** is provided. In any other case, only 75% of **X** was deductible against income (this rate has since been reduced to 50%).

The parties agreed that all the amounts must be converted into Canadian dollars in order to determine the Canadian income tax result. They further agreed that **C** (the issue amount) must be converted at the exchange rate on the date of issue (1989) and that **B** (the amounts actually paid) must be converted at the exchange rate on the date of repayment of the debentures (1999). However, the parties disagreed about the exchange rate applicable to the calculation of **A** (the principal amount). The Crown submitted that **A** is a fixed amount in Canadian dollars as of the issue date, while the taxpayers submitted that for an obligation issued in foreign currency, the principal amount in **A** fluctuates with the exchange rate and is not fixed until the date of repayment.

If, for paragraph 20(1)(f) purposes, the principal amount is to be expressed in Canadian dollars using the foreign exchange rate at the time of issue, the deduction under 20(1)(f) would only relate to the original issue discount. If, on the other hand, for paragraph 20(1)(f) purposes the principal amount of the debt should be converted into

Canadian dollars using the foreign exchange rate at the time the debt was repaid, the deduction under 20(1)(f) would relate to the original issue discount *and* the foreign exchange loss.

Decision of the SCC

In a narrow 4-3 decision, the SCC held that the principal amount of the debentures (**A** in the formula above) must be converted to Canadian dollars on the date of issue. As a result, only an original issue discount, and no foreign exchange loss, is deductible against income under s. 20(1)(f). The split in the Court came down to a classic conflict in the interpretation of the ITA, namely the purpose versus the plain textual meaning of a provision.

The Majority

The approach taken by the majority of the SCC was to focus on the words of the provision that it believed best reflected the statutory scheme and intent of Parliament. To this end, the majority held that it was never intended that s. 20(1)(f) would apply to foreign exchange losses. They supported their conclusion based on, *inter alia*, the following:

- The deductible costs enumerated in section 20 are intrinsic costs of borrowing, such as interest payments and premiums, whereas foreign exchange losses arise only where the debtor chooses to deal in foreign currency and therefore belong to a different class than the costs referred to in section 20.
- There is no express reference in paragraph 20(1)(f) to a foreign currency exchange and the provision refers only to, or best describes, payments in the nature of discounts.

The Dissent

The three dissenting justices were of the view that the foreign exchange losses represent costs that are inextricably linked to the borrowing and therefore fall within the purview of borrowing expenses deductible under s. 20(1). They further reasoned that since nothing in paragraph 20(1)(f) excluded foreign exchange losses, the unambiguous words of the provision should prevail to allow the deduction of such costs. In their view, limiting the deduction to only discounts reads words into the ITA unnecessarily. On a final note, the dissent found that since the principal amount represents the “maximum amount payable on account of the obligation”, it is ascertainable only when the amount is redeemed. Thus, the principal amount of the debts involved should be converted to Canadian dollars at the exchange rate applicable on the date of redemption rather than issuance.

Impact on Exchangeable, Convertible and Commodity-Based Debt

Both the majority and the minority decisions of the SCC mentioned the CRA's long standing administrative position that s. 20(1)(f) allows for a deduction based on variations in the principal amount of debts that are repayable in commodities or other property, such as shares. In a number of published interpretations and rulings, the CRA effectively took the view that for these types of debt instruments, the principal amount (**A** in the formula above) would be determined at the time of repayment rather than the date of issue. As a result, a deduction could be taken if the value of the commodity or share had appreciated between the issue date and the repayment date. Obviously, this contradicts the CRA's position with respect to foreign exchange losses and the decision of the majority of the SCC.

The dissenting justices emphasized this discrepancy in supporting their view as to the proper result of the case. The majority recognized this inconsistency, but held that the CRA's administrative position was not law and should not influence the Court's interpretation of the law as stated in the ITA.

It remains to be seen whether the CRA changes its administrative practice with respect to exchangeable, convertible and commodity-based debt based on the *Imperial Oil* and *Inco* decisions. Corporations that are considering issuing such debt instruments will have to consider this uncertainty in their tax planning.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact:

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