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Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA.

Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

**PRINCIPAL ISSUES:** Whether the interest expense incurred to renovate a building of a 149(1)(l) entity may be deducted from interest income earned on various GIC investments that is to be taxed in the deemed trust under 149(5).

**POSITION:** No.

**REASONS:** Interest expense incurred to renovate a building is not incurred to earn the revenue earned on GIC investments.

January 31, 2013

XXXXXXXXXX Tax Services Centre

HEADQUARTERS

Income Tax Rulings

Directorate

Lori Merrigan

(613) 957-9229

Attention: XXXXXXXXXX

2012-043765

NPO – Interest Expense

This is in response to your correspondence of February 20, 2012, asking for our comments with respect to the treatment of interest income and interest expense in relation to an entity described in paragraph 149(1)(l) of the Income Tax Act (the “Act”). In this letter, unless otherwise expressly stated, all statutory references are to the provisions of the Act.

FACTS

These are the facts as we understand them:

\* XXXXXXXXXX (the “Club”) files an annual T2 return as a tax-exempt corporation under paragraph 149(1)(l) for each taxation year.

\* During the XXXXXXXXXX taxation year, the Club commenced an extensive renovation to the XXXXXXXXXX. In doing so, it transferred \$XXXXXXX from its operating fund to its building fund in order to assist in financing the renovation. The construction period ended during the XXXXXXXXXX taxation year.

\* The total interest earned by the Club’s guaranteed investment certificates (“GICs”) in XXXXXXXXXX was \$XXXXXXX, and, pursuant to subsection 149(5), this was taxed in a deemed trust.

\* Interest expense charged to the renovation project during the construction period (XXXXXXX to XXXXXXXXXX) was \$XXXXXXX. This interest expense was not taken as a deduction in calculating taxable income for purposes of subsection 149(5).

The Club would like to amend its XXXXXXXXXX tax return to reduce the income reported pursuant to subsection 149(5). It proposes to do this by reducing the \$XXXXXXX of interest earned on the GICs by the amount of the interest expense of \$XXXXXXX incurred during the construction period. However, in the same submission, the Club has also alternatively stated that, “In accordance with paragraph 18(3.1)(a) the interest expense should not be deducted, but rather should be netted against the interest revenue and added to the cost of the building.”

## GENERAL COMMENTS

This paragraph includes some very general comments which form the underlying basis of the analysis which follows: The Income Tax Act requires that the income of a taxpayer be calculated on a 'source' basis, including the taxpayer's income from the year from each business and property. The taxable income of an organization, either a for-profit or a not-for-profit entity, generally includes income from a business and income from property. For a not-for-profit entity, their taxable income from a business would generally be considered to be that from their day-to-day activities, which is distinguishable from its income from property. Further, for a 149(1)(l) entity, expenditures incurred in renovating a building used in its day-to-day activities would not be considered to relate to the entity's income from property.

## ANALYSIS

An organization described in paragraph 149(1)(l) is exempt from tax under Part I on its taxable income. Such an organization could have taxable income from its ongoing day-to-day activities as well as from property upon which it is exempt from tax by virtue of paragraph 149(1)(l). However, where the main purpose of an organization is to provide dining, recreational or sporting facilities for its members, subsection 149(5) applies and an inter vivos trust is deemed to have been created. The property of the organization is deemed to be property of the trust and tax is payable by the trust on its taxable income, that is, its income from property, for each taxation year.

In computing the taxable income of the deemed trust, interest income is typically considered to be income from property and included in the calculation of that taxable income. Then, pursuant to subparagraph 149(5)(f)(i), in computing the taxable income, there may be deducted, in addition to any other deductions permitted by Part I of the Act, \$2000.

Deduction of the interest expense:

For interest expenses to be deductible with respect to the calculation of income from property pursuant to subsection 149(5), the conditions of paragraph 20(1)(c) must be fulfilled, by virtue of subparagraph 149(5)(f)(i) which states, "...there may be deducted, ...other deductions permitted by this Part...".

The preamble of subsection 20(1) provides that an amount may be deducted in computing a taxpayer's income from a property where that amount is "...wholly applicable to that source..." while subparagraph 20(1)(c)(i) requires that the interest sought to be deducted be "...borrowed money used for the purpose of earning income from ... property ...". Basically then, interest expense can only be deducted in calculating the income from property in the deemed trust if that interest expense was incurred in order to

generate that income. Paragraph 13 of Interpretation Bulletin IT-533, “Interest deductibility and related issues”, further comments that:

“In Bronfman Trust, the court stated, “...the text of the Act requires tracing the use of borrowed funds to a specific eligible use...” and also stated, “The onus is on the taxpayer to trace the borrowed funds to an identifiable use which triggers the deduction.” In Shell, the Court described the test by saying, “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. In addition, “Interest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use....” In Singleton, the court said, “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.” Further, in Singleton, the court held that “...it is an error to treat this [a sequence of transactions] as one simultaneous transaction. In order to give effect to the legal relationships, the transactions must be viewed independently.”

“Thus, the test to be applied is the direct use of the borrowed money...”

Based on the information provided, in our view, with respect to the calculation of taxable income from property, the conditions of subparagraph 20(1)(c)(i) would not be met since the interest expense was incurred on borrowed money used to renovate the building, which is used in the Club’s ongoing day-to-day business-type activities, and no part of the borrowed money was used to acquire the GICs which generated the interest income. As such, the interest expense is not deductible against the interest income included in the calculation of income from property pursuant to subsection 149(5).

This position has also been supported in case law. The judge denied a deduction of the interest expense in Elm Ridge Country Club Inc v. The Queen (TCC), 95 DTC 715, because, similar to this situation, the funds were not borrowed to make investments and derive income therefrom.

In addition, paragraph 3 of Interpretation Bulletin IT-83R3, “Non-profit organizations – Taxation of income from property”, states that:

“Expenses related directly to the earning of property income (such as income from dividends, interest, rentals, etc.) are deductible in determining the amount subject to tax pursuant to subsection 149(5).” ... “However, the interest paid on money borrowed at other times of the year to finance ongoing club activities would not be deductible in determining the trust’s income.” As reflected in the above paragraph, what needs to be resolved generally for the deduction of expenses of a 149(1)(l) entity when calculating the income from property in the deemed trust is whether the expense was incurred to earn the income that is taxed in the deemed trust.

Moreover, with respect to interest expense in general, to suggest that interest expense arose on borrowed money used for the purpose of earning interest income, as required by subparagraph 20(1)(c)(i), suggests that funds were borrowed for the purpose of earning interest income, and, therefore, depending on the facts of a situation, it could be argued that the entity involved has a profit purpose, and as such, it could be considered that the organization did not meet the requirements of paragraph 149(1)(l).

Capitalization of amount pursuant to subsection 18(3.1):

The taxpayer has referred to our previous document, 59383, wherein they indicate that, in accordance with paragraph 18(3.1)(a), the CRA confirmed that there is a basis for netting interest revenue on a construction loan security deposit against the interest expense incurred during the period of construction.

It should be noted that the comments provided above regarding the deduction of interest and subparagraph 20(1)(c)(i) also apply to income from a business such that: 'The preamble of subsection 20(1) provides that an amount may be deducted in computing a taxpayer's income from a business where that amount is "...wholly applicable to that source...", while subparagraph 20(1)(c)(i) requires that the interest sought to be deducted be "...borrowed money used for the purpose of earning income from ... a business...".'

Also, it should be noted that document 59383 related to a for-profit taxable corporation that pays tax on its taxable income including income from property and income from business. There was a comment made that interest retains its identity which, in our view, clearly suggests that it was income from property. Further, it should be noted that when calculating taxable income, both a for-profit entity and a not-for-profit entity could have a current year deduction under subparagraph 20(1)(c)(i) for interest on borrowed money used for the purpose of earning income from a business, or from property. However, where the 149(1)(l) entity is exempt from tax on its taxable income, but falls under the requirements of paragraph 149(5), it can only have a deduction under subparagraph 20(1)(c)(i) on borrowed money used for the purpose of earning income from property.

Further, the focus of that letter was on what amount might be considered to reasonably be regarded as a cost attributable to the period of construction such that the cost is not currently deductible but is added to the cost of a building. There were no comments made that would suggest that the interest expense on the money borrowed for the construction of the building that was to be used in the entity's business activities was considered to be interest expense on money borrowed for the purpose of earning income from property. In our view, in that letter, the interest expense clearly related to business income. Then, based on hypothetical facts, CRA provided comments on what might be considered to be currently deductible by the taxpayer in the calculation of its business income and what could reasonably be considered to relate to the period of construction. In our view, in 59383, the taxpayer then had interest income from property and an interest expense in the calculation of its income from business.

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To compare that letter to the Club's situation, the Club's interest income retains its identity and would be included as income from property under subsection 149(5). Further, it would seem that the Club could similarly use subsection 18(3.1) to capitalize the interest expense that could reasonably be considered to relate to the period of renovation of the building. However, also in our view, with respect to the interest expense that may not be capitalized, clearly that amount would not be deductible in calculating the Club's income from property for purposes of subsection 149(5).

For further information on the deduction of capital cost allowance please see Interpretation Bulletin 83-R3, in particular, paragraphs 4 and 5.

#### CONCLUSION

In our view, the interest expense was incurred on borrowed money used to renovate the building that was used to provide sporting and recreational facilities to the Club's members, i.e., in the day-to-day operations of the Club, and was not incurred on borrowed money used for the purpose of earning income on the GICs owned by the Club. Therefore, the interest expense cannot be deducted when calculating the income from property that is taxed in the deemed trust by virtue of paragraph 149(5)(f).

Yours truly,

R.A. Albert, CPA, CA

Manager

Non-Profit Organizations and Aboriginal Issues Section

Business and Employment Division

Income Tax Rulings Directorate

Legislative Policy and Regulatory Affairs Branch