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Supreme Court Denies Deduction for Foreign Exchange Losses on Foreign Currency Debt October 24, 2006

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On October 20, 2006, the Supreme Court of Canada issued its decision in the cases of *Imperial Oil Ltd. v. The Queen* and *Inco Ltd. v. The Queen*. In each case, a slim majority of the Court held that foreign exchange losses incurred when retiring debt denominated in a foreign currency give rise to a capital loss and not to a deduction in computing business income.

The facts of the two cases can be succinctly summarized. Each of Imperial Oil and Inco issued debt denominated in U.S. dollars. Each taxpayer later wholly or partially retired the debt at a time when the U.S. dollar had appreciated against the Canadian dollar. Therefore, it cost each taxpayer more in Canadian dollars to retire the debt than the amount in Canadian dollars received on the issuance of the debt. Each taxpayer claimed a foreign exchange loss under paragraph 20(1)(f) of the *Income Tax Act* (Canada) (the "Act") and attempted to apply the loss to other business income. The Minister of National Revenue (the "Minister") denied the deductions, asserting that paragraph 20(1)(f) was limited to deductions for an "original issue discount" and that the foreign exchange losses were capital losses to be dealt with under subsection 39(2) of the Act (a specific yet residual provision dealing with foreign exchange gains and losses). The Tax Court of Canada upheld the Minister's position in each case, while two separate panels of the Federal Court of Appeal reversed the Tax Court of Canada's decisions and ruled in favour of the taxpayers.

The Supreme Court ruled in favour of the Minister and disallowed the deductions of the foreign exchange losses under paragraph 20(1)(f) of the Act. The Court reasoned that raising financing capital was a transaction on account of capital, such that any related costs were non-deductible capital outlays unless a deduction was expressly provided for in the Act. The Court acknowledged that Parliament included in section 20 of the Act numerous provisions expressly providing for the deduction of financing expenses (such as interest and various fees) as incentives for businesses to borrow to raise capital. Such specific provisions include paragraph 20(1)(f) which, while commonly applied to debt issued at a discount, is drafted in broad terms. However, the Court reasoned that these various express provisions in section 20 of the Act dealt with expenses that were intrinsic costs of borrowing and arose regardless of whether the borrowing was done in a foreign currency. In the Court's view, a foreign exchange loss is not the type of implicit cost to which paragraph 20(1)(f) was intended to apply, despite the broad language of the provision. Accordingly, the Court restricted the application of paragraph 20(1)(f) to original issue discounts.

The minority decision of the Court suggests that the majority decision ignores the commercial reality of borrowing in a foreign currency. In such cases, the amount paid "in satisfaction of the principal amount" of the debt obligation necessarily reflects the value of the relevant currency on the date of repayment. In the minority's view, there is no reason to narrowly interpret paragraph 20(1)(f) and a broader interpretation of the provision is more in keeping with Parliament's intention to encourage businesses to borrow to raise capital by permitting deductions for virtually all borrowing costs.

As a result of the majority decision, borrowers will have to claim foreign exchange losses under subsection 39(2) of the Act: only 50% of the loss will be deductible and the loss may only be applied against capital gains. It is unclear how this decision will impact the Canada Revenue Agency's administrative position permitting a borrower to deduct under paragraph 20(1)(f) a loss arising on the repayment of exchangeable debentures (where the loss arises due to fluctuation in the value of the shares used to repay the debentures rather than from any currency fluctuation).

The purpose of this document is to provide information as to developments in the law. It does not contain a full analysis of the law nor does it constitute an opinion of Ogilvy Renault LLP or any member of the firm on the points of law discussed.

For further information, please contact one of the following lawyers:

Jules Charette	(514) 847-4450	jcharette@ogilvyrenault.com
Wilfrid Lefebvre, Q.C.	(514) 847-4440	wlefebvre@ogilvyrenault.com
Adrienne F. Oliver	(416) 216-1854	aoliver@ogilvyrenault.com
Paul Carezza	(416) 216-1885	pcarezza@ogilvyrenault.com
Jacques Côté	(418) 640-5041	jcote@ogilvyrenault.com

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