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Taxpayers Must Pay Interest on Non-Existent Tax Debts

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In *The Bank of Nova Scotia v The Queen*, the Tax Court of Canada (TCC) considered how to calculate arrears interest on an audit adjustment that is offset by a loss carryback. The Court endorsed the Canada Revenue Agency's (CRA's) practice of charging arrears interest on the adjustment through to the year of the *audit*, not the year of the *loss*. The CRA's approach can result in substantial amounts of interest, which can exceed the amount (if any) of actual additional tax due. Taxpayers under audit that have losses available for carryback should carefully consider their potential arrears interest liability and take steps to minimize it.

Background

Following a transfer pricing audit, the Bank of Nova Scotia (BNS) entered into a settlement with the CRA on March 13, 2015, whereby certain amounts would be included in its income for the 2006 to 2014 taxation years. At the same time as the settlement, BNS asked that the balance of its non-capital losses available from its 2008 taxation year be carried back to 2006 to offset the increase in income resulting from the settlement. The CRA agreed but charged BNS interest on the full notional 2006 tax liability to the date of the carryback request (March 12, 2015) rather than the filing date of the 2008 taxation year (April 28, 2009). BNS was thus charged "arrears interest" on a notional tax liability for almost a six-year period during which the liability was extinguished.

The relevant interest-charging provision of the *Income Tax Act* (ITA) is paragraph 161(7)(b), which provides that interest runs on a tax debt offset by a carryback until 30 days after the latest of four dates. One of these dates, set out at subparagraph 161(7)(b)(iv), applies where a reassessment is issued as a consequence of a carryback request in writing, in which case interest runs to the date of the request.

The CRA argued that subparagraph 161(7)(b)(iv) applies in situations like that of BNS – namely, when the CRA makes audit adjustments in a given taxation year that the taxpayer requests to offset through loss carrybacks. Even though no additional tax may be due, the CRA charges interest on the notional amount of tax to the date when the "request" is made – which logically can only happen toward the end of audit when the adjustments are known. In support of this position, the CRA relied principally on the case of *Connaught Laboratories v Canada* (94 DTC 6697 (FCTD)) in support of the proposition that interest can be charged on tax debts that have been extinguished by loss carrybacks.

BNS pleaded that when enacting subparagraph 161(7)(b)(iv), Parliament did not intend to charge interest between the date on which a tax return is filed for a loss year and the date on which the result of a subsequent audit is known. This approach is also in line with the approach taken in respect of other discretionary deductions made available under the ITA. In support of its position, BNS referred to the French version of subparagraph 161(7)(b)(iv) ITA, as well as a judgment of the Alberta courts pertaining to the analogous provision in the *Alberta Corporate Tax Act* (the Alberta Court of Queen's Bench in *Methanex Corp. v Alberta (Provincial Treasurer)*, affirmed by the *Alberta Court of Appeal*).

The Decision

In its reasons, the TCC essentially adopted the reasoning of the CRA, holding that BNS's case was "more akin to that of *Connaught* than *Methanex*" and that "*Methanex* is either wrongly decided or its reasoning cannot be applied to an appeal under the federal *Income Tax Act*." The TCC found that the wording of paragraph 161(7)(b) is unambiguous and that, based on the Department of Finance's Technical Notes issued in 1985 when subparagraph 161(7)(b)(iv) was first enacted, Parliament intended for it to operate in accordance with the CRA's position.

Our Comment

In our respectful view, an attentive review of the text, context and purpose of subparagraph 161(7)(b)(iv) argues strongly for a result different from that arrived at by the TCC:

- Subparagraph 161(7)(b)(iv) applies only “where, as a consequence of a request in writing” the CRA reassesses the taxpayer to take into account a loss carryback. In cases such as BNS’s, the CRA does not reassess as a consequence of a such a request, but rather to implement the findings of an audit with respect to other issues. The application of additional loss carrybacks in such a situation is incidental to the audit adjustments and thus outside the plain wording of subparagraph 161(7)(b)(iv).
- The underlying purpose of paragraph 161(7)(b) – as explained by the CRA itself – “is to cover situations where a taxpayer ignores payment of taxes, anticipating the application of subsequent losses to wipe out the liability.” Given this underlying purpose, the CRA used to not apply subparagraph 161(7)(b)(iv) in situations in which tax liabilities proved to be higher than originally anticipated following an audit (see CRA Doc 2009-0313781I7 and 2011-0420701I7). It is unclear why it chose to abandon this eminently reasonable approach.
- Prior to the enactment of subparagraph 161(7)(b)(iv), when a taxpayer carried back losses to offset tax payable in a prior year, interest would run from the taxable year until the loss year. In 1985, Parliament amended paragraph 161(7)(b) to add, *inter alia*, subparagraph (iv). Officials of the Department of Finance explained to Parliament that these amendments were “not of a controversial nature,” but rather aimed “to deal with the technical problems that had arisen in the administration and application of the Income Tax Act.” As a result, Parliament enacted subparagraph 161(7)(b)(iv) on the understanding that it was not departing significantly from the prior law. It follows that subparagraph 161(7)(b)(iv) should be construed narrowly.
- *Connaught* concerned taxation years that antedated the enactment of subparagraph 161(7)(b)(iv). The case simply does not stand for the proposition that arrears interest can run on a tax liability over the period when the liability is extinguished.
- By definition, interest aims to compensate for the use of money, and it is unreasonable to charge interest on extinguished debts. At a minimum, if Parliament truly intended such a result, the parliamentary proceedings would surely show a clearer record of that intention.

For all these reasons, we hope that the Federal Court of Appeal (FCA) will set the record straight, as it did earlier this year in *Canada v Villa Ste-Rose Inc.*, which also involved a situation in which the tax authorities had adopted the questionable policy of charging interest (and penalties) on non-existent tax liabilities, in that case related to GST.

Implications for Taxpayers

Until and unless the FCA weighs in, taxpayers seeking to offset audit adjustments with loss carrybacks should take steps to calculate the expected interest liability (which may extend well beyond the year of the losses) and take steps to minimize it, such as through the ITA’s interest-offset provisions, the use of other discretionary deductions or applying for discretionary interest relief. Ideally, these steps should be taken prior to the issuance of any reassessments.

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