FEDERAL COURT OF APPEAL UPHOLDS ARREARS INTEREST ON NON-EXISTENT TAX DEBTS: *BANK OF NOVA SCOTIA V CANADA*, 2024 FCA 192

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In *Bank of Nova Scotia v Canada*,[1] the Federal Court of Appeal considered a common problem that arises when taxpayers offset income tax audit adjustments with loss carrybacks. Even if the carryback eliminates an income tax liability, subparagraph 161(7)(b)(iv) of the *Income Tax Act* ("**ITA**")[2] can result in the assessment of arrears interest in respect of notional amounts over periods when no amount was actually owing. Because arrears interest under the ITA is not deductible[3] and compounds daily[4] at a higher rate than that paid on refunds (currently 9% *per annum*),[5] the amounts owing can be considerable, especially after a prolonged audit. The Federal Court of Appeal upheld this counter-intuitive result, essentially on the grounds that it was intentionally chosen by Parliament.

As discussed below, there are steps that taxpayers can take to avoid or mitigate the effects of subparagraph 161(7)(b)(iv), although they do not come with assurances of success.

The Facts

The Canada Revenue Agency ("**CRA**") conducted an audit that concluded in 2015 with a settlement, according to which the bank's income in 2006 was increased by $54.9 million.[6] Such an adjustment would have, in isolation, resulted in additional tax of around $12.9 million.[7] However, like many financial institutions, the bank had significant losses in 2008, and it asked to carry back $54 million of those losses to offset the 2006 adjustment.[8] The CRA reassessed the bank accordingly. Consequently, the bank had no significant additional tax to pay. However, the CRA assessed arrears interest **to 2015** with respect to the $12.9 million of notional tax that would have been payable in respect of 2006 but was negated by losses carried back from 2008.[9] The total "arrears interest" came to around $7.9 million.

Intuitively, it might seem reasonable that the bank be required to pay interest on the $12.9 million between the time it became owing in respect of 2006 and the time it was offset by losses in 2008—since during that interval, the bank had access to those funds that otherwise would have remitted to the Government. Indeed, that is essentially how arrears interest used to be determined under the ITA,[10] and it is also generally what would

happen today in an analogous situation in the United States.[11]

In 1985, however, Parliament amended subsection 161(7) of the ITA to provide that arrears interest would run on a tax liability offset by a carryback until the last of four dates, one of which being the date on which the taxpayer makes a written request that a taxation year be reassessed to take into account the carryback (sub-paragraph 161(7)(b)(iv)). As discussed below, the Department of Finance presented this new provision as an uncontroversial "technical" amendment of a "clarifying and relieving" nature.

In reality, however, subparagraph 161(7)(b)(iv) has hardly proven "clarifying and relieving". In circumstances where taxpayers face audit adjustments that they seek to offset with loss carrybacks, the taxpayer may not be aware of the need to make such a "written request" until the audit is concluded. Consequently, a literal and formalistic application of sub-paragraph 161(7)(b)(iv) can result in the assessment of significant amounts of "arrears interest" over lengthy periods of time when no amounts are owing.

It bears note that no analogous problem occurs with loss carry*forwards*. If a loss year *precedes* the year with an audit adjustment, and the taxpayer carries *forward* the loss to eliminate any tax liability, no arrears interest over any period will be owing, no matter when the request is made.

The Decision

The Federal Court of Appeal acknowledged that there is some ambiguity in the scope the sub-paragraph 161(7)(b)(iv)—particularly in the French version. However, it upheld the CRA's literal and formalistic application of sub-paragraph 161(7)(b)(iv) and its entitlement to $7.9 million of "arrears interest" in respect of the bank's long-extinguished tax liability.

The Court reached this conclusion essentially on the grounds that the anomalous and punitive effects of sub-paragraph 161(7)(b)(iv) with respect to audit adjustments were presumably known by Parliament when it enacted the provision in 1985.[12] The Court noted the differential treatment between loss carrybacks and loss carryforwards, but held that "there is no point in speculating" why Parliament chose to treat them so differently in the calculation of arrears interest.[13]

Observations

With respect, the FCA's assumption that Parliament was aware of and consciously considered the anomalous and punitive effects caused by then-proposed subparagraph 161(7)(b)(iv) in 1985 is not supported by the records of the parliamentary proceedings.

Subsection 161(7)—which deals with how carrybacks affect the calculation of arrears interest— was amended multiple times between 1983 and 1985 in the context of a broader reform of the loss carryback regime. Prior to

1983, losses could be carried back only one year, and such a loss carryback was basically applied automatically. Subsection 161(7), as it originally read, essentially provided than when an amount of tax owing was offset by a loss carryback in the subsequent year, arrears interest would stop running as of the last day of the loss year.

In 1983, the loss carryback regime was amended to allow taxpayers to carry losses back up to three years, and also to "choose not to claim all or part of a loss carryover in computing taxable income for a taxation year but rather to carry such losses forward to be deducted in later years in the carryover period."[14] In the context of this reform, subsection 161(7) was amended to provide that arrears interest with respect to a tax liability offset by a loss carryback would run until the tax return for the loss year was filed or due (whichever was later), instead of the last day of the loss year itself. The Explanatory Notes from the Department of Finance said little about this change other than that it was "consequential on the changes to the provisions relating to the carryback of losses".[15]

Two years later, Parliament considered Bill C-72—a lengthy piece of legislation that combined a headline tax initiative—namely, that taxpayers would no longer have to pay taxes in dispute until the dispute was definitively resolved[16]—with a broad array of "technical amendments" that included subparagraph 161(7)(b)(iv).[17] The Technical Notes from the Department of Finance portrayed the amendment of paragraph 161(7)(b) as a taxpayer-friendly measure that would *limit* the amount of interest that taxpayers would face on tax liabilities offset by loss carrybacks:

> Subsection 161(7) of the Act provides that where the tax payable for the year is reduced as a consequence of the carryback of a loss, tax credit or other amount from a subsequent taxation year, interest on any unpaid tax for the earlier years calculated, without regard to the amount carried back, for the period ending on the later of the day on which the tax return for the subsequent year was required to be filed and the day on which the return was actually filed. Paragraph 161(7)(b) is amended to provide that interest will be charged only until the day on which the taxpayer's return for the subsequent year is filed. Where, however, the taxpayer files his prescribed form claiming a carry back at a later date or the Minister of National Revenue later accedes to the taxpayer's written request to reassess the earlier year, interest will be computed for the period ending on the day on which the form was filed or the request was made. This amendment applies where an amount is carried back from a taxation year ending after 1984.[18] [emphasis added]

This description was frankly deceptive insofar as, following the amendments two years prior in 1983, paragraph 161(7)(b) already provided that interest was charged "only" until the date when the taxpayer's return for the loss years was filed.

During hearings before the Standing Senate Committee on Banking, Trade and Commerce on Bill C-72, Timothy Morris of the Department of Finance testified that the technical amendments "were designed to bring some certainty to the tax law and to repair some technical defects" and were "generally speaking, of a clarifying and relieving nature vis-à-vis taxpayers".[19] Senator John M. Godfrey insistently raised the concern that the "technical" provisions of Bill C-72 had not received sufficient study,[20] but was reassured by Mr. Morris that "[t]here are no controversial aspects still outstanding" and that "many of the amendments are not of a controversial nature".[21]

Given this legislative history, one might reasonably assume that Parliament intended for subparagraph 161(7)(b)(iv) to apply only in circumstances where a taxpayer intentionally foregoes claiming a carryback when filing a tax return for a loss year. Such a scenario would generally not apply in cases where a carryback is requested to offset a disputed audit adjustment.

However, the FCA decided to go in a different direction, such that it will now presumably take a decision of the Supreme Court of Canada, or else an intervention from Parliament, to address the anomalies caused by subparagraph 161(7)(b)(iv).

Options for Taxpayers

Taxpayers may be able avoid some of the more onerous effects of subparagraph 161(7)(b)(iv) by making "prospective" written requests for the CRA to apply loss carrybacks to anticipated or potential audit adjustments. This might be accomplished by:

(a) requesting loss carrybacks in terms of what amount taxable income should be reduced *to* (as opposed to a what amount of losses should be carried back)—which may in turn require adding an explanatory note to the CRA's *Request for Loss Carryback* form; and/or

(b) if the CRA commences an audit of a taxation year that precedes another taxation year with unused losses, sending a written request at the beginning of an audit asking that, if the audit results in adjustments, any available losses be carried back to offset them.

Note that is it not clear whether the CRA or the Courts would regard such prospective requests as triggering subparagraph 161(7)(b)(iv); this may fall to be decided by future cases. Note also that when carrying back losses, it may be often prudent to leave a nominal amount of taxable income to avoid uncertainties about the taxpayer's right of objection and appeal (if there is a desire to contest any of the audit adjustments).[22]

Finally, taxpayers faced with assessments of "arrears interest" on extinguished tax liabilities pursuant to subparagraph 161(7)(b)(iv) can potentially apply for the discretionary waiver or cancellation of the interest pursuant to subsection 220(3.1). In *Wax v Canada*, for example, the CRA agreed to "deem" a taxpayer's

"effective date" for a loss carryback request to have been earlier than when it was actually made, thereby relieving the taxpayer from the application of subparagraph 161(7)(b)(iv).[23] However, the CRA apparently does not routinely grant interest relief simply on the grounds that a notional tax debt has been offset by carrybacks, and taxpayers who have challenged such refusals of interest relief in the Federal Court have had mixed success.[24] It also bears note that the CRA is only permitted to cancel interest that has arisen within the 10 years preceding an application.[25]

Conclusion

If one assumes that the overarching policy objective of charging arrears interest on tax liabilities is to provide fair compensation to the State for the use of its money, charging interest on notional amounts of tax that are not actually owing is absurd and calls into question the fairness of the tax administration system. A comprehensive review of the interest provisions in the ITA is long overdue.

[1] *Bank of Nova Scotia v Canada,* 2024 FCA 192, confirming 2021 TCC 70 ("**Decision**").

[2] RSC 1985, c 1 (5th Supp). Unless otherwise indicated, all statutory references are to the ITA.
[3] ITA, paragraph 18(1)(t).
[4] ITA, subsection 248(11).
[5] Canada Revenue Agency, "Interest rates for the fourth calendar quarter", online. Note that corporations (though not individuals and trusts) can potentially avail themselves of section 161.1 to offset amounts owing with refunds due, such that no arrears interest accumulates over periods where the liability and refund offset each other.
[6] Decision, paragraphs 2, 5 (FCA).
[7] This amount does not appear in the judgement of the FCA or the TCC below but can be estimated using the "CRA Interest Calculator". Inputting a due date of December 31, 2006 [*i.e.*, two months after the bank's taxation year-end of October 31, 2006], a payment date of March 12, 2015, and an "amount due" of $12,885,610 results in interest owing of $7,931,087.54, which was the amount of arrears interest assessed (Decision, paragraph 3 (FCA)).
[8] Decision, paragraph 5 (FCA).
[9] *Ibid*.
[10] See subsection 161(7) of the ITA as it stood prior to 1983.
[11] IRC §6601(d).
[12] Decision, paragraphs 50-53 (FCA).
[13] *Ibid*, paragraph 53 (FCA).
[14] Department of Finance, *Explanatory Notes to a Notice of Ways and Means Motions Relating to Income Tax* (November 1983), page 78, online.

[15] *Ibid*, page 128. The amendment was enacted as SC 1983-84, c 1, s 86(2).
[16] ITA, section 225.1.
[17] The "Technical Amendments" that eventually found their way into Bill C-72 were first introduced a *Notice of Ways and Means Motion* dated May 9, 1985, online. The revisions to paragraph 161(7)(b) appear at section 87(3). The proposed revisions also replaced the word "his" in subparagraph 161(7)(b)(ii) with gender-inclusive "the taxpayer's".
[18] Department of Finance, *Technical Notes to a Notice of Ways and Means Motions Relating to Income Tax* (September 9, 1985), page 92, online.
[19] Senate of Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce* (October 17, 1985), page 18:7, online.
[20] *Ibid*, pages 18:7-18:10.
[21] *Ibid*, page 18:9.
[22] See *Nottawasaga Inn Ltd v The Queen*, 2013 TCC 377 (Informal Procedure), where a taxpayer was found to have waived its right to object to or appeal a disputed adjustment because it completely offset the adjustment with a loss carryback. For a discussion of this decision, see "Income Tax Disputes Involving Loss Years: Pitfalls, Foibles, and Possible Reforms" (2019) 67:3 CTJ 499, pages 521-522.
[23] *Wax v Canada (Attorney General)*, 2006 FC 675, paragraph 18. See also *Neyedly v Canada (Attorney General)*, 2020 FC 678, paragraphs 9, 11, 67-69 (in the context of a settlement agreement, loss carryback "backdated to the earliest date possible under the law").
[24] See *Maarsman v. Canada (Customs and Revenue Agency)*, 2003 FC 1234 (taxpayer successful); *Shea v Canada*, 2019 FC 787 (taxpayer unsuccessful); *Toastmaster Inc. v Canada (National Revenue)*, 2012 FCA 317 (taxpayer unsuccessful).
[25] ITA, subsection 220(3.1). For a discussion of this 10-year limitation, see "Bending Limitation Periods to Achieve Equity" (2023) 71:1 CTJ 281.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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