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Interpretation Bulletin IT-341R4

Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate and Expenses of Borrowing Money

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February 26, 2007

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REFERENCE: Paragraphs 20(1)(e) and (e.1) (also section 21, the definition of "eligible capital expenditure" in subsection 14(5), subsections 18(9) and (9.1), and paragraphs 18(1)(a), (b), (c), (f), and (h), 20(1)(b), (c), (e.2) and (f), and subparagraph 53(2)(c)(x) of the INCOME TAX ACT (the "Act"))

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Application

This bulletin cancels and replaces Interpretation Bulletin IT-341R3 dated November 29, 1995. The effective date of a particular legislative provision discussed in the bulletin may be indicated in the EXPLANATION OF CHANGES section (or, in some cases, in the DISCUSSION AND INTERPRETATION section) of the bulletin. However, where the bulletin is silent with respect to the effective date of a particular provision, such date can be obtained from the legislation itself. Unless otherwise stated, all statutory references throughout the bulletin are to the Act.

Summary

This bulletin deals with expenses incurred in the course of (i) issuing or selling securities, (ii) borrowing money and (iii) incurring, rescheduling or restructuring indebtedness. Such expenses are normally deductible in equal portions over five years subject to a pro-rata reduction for short taxation years.

This bulletin also deals with the provision that overrides the five-year apportionment for certain financing fees incurred after 1987 that relate only to a particular taxation year and may be deducted in computing income for that year.

Discussion and Interpretation

General

¶ 1. In computing a taxpayer's income for a taxation year from a business or property, paragraphs 20(1)(e) and (e.1) provide for the deduction of expenses incurred in the course of a transaction referred to in ¶s 2 and 7 even though the expenses may not otherwise be deductible because of paragraph 18(1)(a), (b), or (h). Expenses that do not meet the requirements of paragraph 20(1)(e) or (e.1) may qualify as eligible capital expenditures, provided they meet the requirements of that definition in subsection 14(5). For details of these requirements, see the current version of IT-143, MEANING OF ELIGIBLE CAPITAL EXPENDITURE. Conversely, if a deduction for such expenses is otherwise available under the Act, the rules in paragraph 20(1)(e) do not apply. For example, when money borrowed constitutes the borrower's stock-in-trade, costs incurred in borrowing

money to be used in a money-lending business are not subject to the restrictions in paragraph 20(1)(e). Expenses incurred in these circumstances would normally be deductible as ordinary business expenses.

¶ 2. Paragraph 20(1)(e) provides that a taxpayer can deduct an amount (other than an "excluded amount") for certain expenses that are incurred in the course of:

(a) an issuance or sale of

- shares in the capital stock of a corporation by the corporation,
- units in a unit trust by the unit trust,
- interests in a partnership by the partnership, or
- interests in a syndicate by the syndicate;

(b) a borrowing of money used by the taxpayer for the purpose of earning income from a business or non-exempt income from property;

(c) incurring indebtedness that is an amount payable for property (other than an interest in a life insurance policy) acquired for the purpose of gaining or producing income from a business or for the purpose of gaining or producing non-exempt income from property;

(d) an assumption of a debt obligation by the taxpayer in respect of a borrowing described in (b), or an amount payable described in (c), above; or

(e) rescheduling or restructuring a debt obligation of the taxpayer in respect of a borrowing described in (b), or an amount payable described in (c), above, that provides for:

- the modification of the terms or conditions of the debt obligation,
- the conversion of the debt obligation to a share or another debt obligation, or
- the substitution of the debt obligation with a share or another debt obligation.

"Excluded amount" means:

- an amount paid or payable on account of principal or interest for a debt obligation;
- an amount that is contingent or dependent on the use of or production from property; or
- an amount that is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of a corporation.

¶ 3. Specifically included in the expenses deductible under paragraph 20(1)(e) are commissions, fees, or any other amounts (which would include a bonus) paid or payable for, or on account of, services rendered by a person as a salesperson, agent, or dealer in securities (e.g. in an agency best effort placement) in the course of the issuance, sale or borrowing.

Five-year apportionment

¶ 4. Expenses incurred in transactions described in ¶ 2 are normally only deductible in equal portions over five years (hereinafter referred to as "the five-year apportionment rule"). The deduction in a taxation year for such an expense is restricted to the least of:

(a) 20% of the expense;

(b) the proportion of (a) above that the number of days in the taxation year is of 365; and

(c) the amount, if any, by which the expense exceeds the total of each amount deductible in respect of the expense in computing income for a preceding taxation year.

If a corporation which has an undeducted balance of such an expense is wound-up into, or amalgamated with, another corporation, the parent corporation, or new corporation, as the case may be, may continue to deduct the expense over the balance of the five-year period. A taxpayer who fails to deduct the maximum allowable in a taxation year for an expense under paragraph 20(1)(e) cannot carry forward the undeducted portion to a subsequent taxation year.

Example: A unit trust incurs unit issue costs, which are deductible at a maximum rate of 20% per year under paragraph 20(1)(e). However, the trust is wound up before four years have elapsed and a balance of issue costs representing more than 20% of the original issue expense remains to be deducted in its final taxation year. In the year of windup, the deduction by the trust would be limited to that proportion of 20% of the original expense that the number of days in the final year is of 365. Therefore, the trust would not be able to deduct the balance of the unit issuance costs.

Exceptions to five-year apportionment

¶ 5. If, in a particular taxation year, a taxpayer settles or extinguishes all debt obligations for a borrowing or an indebtedness described in ¶ 2 (b) or (c), otherwise than as part of a series of borrowings or other transactions and repayments, the balance of the expenses that was not deductible in a previous taxation year because of the five-year apportionment rule will be deductible in that particular taxation year by virtue of subparagraph 20(1)(e)(v). However, this subparagraph will only apply if the taxpayer settles or extinguishes all

debt obligations for consideration that does not include any unit, interest, share, or debt obligation of:

(a) the taxpayer;

(b) any person with whom the taxpayer does not deal at arm's length; or

(c) any partnership or trust of which the taxpayer or a person described in (b) above is a member or beneficiary.

For a debt obligation to be "settled or extinguished," all liability for payment must be terminated. Payment, cancellation, set-off, substitution of debtors, and release are examples of some possible means of settlement. A debt or obligation is not settled when a creditor abandons his or her right to enforce payment or becomes statute-barred from enforcing his or her right to payment. However, a settlement does occur when, by statute, the debtor's actual liability to pay is extinguished after a specified period of time has elapsed. The comments in the current version of IT-119, DEBTS OF SHAREHOLDERS, CERTAIN PERSONS WITH SHAREHOLDER, regarding whether a repayment is part of a series of loans or other transactions and repayments are

helpful when determining whether a repayment is part of a series of borrowings or other transactions and repayments under subparagraph 20(1)(e)(v).

¶ 6. If a partnership ceases to exist, expenses incurred in situations described in ¶ 2 that were not deductible by the partnership in a taxation year prior to the dissolution because of the five-year apportionment rule, will not be deductible by the partnership but will be deductible over the remainder of the five-year period in the hands of the partners by virtue of subparagraph 20(1)(e)(vi). Such expenses are allocated to each partner in proportion to the relationship of the fair market value of the partner's interest in the partnership immediately before it ceases to exist to the overall fair market value of all interests in the partnership at that time. The adjusted cost base to a taxpayer of an interest in a partnership which has ceased to exist is reduced by the taxpayer's allocation under subparagraph 20(1)(e)(vi) by virtue of subparagraph 53(2)(c)(x). If subparagraph 20(1)(e)(v) applies to a partnership (see ¶ 5) in the fiscal period it ceased to exist, the partners will be entitled to deduct the expenses that were not previously deductible by the partnership, because of the five-year apportionment rule, in each partner's first taxation year that ends after the partnership ceases to exist.

Fees that relate only to a year

¶ 7. Paragraph 20(1)(e.1) provides that certain fees payable by a taxpayer in a particular taxation year may be deducted in computing the taxpayer's income for that year if they can reasonably be considered to relate only to that year, and are incurred by the taxpayer in any transaction described in ¶ 2 (b) to (e). It is a question of fact whether a particular fee is reasonably considered to relate solely to the year. For example, a one-time fee related to a loan with a term longer than one year, such as a loan-structuring fee or loan-placement fee, is not reasonably considered to relate only to the year in which the loan was made. Annual standby charges incurred by a taxpayer to maintain a line of credit with a financial institution, would generally be deductible under paragraph 20(1)(e.1) in the year incurred provided the taxpayer intends to use the line of credit.

¶ 8. The fees deductible under paragraph 20(1)(e.1) include standby charges, guarantee fees, registrar fees, transfer agent fees, filing fees, service fees, or any similar fees, provided such fees are not:

- contingent or dependent upon the use or production from property;

- computed by reference to revenue, profit, cash flow, commodity price, or any other similar criterion; or
- computed by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

Purpose of borrowing money

¶ 9. If a taxpayer incurs expenses when borrowing money, paragraphs 20(1)(e) and (e.1) require that the taxpayer use the borrowed money for the purpose of earning income from a business carried on by the taxpayer or for the purpose of earning non-exempt income from property. For example, this requirement is generally met when bonds are issued and the proceeds are used to redeem preferred shares. This requirement is also met when, for example, borrowed money is used to provide working capital. In addition, paragraphs 20(1)(e) and (e.1) require that, if a taxpayer incurs expenses in the course of incurring indebtedness that is an amount payable for property acquired, the taxpayer must acquire the property for the purpose of gaining or producing income from a business or non-exempt income from the property. These requirements are met when the amount payable is for depreciable property acquired for use

in a business or for capital property (other than an interest in a life insurance policy) that earns non-exempt income. If money is borrowed partly for a qualifying purpose under paragraph 20(1)(e) or (e.1) and partly for some other purpose, only the part of the expenses that may reasonably be considered applicable to the qualified purpose is deductible.

¶ 10. The deduction permitted by paragraph 20(1)(e) or (e.1) is restricted to the taxpayer who enters into a transaction described in ¶ 2. If for example, expenses are paid by a parent company on behalf of its subsidiary, in connection with the issuance of shares by its subsidiary, they are not deductible by the parent company under paragraph 20(1)(e). However, provided such expenses are reimbursed by the subsidiary to the parent, and are reasonable in the circumstances, they would be deductible by the subsidiary.

¶ 11. A parent company that is subject to the tax laws of a foreign jurisdiction may guarantee a third-party loan of its Canadian subsidiary without stipulating the payment of a fee by the subsidiary for the guarantee given. If, as a result, the tax authorities of the foreign country impute a guarantee fee to the parent company, any payment by the Canadian subsidiary to its foreign parent for the

imputed amount is in the nature of a payment arising from the assessing action of these tax authorities and is not a deductible expense incurred in the course of borrowing money.

Transactions actually incurred

¶ 12. Under paragraphs 20(1)(e) and (e.1), a taxpayer seeking the deduction must actually carry out one of the transactions referred to in ¶ 2. Therefore, when such transactions are proposed, the taxpayer generally cannot deduct any amount under those paragraphs if the transactions are not carried out. An exception to the rule would be in the case of an annual standby charge to maintain a line of credit as explained in ¶ 7. The fact that a plan for a transaction described in ¶ 2 was abandoned would not result in a disallowance of expenses relating to that plan if the transaction is actually carried out pursuant to a new transaction plan that was substituted for the original one.

Example 1

A taxpayer has paid commitment fees to a financial institution with respect to a proposed loan to be used to acquire an income-producing investment. The taxpayer subsequently borrows the

money from a different financial institution. The commitment fee paid to the first financial institution would be considered to be an expense incurred in the course of borrowing money within the meaning of subparagraph 20(1)(e)(ii) if the taxpayer used the borrowed money to acquire the income-producing investment. The actual financing must be a substitute for the loan originally sought.

Example 2

A corporation attempts to raise money through the issuance of debt. The debt proceeds are to be used by the corporation to finance its business activities. The corporation incurs various legal and accounting costs with respect to the attempt to raise money through the issuance of debt; however, untimately, the loan transaction is not carried out. As such, the expenses incurred do not meet the requirements for a deduction under paragraph 20(1)(e). Assuming the borrowed money would not have been the taxpayer's stock-in-trade (as would be the case if the taxpayer is not a money lender), the borrowing would have been on account of capital and a deduction thereof would be denied pursuant to paragraph 18(1)(b). However, expenses on account of capital and incurred for the purposes of gaining or producing income from a business may

qualify as an "eligible capital expenditure" under that definition in subsection 14(5).

¶ 13. For expenses to qualify under paragraph 20(1)(e), in connection with the issuance or sale of shares, it is not necessary for the taxpayer to obtain additional capital by the issuance or sale of shares. For instance, a taxpayer may incur deductible expenses under paragraph 20(1)(e) in a capital reorganization when shares of one or more new share classes are substituted for shares of one or more old share classes.

Timing of deduction

¶ 14. An expense, arising in the course of one of the transactions referred to in ¶ 2, will begin to be deductible, under the five-year apportionment rule, in the year in which the expense is incurred, or will be fully deductible in that year if paragraph 20(1)(e.1) (see ¶ 7) applies to the expense. This would normally be the same year in which the transaction takes place. In certain cases, however, such an expense may begin to be deductible under paragraph 20(1)(e), or be fully deductible under paragraph 20(1)(e.1), in a year before the one in which the transaction took place. For example, this would be the

case when an expense to arrange for an issuance of shares is incurred in a year prior to the one in which the shares are actually issued. In that situation, the expense will normally be considered to be incurred in the course of the issuance. An expense may also begin to be deductible under paragraph 20(1)(e), or be fully deductible under paragraph 20(1)(e.1), in a year following the one in which the actual transaction takes place provided there was a commitment to incur a future expense at the time the transaction was arranged. For example, as a condition of a loan agreement, a borrower may be required to pay to the lender, for a certain number of years, a portion of the revenue from the property acquired with the borrowed money. Provided they are not interest payments or compensation payments for the use of borrowed money, such payments would begin to be a deductible expense to the borrower under paragraph 20(1)(e) in the years in which they become payable, or would be a deductible expense in that year if subparagraph 20(1)(e)(v) applies (see ¶ 5).

Election to capitalize expenses

¶ 15. If a taxpayer borrows money for the purpose of acquiring depreciable property, and incurs expenses in the course of borrowing

that money that would otherwise be deductible under paragraph 20(1)(e), the taxpayer may elect under section 21 to capitalize these expenses along with the interest paid or payable on the borrowing. When these costs are capitalized as a result of an election under section 21, they form part of the capital cost of the depreciable property subject to capital cost allowance.

Deductible expenses

¶ 16. When a corporation, partnership, or syndicate enters into a transaction described in ¶ 2(a), the expenses listed below would be deductible under subparagraph 20(1)(e)(i) in computing income for the year in which they are incurred:

(a) legal fees in connection with the preparation and approval of a prospectus pertinent to the issuance or sale of shares, units, or interests;

(b) accounting or auditing fees in connection with the preparation of reports on financial statements and statistical data for inclusion in, or for presentation with, the prospectus;

(c) the cost of printing the prospectus, new share, unit, or interest certificates, etc;

(d) registrars' or transfer agents' fees; and

(e) filing fees charged by any public regulatory body which requires the filing of a prospectus for acceptance.

¶ 17. Subject to ¶s 9 and 12, the following expenses incurred in the course of borrowing money and not otherwise deductible under paragraph 20(1)(e.1) (see ¶ 7), are of a deductible nature under subparagraph 20(1)(e)(ii):

(a) legal fees in connection with the preparation and approval of a prospectus when the money is to be borrowed by means of an issue of bonds or debentures;

(b) the cost of printing the prospectus, bonds, or debentures, etc;

(c) a commitment fee paid to a lender pursuant to an agreement between the borrower and the lender whereby the lender is committed to make a specified amount of money available to the borrower from time to time as, and when, the borrower requests;

(d) an amount paid to the guarantor of a loan either on a periodic basis during the continuance of the loan, or as a one-time payment at the commencement of the loan;

(e) certain "soft costs" an investor incurs in the course of financing the construction of a building to be used for the purpose of earning income from property in which the investor has the beneficial ownership at the time such costs are incurred. The more frequently encountered soft costs (i.e., costs not related to the acquisition of the land, buildings, and equipment) that an investor pays which are deductible under paragraph 20(1)(e) are:

- mortgage application, mortgage appraisal, mortgage processing, and mortgage insurance fees,
- mortgage guarantee fees (see (d) above),
- mortgage brokerage (placement) and finder's fees, and
- legal fees related to mortgage financing;

(f) promoter's service fees related to those soft cost expenses that are deductible under paragraph 20(1)(e);

(g) certification fees and certain other expenses incurred, such as commissions charged by a bank, in connection with the sale of bankers' acceptances; and

(h) expenses described in ¶ 16(b), (d), and (e), if they are incurred in the course of borrowing money and not otherwise deductible under paragraph 20(1)(e.1).

¶ 18. A corporation proposing to issue shares or bonds, a partnership proposing to issue interests, or a unit trust proposing to issue its own units may enter into an agreement with an underwriter who undertakes to organize a group of agents who will solicit and make sales on a commission basis. The underwriter may also agree to maintain the required records, disburse those commissions and perform the necessary administrative and clerical work concerning the issue, for a fee or a commission. When such a fee or commission is a fixed amount or is calculated with reference to the number of sales or the sales value of completed transactions, they are regarded as commissions, fees, or any other amounts for the purposes of ¶ 2.

¶ 19. In some cases, an underwriter or dealer in securities acting as a principal may give advice or perform certain services in the capacity

of a financial adviser to prepare for an issue of shares, interests, units, or bonds. If an amount is paid or payable to the underwriter or dealer in that capacity, it would be deductible under either paragraph 20(1)(e) or (e.1).

Non-deductible expenses

¶ 20. A discount of a debt obligation is not deductible under paragraph 20(1)(e), but may be subject to the provisions of paragraphs 18(1)(f) and 20(1)(f). When a corporation sells shares of its capital stock at a discount, or a taxpayer sells trust units or partnership interests at a discount, the discount is not an expense incurred in the course of selling shares, units, or interests that is deductible under paragraph 20(1)(e) nor is it deductible under any other provision of the Act. So-called commissions, fees, or other amounts (including bonuses) paid or payable to a person to whom the shares, units, or interests were issued or sold, or from whom the money was borrowed, are normally considered to be discounts and are not deductible under paragraph 20(1)(e) or (e.1). Also, they do not qualify as eligible capital expenditures (see the current version of IT-143). However, when a person acting as a principal in such a

transaction is an underwriter, any reasonable underwriting fees that are clearly associated with the transaction are deductible under paragraph 20(1)(e), or under paragraph 20(1)(e.1). There must be distinct evidence that the underwriter acquired the shares, units, interests, or debt obligations for the purpose of publicly distributing them. Any additional payment, which is in substance a discount, will not be deductible. In making this determination in a given case, a comparison would be made of the normal underwriting practices regarding charges for services when the underwriter acts as an agent for similar issuances, sales, or borrowings.

Fees paid to an investment banker are usually incurred in the course of acquiring a business involving the acquisition of share capital. Such costs should be added to the cost of the shares acquired by the purchaser. Consequently, this type of expense is usually not deductible pursuant to subparagraph 20(1)(e)(i).

¶ 21. Foreign currency gains or losses that arise on the realization of an exchange conversion would not be deductible under paragraph 20(1)(e). Furthermore, losses on the exchange of currencies do not meet the definition of an "amount that is not otherwise deductible" that is an expense incurred by a taxpayer in the

course of borrowing for the purposes of subparagraph 20(1)(e)(ii). Such exchange losses are incurred in respect of a repayment of a borrowing and not "in the course of a borrowing of money", thus falling outside the scope of paragraph 20(1)(e).

¶ 22. Expenses of incorporation, including legal and accounting fees, and expenses of obtaining the original or supplementary letters patent or expenses of amending the original charter (e.g. for the purpose of increasing the company's authorized capital as a preliminary to the issuance of shares) do not qualify for a deduction under paragraph 20(1)(e). Such expenses may, however, be eligible capital expenditures and hence form part of a taxpayer's cumulative eligible capital as defined under subsection 14(5). As such, they are deductible to the extent provided by paragraph 20(1)(b). (See the current version of IT-143.)

Deduction under subsection 18(9.1)

¶ 23. Subsection 18(9.1) deals with the deductibility of fees paid to a person or partnership to reduce the interest rate on a debt obligation, or as penalties or bonuses in consideration for the repayment of all or a portion of a debt obligation prior to its maturity.

Subsection 18(9.1) deems such payments, either in respect of borrowed money or on an amount payable for property acquired by the taxpayer, to have the characteristics needed for deductibility under paragraph 20(1)(c) as interest expense, provided the payments are made in the course of carrying on a business or earning income from property. However, subsection 18(9.1) does not apply to any fee, penalty, or bonus that:

- may reasonably be considered to have been paid for the extension of the term of a debt obligation or as consideration for the substitution or the conversion of a debt obligation into another debt obligation or into a share;
- is contingent or dependent upon the use of, or production from, property;
- is computed by reference to revenue, profit cash flow, commodity price, or any similar criterion; or
- is computed by reference to any dividends paid or payable on any class of shares in a corporation.

Explanation of Changes

Introduction

The purpose of the EXPLANATION OF CHANGES is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations.

Overview

We have revised this bulletin to incorporate the amendments to the INCOME TAX ACT enacted by S.C. 2001, c. 17 (formerly bill C-22).

Legislative and other changes

Generally, we have rewritten this bulletin to improve clarity and readability.

¶ 2 was revised to reflect the changes to paragraph 20(1)(e) as amended by the 2001 Technical Bill, effective for expenses incurred by a taxpayer after November 1999, other than expenses incured

pursuant to a written agreement made by a taxpayer before December 1999. The preamble to paragraph 20(1)(e) was amended by adding "(other than an excluded amount)". The words between subparagraph 20(1)(e)(ii.2) and (iii) have been amended to delete "but not including any amount that is paid or payable as or on account of the principal amount of the indebtedness or as or on account of interest". A portion of this phrase was essentially moved to subparagraph 20(1)(e)(iv.1). Subparagraph 20(1)(e)(iv.1) was added to define "excluded amount". The addition of the definition of "excluded amount" ensures that participating payments are not deductible pursuant to subparagraph 20(1)(e)(iv.1).

¶ 4 was revised to provide an example of a situation when the five-year apportionment rule would apply to deny the deduction of issue costs.

¶ 12 was revised to explain that the taxpayer seeking the deduction under paragraphs 20(1)(e) and 20(1)(e.1) must actually enter into the transactions these paragraphs describe. We have revised this paragraph to provide two examples. The first example addresses the deductibility of a commitment fee paid to a financial institution with respect to a proposed loan when a taxpayer subsequently borrows

money from another financial institution. The second example deals with the deductibility of legal and accounting costs incurred with respect to an abandoned attempt to raise money through the issuance of debt.

¶ 20 was revised to add a comment with respect to fees paid to an investment banker in the course of acquiring a business.

New ¶ 21 has been added to clarify that foreign currency gains and losses that arise on the realization of an exchange conversion would not be deductible under paragraph 20(1)(e)