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Tax & Estate

Making your interest tax-deductible

Also referred to as "leverage," borrowing to invest may be an integral part of an investor's financial plan provided that the investor's ability and willingness to assume this type of risk is suitable. In comparison to consumer debt, which generally results in a reduction to an individual's net worth, debt incurred for the purpose of investing has the potential to increase an investor's net worth over the long run. Further, as discussed in this bulletin, there are many factors to consider in making your interest tax-deductible.

Interest deductibility

For interest to be deductible in a given taxation year, it must have been paid or was considered payable during that particular year due to a legal obligation. In addition, the amount of interest paid must be reasonable; a reasonable rate of interest should generally consider the credit risk, credit terms and the prevailing market rates. The interest must also have been from borrowed money that was used for the purpose of earning income from a business or property, or used to acquire property for the purpose of producing income from a business or property. Although the requirements may seem straightforward, there are various matters and special situations that may affect whether or not interest can be deducted for tax purposes.

Reasonable expectation of profit (REOP)
With regard to demonstrating that the funds were used to earn income from a business or property, an examination of the facts is necessary. As established in *Moldowan v. The Queen 77 DTC 5213*, the REOP test requires an investor to have a reasonable expectation of earning income when the initial investment is made. An expectation of earning business income, rental income, dividends or interest income will generally satisfy this condition. However, the potential to earn capital gains only is not an expectation of earning income for the purpose of interest deductibility. The REOP test was once used as a benchmark for determining whether interest is deductible; however, due to the issues subsequent courts have had in the application of the REOP test, a new two-stage test has been developed.

Borrowing to invest in registered plans

Interest is not deductible if the borrowed money is invested in registered plans, such as registered retirement savings plans and tax-free savings accounts.

New two-stage test

In *Stewart v. The Queen 2002 SCC 46*, the Supreme Court of Canada (SCC) applied a two-stage test in determining whether interest is deductible. The test initially involves categorizing the income source in question as either for commercial or as a personal endeavour. Where the venture is not found to be a personal endeavour, the following two-stage process may be applied:

1. distinguish between commercial and personal activities; and
2. categorize the source of income, and complete an analysis of appropriate associated expense.

The first part of the test is to simply determine whether there is a personal or hobby element attached to the activity. Where there is, the REOP test is one factor that can be considered. Where there is no personal or hobby element, a determination of the source of income must be identified as either business or property income in order for the interest to be deductible. Additionally, the SCC indicated that the analysis of whether a source of income exists and the deductibility of expenses must be analyzed separately. Expenses in this case must be reasonable, relate to the source of income and also be in accordance with the provision of the *Income Tax Act* (Canada) [the "Act"] to be deductible.

Making your interest tax-deductible: *Singleton v. Canada 2001 SCC 61*

John R. Singleton, a partner in a law firm, structured a transaction to make the interest on his mortgage tax-deductible. He did this by withdrawing $300,000 from his law firm's capital account and using the funds to purchase a home. He then borrowed $300,000 from a bank to replenish his capital account. Interest on a mortgage used to acquire a principal residence is not tax-deductible. However, interest on the loan to fund a capital account contribution is.

Mr. Singleton originally deducted interest of about $3,700 and $27,000, respectively, in 1988 and 1989. The Canada Revenue Agency (CRA) reassessed Mr. Singleton, refusing to allow his interest deduction for each of those years. Mr. Singleton appealed to the Tax Court of Canada (TCC).

Tax Court of Canada

The TCC found that all the transactions that Mr. Singleton undertook were related. As a result, the TCC determined they should be considered as one transaction – the purchase of the home – for which interest is not tax-deductible. The TCC ruled that the money was not borrowed for business purposes as the true purpose of borrowing the money was to buy a home.

Federal Court of Appeal

The Federal Court of Appeal (FCA) reversed the TCC's decision. The FCA stated, "The issue was whether the separate transactions undertaken by [Mr. Singleton] should be treated as independent transactions or as one transaction." The FCA held that the transactions should be considered independently. It found that the interest was deductible because the direct use of the funds was to refinance the capital account in the partnership and was therefore a valid business expense. Mr. Singleton was entitled to deduct his interest expense because he could clearly trace the borrowed money to an income-earning purpose (i.e., the refinancing of his partnership capital account).

Supreme Court of Canada

The SCC sided with the FCA's reasoning. It stated: "While courts must be sensitive to the economic realities of a transaction and to the general object and spirit of the provision, where the provision at issue is clear and unambiguous, as in this case, its terms must simply be applied. … In this case, a direct link can be drawn between the borrowed money and an eligible use, so [Singleton] was entitled to deduct from his income the relevant interest payments. The transactions in question are properly viewed independently."

Ultimately, Mr. Singleton was considered to be borrowing for the purpose of earning business income from the partnership. By doing this he was able to convert non-deductible interest into deductible interest.

Implications of *Singleton v. Canada*

Only the current direct use of the funds is considered when determining whether the borrowed money has been allocated to an eligible use. The taxpayer is responsible for linking the borrowed money to a direct use that would enable the deductibility of the interest. For example, if an investor wishes to borrow money from his or her line of credit to invest in income-producing mutual funds, the investor would be responsible for demonstrating a direct link between his or her line of credit and investment account.

Lipson v. Canada 2009 SCC 1

While the Singleton decision was happily received by those seeking to deduct interest, the scope of legal review was limited to the specific sections of the Act. It would be eight years later before the SCC would be able to provide further commentary with respect to potential application of the General Anti-Avoidance Rule (GAAR).

Facts at issue

In April 1994, Jordanna Lipson borrowed $562,500 from a bank, which she then used to purchase some shares of the family investment corporation from her husband Earl. He used that money to buy a new family home, and obtained a mortgage loan of $562,500 from the bank. The mortgage proceeds were used that same day to retire Jordanna's earlier share finance loan.

By virtue of certain spousal rollover and income attribution sections of the Act, Jordanna then owned the shares, but the dividend income and losses were attributed to Earl. Another section of the Act allowed for the mortgage loan to take on the character of the original share loan, thereby preserving interest deductibility. The attribution section also then cast the interest deduction back to Earl.

Decision from SCC in 2009

The sole issue before the SCC was whether the GAAR applied to the series of transactions. While obtaining interest deductibility was a transaction in the series, the SCC made it clear, with reference to the Singleton case, that deductibility in itself was not in question. Specifically, "The tax benefit of the interest deduction resulting from the refinancing of the shares of the family corporation by Mrs. Lipson is not abusive viewed in isolation, but the ensuing tax benefit of the attribution of Mrs. Lipson's interest deduction to Mr. Lipson is." The SCC concluded the series of transactions were executed for the purpose of tax avoidance and GAAR applied. The result of this application was the denied attribution of the interest deduction to Earl, and therefore the interest was deductible in Jordanna's hands.

It would appear then that the plain vanilla Singleton shuffle remains safe. That said, if a plan attempts to bring in other elements, the SCC observed that "the GAAR may introduce a degree of uncertainty into tax planning, but such uncertainty is inherent in all situations in which the law must be applied to unique facts."

What is the General Anti-Avoidance Rule (GAAR)?

GAAR permits the CRA to deny a tax benefit resulting from a transaction or series of transactions if three specific conditions are met. First, a tax benefit must result from the transaction. Second, the transaction must be considered an avoidance transaction. If one of the primary purposes of a transaction was to receive a tax benefit, then the transaction is generally considered an avoidance transaction. Third, the transaction must be a misuse or abuse of tax legislation that does not reflect the original spirit or purpose of the rule that the taxpayer is relying upon to receive the tax benefit. If GAAR applies to a specific transaction, the tax benefit can be denied.

Properly structuring a transaction is crucial

The importance of a direct link to an eligible use was also applied in *Sherle v. The Queen, 2009 TCC 377*. Mrs. Sherle wanted to shift her mortgage from her principal residence to her rental property. She successfully did this by taking out a mortgage on the rental property and used the proceeds to pay off the mortgage on her principal residence. Although the effective nature of the arrangement was to borrow to earn rental income, the direct use of the borrowed money was to pay off a mortgage on a principal residence, which is not an eligible use. The TCC's denial of the interest's deductibility further demonstrates that the current direct use is the main consideration and that the effective economic nature of the arrangement is irrelevant.

Borrowing to invest in mutual funds

There are unique tax considerations that may apply to borrowing to invest in mutual funds. Canadian mutual fund trusts are able to flow through interest income, dividends (Canadian eligible and dividends other than eligible), capital gains dividends, foreign income and return of capital (ROC) to unitholders. Canadian mutual fund corporations (e.g., Invesco Corporate Class Inc.) can distribute capital gains dividends, Canadian eligible dividends, other than eligible dividends, and ROC. As long as there is a reasonable expectation that the fund will distribute income to its unitholders, the investment is generally considered to be an eligible use.

Example

In 2017, an investor borrows $100,000, and directly uses the funds to purchase 5,000 shares of ABC Corp. at a price of $20 per share. ABC Corp. has a long history of consistent dividend payments. This is an eligible use of the borrowed money, so the investor deducts all of the interest paid throughout 2017 on his or her 2017 income tax return. In the following year, ABC Corp.'s share price falls rapidly to $13 per share, and the investor decides to sell all 5,000 shares at a loss. The proceeds of disposition of $65,000 ($13 × 5,000) are used to reduce the balance of the loan. However, a loan balance of $35,000 remains outstanding. The disappearing source rules allow the interest charged on the remaining $35,000 balance to be deductible regardless of the fact that the use ceases to be used to earn income from property.

Deductibility and income distributions from mutual funds

As previously discussed, interest on debt will be deductible provided that the debt is linked to an eligible use. Distributions of income from mutual fund trusts and corporations may affect future deductibility depending on whether the distributions are reinvested or paid to the unitholder in cash.

If the mutual fund units that were initially purchased using the borrowed money remain invested and the income distributions are paid in cash to the unitholder, the current direct use of the borrowed money will remain the same. If income distributions are reinvested into the mutual fund, all of the interest will remain deductible. However, if the reinvested distributions are redeemed at a later date, a proportion of the interest may no longer be deductible.

Example

An investor borrows $100,000 to purchase 2,000 units of XYZ bond fund with a net asset value (NAV) of $50 per unit. At the end of the year, the fund distributes $4,000 ($2 per unit) of interest income to the unitholder, which is subsequently reinvested by purchasing an additional 80 units (NAV is still $50 per unit). The unitholder immediately decides to redeem the exact number of units that had been purchased by the reinvested distribution.

	Original	**Distribution**	**Total**
Value	$100,000	$4,000	$104,000
Units	2,000	80	2,080

When the distribution is reinvested, it is "blended" into the original income source. Therefore, when the unitholder decides to redeem the 80 units that were purchased using the distribution, he or she is actually disposing of a proportion of the original income source. The unitholder redeems $4,000 (80 units × $50 per unit), and the following calculations illustrate which proportions of the redemption represent the original income source and reinvested income:

> (2,000 ÷ 2,080) × 80 = 77 units (96%) of the redemption is from the original income source; and (80 ÷ 2,080) × 80 = 3 units (4%) of the redemption is from the reinvested income

Therefore, after the 80-unit redemption, approximately 96% [(2,000 – 77) ÷ 2,000] of the original income source remains and 4% has been disposed. Unless the proceeds from the disposition of the 77 units are used to pay down the original borrowing or are put towards an eligible use, only 96% of the interest on the original borrowing would remain deductible for tax purposes. The key lesson to take away from this example is that reinvesting mutual fund income distributions and subsequent redemptions may affect interest deductibility.

Draft legislation on losses abandoned (including losses from the deduction of interest)

In October 2003, the federal Department of Finance proposed the requirement of a REOP test in order to claim a business or property loss. In November 2014, the department confirmed that it had withdrawn this proposal and all related work.

What if my investments decease in value?

All of the interest on the loan may continue to be deductible. The disappearing source rules permit the interest to remain deductible (in certain circumstances) even though the direct use of the borrowed money is no longer for the purpose of earning income from a business or property.

What about ROC distributions paid in cash?
Many mutual funds with a target distribution rate may distribute ROC when there is insufficient income to fund the distribution. There is typically no immediate taxable event when receiving a ROC distribution. However, the distribution will lower the unitholder's adjusted cost base by the amount of the ROC. The unitholder may need to pay tax on capital gains when he or she eventually disposes of the mutual fund.

Compared to income distributions, distributions of ROC from mutual funds affect interest deductibility differently. Borrowing to invest in mutual funds that pay ROC will require a continuous examination of the current use of the borrowed money. Generally, when a mutual fund unitholder receives ROC distributions and puts them towards a personal use (e.g., using the ROC distributions to buy groceries) rather than to reacquire units of the same fund, pay down the borrowed money or for another purpose of earning income from a business or property, interest on the proportion of the debt that is attributable to the ROC is no longer deductible.

Quebec and interest deductibility

Further rules regarding interest deductibility will apply to taxpayers who reside in Quebec. These rules apply solely to the deduction of "investment expenses" from a taxpayer's "investment income." Investment expenses generally include administration or management expenses, custody expenses, investment counsel fees and interest paid on money that was borrowed to invest. Investment income includes taxable (grossed-up) Canadian dividends, interest from Canadian sources, gross foreign income, taxable capital gains, trust income and accumulated income of a life insurance policy. Investment expenses paid in a given year are deductible only to the extent of any investment income earned in that same year. Any excess expenses that could not be deducted can be carried back and deducted against investment income in any of the three previous tax years or carried forward and deducted from investment income in future years. Generally, the oldest unused investment expenses must be the first to be deducted. The limitations discussed above are generally not applicable to investment expenses incurred to earn rental or business income.

Conclusion

Before borrowing to invest, it is advisable to consult an accountant to determine whether the interest will meet the requirements to be deductible. Moreover, leveraging an investor's portfolio may only be suitable where the investor can tolerate the increased level of risk.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at invesco.ca.

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