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The Do's and Don'ts of Interest Deductibility

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The Income Tax Act specifically permits a deduction for interest paid or payable where the “borrowed money (has been) used for the purposes of earning income from a business or property”. Over the years, the Canada Revenue Agency (“**CRA**”) has clarified its position on this provision’s meaning and outlined exceptions to this general purpose test when interest may still be deductible. The deductibility of interest continues to be a frequent subject the tax courts. When structured or restructured correctly; however, taxpayers, including homeowners and businesses, have opportunities to benefit from the tax sheltering created by an interest deduction.

Interest Deductibility for Homeowners

Unlike the tax code of our neighbours to the south, Canadian tax rules, generally, do not permit a deduction for the mortgage interest related to a personal home when calculating personal income tax. However, one is permitted to deduct mortgage interest related to a personal home if those

borrowings were used directly for the purpose of earning income from a property or business. For example, if an individual has equity in their home (the value of the home, which exceeds any existing mortgage), they could borrow against the home as collateral and use the mortgage (or home equity line of credit) proceeds for investment purposes. The interest on the mortgage (or home equity line of

credit) would then be deductible for tax purposes. Consider an individual who is in the highest marginal income tax bracket in Ontario borrows money at 3.5 percent per annum and invests the funds in a portfolio that yields a return of 6.5 percent annually.

| Amount borrowed | Investment income earned | Interest expense | Tax paid on investment income | Tax savings from interest deduction | Net tax owed on investment income |
|-----------------|--------------------------|------------------|-------------------------------|-------------------------------------|-----------------------------------|
| \$200,000 | \$13,000 | (\$7,000) | \$6,959 | (\$3,747) | \$3,212 |
| \$400,000 | \$26,000 | (\$14,000) | \$13,918 | (\$7,494) | \$6,424 |
| \$600,000 | \$39,000 | (\$21,000) | \$20,877 | (\$11,241) | \$9,636 |
| \$800,000 | \$52,000 | (\$28,000) | \$27,836 | (\$14,988) | \$12,848 |

Taking it one step further, consider an individual who has an existing portfolio of investments of \$600,000 and a mortgage of \$600,000 on his personal home. Currently, the individual is paying mortgage interest and is not permitted to deduct it for personal income tax purposes. If the individual liquidates their portfolio, uses the money to pay off the existing home mortgage, then remortgages (or uses a home equity line of credit) to repurchase the investment portfolio, the mortgage interest becomes deductible. The individual has restructured the borrowings in order to convert what was previously non-deductible interest into interest that is now deductible for tax purposes.

Similar restructuring strategies may be used by an individual who is a shareholder of company or a partner in a partnership

under certain circumstances where the respective company or partnership owes the individual funds via a shareholder loan or partnership capital.

Even if the investments generate a less than stellar return in a given period, the interest on borrowed funds may still be deducted. The Canadian courts have ruled that, as long as there is an *expectation* of earning income, the interest is deductible in most circumstances. If the interest paid or payable in a year exceeds the investment income earned, you will have a loss for tax purposes that may possibly offset other sources of income, such as employment income. If you don't have other sources of income, the loss can be carried back three years or carried forward for up to 20 years.

A word of caution – care must be taken to ensure the investment continues to be held (i.e. not liquidated) and can be tied to the current use of the borrowing. Earlier this year, the **Tax Court of Canada** cautioned the ability to deduct interest where an investment paid a significant amount of money back to the investor as a return of capital. In this case, the taxpayer could no longer deduct interest on his borrowings which were initially used to purchase investments.

Interest Deductibility for Business Owners – Corporations and Partnerships

Business owners may also be able to benefit from the interest deductibility rules, but in different ways. The CRA permits the deduction of interest on borrowing, for instance, to pay a dividend or to pay out

income earned in a partnership so long as the distribution does not create a deficit in the retained earnings or partners' capital. The CRA also accepts the deductibility of interest on a loan where the funds are used to redeem shares of a shareholder. The idea is that the business is swapping after-tax earnings from its business for debt, a concept referred to as "filling the hole". Keep in mind that this is the CRA's administrative position and is not codified in the income tax legislation. As such, taxpayers should be very careful and speak to their advisors before borrowing to "fill the hole".

The Take-Away?

In certain circumstances, taxpayers can obtain an interest deduction for borrowings made for specific purposes. The general rule of thumb is that interest is deductible to the extent the borrowed monies are used for the purposes of earning income; however, there are additional accepted circumstances where interest can be deducted for tax purposes based on Canadian jurisprudence and the CRA's administrative positions. With

proper planning and advice, taxpayers may be able to structure their borrowings to provide the maximum tax benefit. To learn more about taking advantage of your potential tax savings and strategically structuring your borrowings, contact one of our Tax Group specialists today.

This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.

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