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Borrowing to Invest

Interest Deductibility Rules

Before you borrow to invest, you may want to understand the risks involved and the conditions you may have to satisfy to deduct the interest on the money borrowed. This article will provide you with general information on interest deductibility when borrowing to invest.

An amount is considered to be interest if, in general terms:

- It represents compensation for the use of money;
- It is related to a principal sum that was borrowed; and
- It accrues day to day.

It's important to note that the strategy of borrowing to invest has significant risks. Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same even if the value of the securities purchased declines.

Interest Deductibility

It may seem straightforward, but the rules of interest deductibility can be complex. In recent years, there have been important developments in this area.

Generally, interest expenses are considered to be a capital expense and are not deductible unless it meets specific requirements of the *Income Tax Act (ITA)* such as:

- the interest amount to be paid in the year or payable in respect of the year is under a legal obligation to pay interest; and
- the amount paid or payable must be reasonable.

In addition, there are two other criteria that require further examination when money is borrowed which is its purpose and its use:

- First, the *ITA* requires interest expenses to be incurred “for the purpose of earning income (other than exempt income or to acquire an interest in certain life insurance policies) from a business or property”. If the sole purpose is to realize capital gains, the interest

- incurred may not be deductible from income. However, the purpose of earning income need not be the only purpose for the borrowing. For example, a taxpayer can borrow money to acquire common shares for the purpose of earning dividends and capital gains. In this case, the interest should be deductible. This would also commonly apply to mutual funds.
- Secondly, court cases have ruled that the test to be applied is the direct use test of the borrowed money. If the direct use is to earn income from business or property, the interest is deductible. If the direct use is not to earn income from business or property the borrowing is generally not deductible. The relevant use is the current use and not the original use of the borrowed money.
 - In the case of a fund or investment that allows for a Return of Capital, whereby the fund distributions include portions of the original capital. Although the initial investment may have qualified under this

rule, and been considered as used to earn income from property, it should be noted that the use of the funds withdrawn must also be used for the purposes of earning income. If they are not then the ability to deduct the interest on the original investment can be disallowed.

registered pension plan, a specified pension plan, a registered education savings plan (RESP) or a tax-free savings account (TFSA) cannot be deducted for tax purposes. If the interest is deductible for tax purposes, you can claim the interest under Line 221 of your personal tax return which is allocated for carrying charges and interest expenses.

It is important to note that interest you paid on money you borrowed to contribute to a registered retirement savings plan (RRSP), a pooled

Here are some examples of when interest paid should be deductible for tax purposes:

Example 1

Mr. Jones owns 1,000 common shares of ABC. Corp. trading on the TSX. Mr. Jones also owns a vacation condo that was financed with borrowed money. At this point, the direct use of the borrowed money is to purchase a vacation home (which is used for personal purposes) and the interest is not tax deductible. Mr. Jones may consider restructuring his debt by selling the 1,000 shares and use the proceeds to pay off the mortgage. Subsequently, Mr. Jones can borrow to purchase the 1,000 common shares where the loan will be directly used to earn income. Thus, the interest may now be deductible since the direct use test is now met.

In addition, interest on borrowed money may be deductible even where profit was not earned. The Canada Revenue Agency (CRA) has traditionally denied deductibility of interest expenses unless profit (net income) was realized from the underlying property after taking the interest expense into account. However, the Supreme Court (Ludco) dismissed CRA's position and held that "income" does not mean "net income" or "profit".

Example 2

You borrow \$10,000 at a rate of 5% to purchase ABC common shares with a reasonable expectation to receive dividends in the future. ABC shares failed to pay dividends during the year, but you have accumulated \$500 of interest expense. In this situation, the income purpose test will generally be met and any interest on borrowed money to acquire the ABC common shares would normally be deductible against your income.

Note: The province of Quebec has its own set of tax legislations related to interest deductibility. The above tax rules may not apply in Quebec.

Considerations

There may be tax benefits and certain risks when borrowing to invest so it is important to determine whether this strategy is right for you. Interest deductibility rules are complex therefore to ensure you fully understand the potential risks and tax implications, please speak with your advisor and/or tax professional for your personal situation.

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