Wealth Management

RBC Wealth Management Services

Borrowing to invest – When is interest tax-deductible?

As part of your overall financial plan, you may have borrowed money in order to invest. One attraction of borrowing to invest is the ability to deduct your interest expense for tax purposes. This deductibility allows you to increase your after-tax rate of return on your investment. However, it is important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines. The purpose of this article is to provide information with respect to commonly asked interest deductibility questions.

The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Please contact us for more information about the topics discussed in this article.

When is interest tax-deductible?

When you borrow money, there are four requirements that must be met in order for the interest expense to be tax-deductible:

1. The money you borrowed must be used for the purpose of earning income from a business or property. Business income includes any activity you carry on for profit or with a reasonable expectation of profit. Employment income is not considered business income. Property income includes interest income, dividends, rents, and royalties.

2. You must pay the interest during the year in which you are claiming the deduction. Note that compound interest (interest on your interest) is only deductible in the year it is actually paid.

3. There must be a legal obligation pay the interest. The lender must be able to seek legal recourse against you in the event you do not make the interest payments.

4. The interest rate charged must be reasonable. The Canada Revenue Agency (CRA) has indicated that a reasonable interest rate would

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be one that is established by prevailing market rates for debts with similar terms and credit risks.

How much can you deduct?

In provinces and territories (with the exception of Quebec, discussed below), you need only to establish an *intention* to generate income. Actually generating income from the business or property is not necessary. In addition, the amount of income you earn (or expect to be earned) does not need to exceed the interest you pay in order to deduct it. For example, if you borrowed money at 8% to invest in something that earns 5%, the CRA will allow you to deduct the full 8%, unless the transaction is a sham. In other words, you must have real and true intentions of earning income from the investment in order to deduct the full amount of interest. Before undertaking such a strategy, consider the effect it will have on your cash flow.

If you live in Quebec, the provincial tax laws limit the interest you may deduct in any given year to the investment income you earn in that year. Unused interest expenses can be carried back three years and carried forward indefinitely to be deducted against investment income in other years.

Types of investment income

Capital gains

It is important to note that capital gains are not considered to be income for tax purposes, so interest resulting from borrowing to generate capital gains alone will not be deductible. For example, interest on money borrowed to purchase a piece of art as an investment, would likely not be deductible.

Common shares

If you borrow money to purchase common shares, the interest expense will generally be deductible if there is a reasonable expectation, at the time the shares were acquired, that you will receive dividends. Recent court cases have proved the importance of being able to clearly demonstrate an income-earning purpose even on an ordinary acquisition of common shares.

The courts may also pay particular interest to the company's history of paying dividends. There have been cases in which, considering all the circumstances, interest deductibility was denied because there had been no history of paying dividends on the company's shares. All the more so, if a company expressly declares its intentions not to pay any dividends, or the class of shares does not allow for dividends to be paid, then the interest incurred on borrowed money would not be deductible.

Return of capital

There are certain types of investments that could make return of capital (ROC) distributions to you. These include, but are not limited to certain mutual funds, Real Estate Investment Trusts, Limited Partnerships, and Mortgage-Backed Securities. Since these investments have the potential to pay income, interest paid on borrowed money used to invest in these funds is generally tax-deductible. However, how you use your ROC distribution will impact the deductibility of interest each year. Consider the following example:

Suppose you borrowed $10,000 at 4% interest and invested it in mutual fund units. In the first year, you incurred an interest expense of $400 on the borrowed money and received distributions of $1,400 in cash from the mutual fund. The distribution occurred at the end of the year and the distribution breakdown was "other income" of $500 shown on a T3 slip and ROC of $900. You then used the entire distribution of $1,400 for personal use. Is the entire interest expense of $400 ($10,000 x 4%) deductible for tax purposes?

In determining whether your interest

expense is deductible for that year, you need to look at what you are currently using the borrowed funds for (rather than the initial use of the funds). For the first year, your entire interest expense of $400 is deductible for tax purposes since for that year you invested the borrowed money in mutual fund units. The capital was only returned to you at the end of the year. For the second year, only the portion of the borrowed money that related to your remaining investment of $9,100 ($10,000 - $900) would be deductible. The portion of interest that related to ROC from the mutual fund of $36 ($900/$10,000 x $400) would not be deductible since you used it for personal purposes and not for purposes of earning income. Assuming you continue to spend your ROC distributions for personal purposes, your interest deduction will continue to decrease.

Alternatively, if you reinvested the $900 ROC payment to acquire more units of the mutual fund or another income-producing investment, then the entire interest expense on the $10,000 of borrowed money should continue to be deductible, so long as you do not subsequently sell the exact same number of mutual fund units as were purchased through the reinvestment.

Disposing of your investments

When you dispose of all or a portion of your investments, you will need to identify the current use of borrowed money to determine the extent to which interest remains deductible.

Investing in a new income source

If you invest the proceeds from the sale into a new income source, the entire interest expense should continue to be deductible. If you sell your investments at a loss, it is likely that the proceeds will only cover a replacement investment of lesser value. As long as you can trace the cost of the replacement investment to the entire original borrowed amount, the full amount of the interest expense should be deductible.

Paying down debt

If you dispose of a portion of your investments and decide to pay down your investment loan with the proceeds from the sale, then the interest expense on the remaining portion of the loan will generally continue to be deductible. In the case where you dispose of all of your investments at a loss, the proceeds from the sale may not be adequate to pay off the entire outstanding loan balance. In this case, the interest expense on the remaining portion of the loan will generally continue to be deductible as long the original loan was used to purchase income producing assets.

Other uses

If instead you decide to transfer a portion of your investments to a registered account (such as an RRSP or TFSA), or dispose of your investments and use the sale proceeds for personal purposes (such as travel, renovating your home, or paying down your mortgage), the interest on that portion of borrowed funds would cease to be deductible. Likewise, if you sell your investments at a loss, you will need to identify what portion of the originally purchased investments has been disposed of, and a pro-rated interest expense calculation will be required to determine the amount that remains deductible.

Please note that the rules relating to disposing of investments at a loss only apply when borrowed money is used to acquire non-depreciable capital property such as dividend-paying shares or partnership interests. The rules do not apply when borrowed money is used to acquire real property or depreciable property.

An example

Suppose you borrowed $100,000 in order to acquire 100,000 mutual fund units for an original cost of $1 per unit. Let's also assume that interest on your borrowings is deductible for tax purposes. A few years later, the mutual fund units have increased in value to $120,000 ($1.20 per unit) so you decide to dispose of a portion of the units, say 16,667 units in order to realize some accrued capital gains. The market value of the original units disposed of is $20,000 (16,667 unit x $1.2 per unit). That leaves 83,333 original mutual fund units remaining, with a total market value of $100,000.

In this example, only 83.33% of the source of income acquired with the original borrowing remains. How the proceeds from the 16,667 original units disposed of are used, will determine whether the interest on the entire $100,000 original borrowing remains deductible or not. Where the proceeds are used to pay down the original loan, interest on the remaining loan would continue to be 100% deductible. Where proceeds are used to acquire another source of income, interest on 83.33% of the original loan would continue to be deductible and interest on 16.67% of the original loan, to the extent it is reflected in the cost of the new income source, would be deductible. Where proceeds are used for personal (non-income producing) purposes, only interest on 83.33% of the original borrowing would continue to be deductible.

Refinancing your debt

Where borrowed money is used to repay existing borrowed money, such as a previous loan on which the interest is deductible, the new borrowed money is considered to be used for the same purpose as the previously borrowed money, thereby making it deductible too. Interest that is deductible does not cease to be deductible because the original loan was refinanced.

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Non-deductible interest

Registered plans

Generally, interest and other borrowing costs incurred by you to fund contributions to **RPPs, RRSPs, DPSPs, RESPs, RDSPs and TFSAs** are not deductible.

Life insurance policies

With some exceptions, interest on money borrowed to acquire an interest in a life insurance policy is not deductible. A discussion of these exceptions is beyond the scope of this article. Please consult with your life licensed advisor as well as your professional tax advisor regarding the tax consequences of your particular life insurance policy.

Income tax assessments

Interest charged to you in respect of unpaid income tax or late instalments is not deductible for tax purposes since it is not paid for the purpose of gaining or producing income. Interest on GST/HST assessments is not deductible either.

Conclusion

With greater knowledge, you can become a more informed investor and make better decisions with respect to your borrowing to invest decisions. Determining whether interest is deductible in your case is usually dependent on the facts and evidence of your particular circumstances. Since current assessing practices on interest deductibility are always subject to change, your qualified tax advisor can help you evaluate whether or not borrowing to invest makes sense for you.

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