TD Wealth

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.

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. For more information on the risks of borrowing, please refer to TD Wealth's Account and Service Agreements and Disclosure Documents.

Interest Deductibility

It may seem to be straightforward, but the rules of interest deductibility can be complex. In recent years, there have been important developments in this area. However, given the complexity of the income tax rules surrounding interest deductibility, it's recommended that you consult with a tax professional as it relates to your personal circumstance.

There are certain criteria that must be met for the interest on borrowed money to be deductible. Generally, the *Income Tax Act* (ITA) requires the interest to be paid or payable for the year; there must be a legal obligation to pay the amount and the amount paid or payable must be reasonable. In addition, there are two other criteria that require further examination.

- 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.

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 1000 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.

Final Thoughts

There may be tax benefits when borrowing to invest, and also certain risks; to determine whether this strategy is right for you and ensure you fully understand the potential risks and tax implications, speak with your advisor and/or tax professional.

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