Sun Life

# Interest deductibility

A person or a business, in one way or another, will borrow money during their lifetime. You may borrow for personal reasons such as a mortgage, or for investment purposes. Your corporation may borrow to expand operations, meet supply needs, or replace existing assets. In any case, the question one asks is: can I expense the interest for tax purposes? There is no simple answer to this question. The Income Tax Act (ITA) initially treats interest costs as capital outlays and not as a tax-deductible expense. This article guides you through the rules for when interest is deductible.

## What is interest?

Interest is not a defined term in the ITA. However, the Canada Revenue Agency (CRA) indicates in Income Tax Folio S3-F6-C1 that an amount is interest if it:

- represents compensation for use of money;
- is referable to a principal sum; and
- accrues day-to-day.

Under the ITA, interest is initially a capital outlay. A capital outlay is not deductible[1] unless an exception allows for it. To find out whether the interest paid on debt is deductible, we will explore the certain conditions required.

### Interest as tax deduction

Once you have determined the amount paid is interest, you need to determine if it is a deductible expense. For interest to be an expense for tax purposes, you must satisfy the conditions in the ITA:[2]

- The amount is paid or payable in the year based on a legal contract to pay interest on:
  - Borrowed money that was used for the purposes of earning income from a business or property; or
  - An amount payable for property acquired for purposes of gaining or producing income from the property or business.
- The amount is reasonable.

Interest is not deductible on borrowed money used to obtain property from which the income is tax exempt. Nor can you deduct interest when you borrow to purchase a life insurance policy.

The amount must also be reasonable. This means you cannot arbitrarily choose interest rates to increase your tax expense. Prevailing market rates between arm's length borrowers and lenders is a starting point. However, they are not determinative. CRA requires you to look at all the circumstances of the situation. In a non-arm's length transaction, the interest rate is even more important. This is because you have more control to influence the interest rates. Interest rates available in the market for similar terms and risk is best used. This market rate would ensure you get the deduction you are looking for. We recommend you review interest rates and terms with your professional tax advisors prior to deducting.

There are two methods of reporting income. Where you use the cash method, the interest deduction occurs in the year of the interest payment.  Where you use the accrual method, the deduction occurs when the interest is payable.

### Purpose test

To be deductible, CRA applies a purpose test. You must use the borrowed money to earn income from a business or property to create the tax expense. Income includes interest, dividends, royalties, rent and business income. Capital gains or return of capital ("ROC") is not income for the purpose test. Each situation will have unique factors to consider based on the income produced. However, you need to show that you had a reasonable expectation of income. This expectation of income needs to exist at the time of the first investment. However, you do not need produce a profit or net income from the start. The reference to profit and net income is not the same as the term income itself. Where you produce income, the tax deduction is for the full amount so long as it is reasonable. Even where the income does not exceed the interest expense, you may create a deduction.[3]

### Use test

There are also conditions on how you "use" the borrowed funds. Generally, the CRA requires you to use borrowed money directly for the above purpose. That is, you need to trace the money to a qualified use. Unlike the purpose test, the use test is ongoing. You need to create a link between the money borrowed and the current use. The onus is on the taxpayer to trace or link the borrowed money to a specific qualified use.

In certain settings, the CRA may accept an indirect use. As an example, your corporation may borrow money to "fill the hole" on preferred share redemptions. This is not a direct use of the money for an income producing purpose. However, indirect use requires exceptional circumstances.

Other exceptions to the direct use test include the return of capital and payment of dividends from corporations. These situations meet the purpose test as the money replaces capital that previously qualified for an acceptable use. As an example, in paying dividends, the capital would replace retained earnings. The key idea here is borrowing to fill the hole left by the money used.

Where borrowed money no longer serves its first purpose, the current use needs to satisfy the deduction. There must be a link between the money borrowed and its current use. For example, proceeds from one property used to buy another income property will allow the interest deduction to continue.

When borrowed money creates income from business or property, interest will generate a tax expense. For businesses or property that carry a stated interest or dividend rates, these rates satisfy the purpose and use tests. However, this does not apply directly to certain investments that produce non-taxable distributions. As an example, many corporate class funds will distribute ROC that is not taxable. Where investments produce ROC distributions, interest deductions may not be deductible in full. The potential issue with ROC is that you may no longer meet the current use test. Even though you may meet the original purpose test, the current use of the ROC determines what portion of the borrowed funds remains deductible. Tracing the current use of the borrowed money becomes increasingly important in these situations. You may limit your interest deductibility if you borrow to invest but then use the ROC for personal expenses.

What if the business no longer exists or the property stops producing income? Since 1994, the ITA deems interest on borrowed money to be deductible where the money no longer produces incomes.[4] Proceeds on the sale of property or business can serve many purposes. You may use it to invest in another asset or to lower an unpaid loan related to the asset.

Where proceeds do not lower a related loan, the full amount of the unpaid loan may not generate a full tax expense. A prorated amount determines the portion of the loan that creates interest tax expense.

## Life insurance

You can borrow money to pay for life insurance premiums. However, the interest expense on this loan is not for the purposes of gaining or producing income. Therefore, the interest costs are not deductible.[5]

### Collaterally assigned insurance

Sometimes lenders require insurance policies as collateral when you obtain financing from a 'restricted financial institution'.[6] The bank is looking for protection in the event you pass away. A policy used as collateral may allow part of the insurance cost to be a tax expense. Keep in mind; this is different from deducting the interest on borrowed funds. The allowable expense amount is the lesser of the Net Cost of Pure Insurance (NCPI) and the actual premium paid. Further, the allowable deduction is prorated by the ratio of the outstanding loan balance to the total policy death benefit.

Part of the above test is the existence of a loan for the collateral assignment. The interest on the loan could qualify as a deduction based on its purpose and use. As an example, if you use the borrowed funds to purchase income producing investments. However, the interest deduction is separate from the existence of the policy itself.

Many permanent insurance policies have an investment savings component. These savings grow and make up the cash surrender value ("CSV") of a policy. A permanent insurance policy with CSV is an asset the bank may accept as collateral for a loan. Similar to above, interest on the loan is only deductible if it meets the conditions of the purpose and use tests. If you use the loan proceeds for personal expenses, there is no qualified purpose.

### Policy loans

Policy owners can take a loan against the CSV of the policy if the contract allows. This type of loan is an advance on the death benefit payable under the policy. It will directly reduce the amount of the death benefit payable. Policy loans are tax-free up to the adjusted cost basis ("ACB") of the policy. If the policy loan amount exceeds the policy's ACB, the excess amount is taxable to you. Interest on a policy loan is deductible if you satisfy the conditions of the purpose and use tests. In addition, to be deductible, the insurer must verify in prescribed form: [7]

- The amount of interest paid in the year on that loan; and
- That interest paid did not increase the ACB of the policyholder's interest in the underlying policy.

If you use the loan for personal reasons, the interest is not deductible. The interest paid instead increases the ACB of the policy.

## Other considerations

### Compound interest

Compound interest is interest charged on unpaid interest. Where such interest exists on a loan, the tax expense continues if interest on the first loan is qualified. Compound interest is deductible in the year the payment occurs. If no payment of compound interest occurs, the loan amount increases (i.e. capitalized interest). In this instance, the ability to deduct the interest does not exist due to non-payment.

### Capitalized interest

If you do not pay interest, regular or compound, it is capitalized interest. Capitalizing interest can occur in two ways. First, unpaid interest amounts can increase the unpaid loan balance. Second, you can create a new loan for the unpaid interest amount.

Capitalizing interest in a leveraged life insurance strategy will likely result in denial of the deduction. This is because the payment did not occur. [8] Loans in these strategies are unpaid until the insured person passes and the beneficiary collects the death benefit. The accumulated interest will become tax deductible at the time the loan repayment with the death benefit occurs.

Setting up a second loan to pay interest on the first loan would create an interest payment. This payment may cause the interest on the first loan to be a tax expense. [9]

### Quebec specific

Although not specific to interest costs, Quebec limits the amount of investment related expenses you can claim. You can only claim expenses related to the investment income earned from passive assets during the year. Where investment costs exceed investment income, you cannot claim against other income. The excess costs in the current year can create deductions against passive income from other years. That is, you can carry the excess costs back to the three previous years. You can also carry forward excess investment costs for use in any future tax year. Quebec imposes limits on individuals and trusts resident in the province; however, they do not apply to rental properties.

## Summary

Simple borrowing situations for business and investment purposes will create interest deductions for the interest paid. However, many situations may cause that same interest or a part of that interest not to be a tax expense. Engage your professional advisors to determine whether the interest you are paying is an expense for tax purposes.



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[1] Paragraph 18(1)(b) considers interest expense to be a capital expenditure.

[2] Criteria for interest deductibility for tax purposes can be found in paragraph 20(1)(c).

[3] So long as there was a bona fide, actual, real, and true objective of producing income and the arrangement is not a sham.

[4] Subsection 20.1(1) and 20.1(2) ensure that the deductibility continues

[5] Subparagraph 20(1)(c)(i) specifically addresses life insurance.

[6] 248(1) defines a restricted financial institution as a bank, a trust company, a credit union, an insurance corporation, and a corporation whose principal business is the lending of money to arm's length parties.

[7] Form T2210, Verification of Policy Loan Interest by the Insurer

[8] A series of transactions set up to make capitalized interest deductible may also be subject to CRA's general anti-avoidance provisions.

[9] Subsection 20(3) deems the funds borrowed to pay interest on a loan to have been borrowed for the same purpose as the first loan. However, it may be viewed as compound interest and only deductible when paid.