CORPORATE Newsletter

November 2016 Issue 38

Is Interest Tax-Deductible?

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The income tax rules surrounding the deduction of interest are complicated. If you borrow money for the purposes of acquiring non-income producing assets (such as land held for future development purposes, for example), the interest on that loan is generally added to the cost of that asset. However, potentially complex rules are involved when you want to deduct interest as a current expense. This article will provide you with a broad overview of these rules.

What Conditions Must Be Present for Interest to be Deductible?

According to the income tax rules (paragraph 20(1)(*c*) of the Canadian *Income Tax Act*), the following criteria must be met for interest to be deductible:

1. the amount must be paid in the year or be payable in the year in which it is sought to be deducted;
2. the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
3. the borrowed money must be used for the purpose of earning income from a business or property; and
4. the amount must be reasonable, as assessed by reference to the first three requirements.

What is Considered Interest?

Past court decisions provide guidance on what constitutes "interest" for the purposes of the interest deductibility tax rules. Generally, interest must be an amount that is:

- calculated on a day-to-day accrual basis;
- calculated on a principal amount; and
- compensation for the use of that principal.

This definition seems straightforward when it comes to traditional loan arrangements, but there are numerous types of borrower-lender arrangements that deviate from this common setup that have been subject to scrutiny by the courts. For example, where the

amount payable is supplemented or replaced by payments based on other criteria, such as cash flow or gross profits above a certain level, it is often the CRA's view that payments based on any criteria other than the principal are not deductible as interest. Instead, these amounts may be considered a return on investment.

Income from a Business or Property

Often referred to as the "purpose test", condition (c) requires that borrowed money is used for the purpose of earning income from a business or property. According to a decision by the Supreme Court of Canada, the term "purpose" essentially means that the taxpayer had a reasonable expectation of income at the time of making the investment (such as an investment in shares or debentures).

Borrowing to Invest in Common Shares

If you use borrowed money to acquire an investment that has a stated interest or dividend rate, you have generally met the income-earning test. However, if your investment does not have stated payment rate (common shares for example), the test may not in fact be met. If at the time you acquire the shares, it is reasonable that the corporation will pay dividends in the future or does not have a no-dividend policy, you might still meet the purpose test. This is a grey area, and thus the guidance of a tax professional is paramount in this regard.

Current and Direct Use

According to the Supreme Court of Canada, there must be a current and direct use of the borrowed money for the resulting interest payable to be deductible. Moreover, the direct use of the borrowed funds is to be viewed independently of other related transactions. For example, in *The Queen v. Singleton*, the taxpayer withdrew funds from his law firm capital account and used this amount to assist in the purchase of a house. Later on the same day, he borrowed funds from a bank which he used to refinance his capital account. Interest on the loan was deductible because the transactions were viewed independently and the proceeds from the loan were used to earn income. The reasoning behind this decision is that the two transactions were not viewed as one simultaneous transaction.

Borrowing to Redeem Shares, Return Capital, or Pay Dividends

Interest paid on borrowed money that is directly used to redeem shares or return capital to shareholders can be deductible to the corporation if that borrowed money replaces capital that would have been put to a direct eligible use had it been borrowed money. For example, a corporation is using its capital to earn income from a business, which is an eligible use for the purpose of the interest deductibility rules. If the corporation borrows money to repay this capital to shareholders, the interest would generally be deductible if all of the other conditions are met. A similar rule applies with respect to borrowing to pay dividends.

Interest on Interest

A separate deductibility rule applies to compound interest. Compound interest is deductible if it is paid in the current year on interest that would be deductible if it were paid or payable in that year. Also, interest paid or payable on a loan that was used to pay interest on another loan is deductible provided that the interest on that other loan is deductible.

Note-Worthy Court Decisions

These seemingly simple conditions have been subject to ample litigation over the years. These decisions are the best examples of the many pitfalls and complexities associated with the interest deductibility rules.

In *Lipson v. The Queen*, a taxpayer's wife obtained a bank loan to purchase shares of a

family corporation from him. He used the proceeds to buy a new house. They then took out a mortgage on the house and used it to pay off the bank loan. The mortgage interest was deducted from her dividend income and the resulting loss was attributed back to him. This was found not to be an abuse of the interest deductibility rules. However, the arrangement was found to be an abuse of the attribution rules, so the general anti-avoidance rule (GAAR) was used to disallow deduction of the mortgage interest.

In *A.P. Toldo Holding Corporation v. The Queen*, interest payable by the taxpayer was not deductible. The taxpayer obtained loans to purchase and cancel its own shares and the shares of a subsidiary. This transaction was not for the purpose of gaining, producing, or protecting income from a business, and there were no exceptional circumstances to justify a deduction.

Questions?

Interest deductibility is a complicated subject, and we have merely covered some of the basics. Practically speaking, appropriately structuring your affairs with interest deductibility in mind requires the guidance of a tax professional.