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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment
Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Borrowing using joint lines of credit

How to avoid the attribution rules and keep your
interest deductible

In many cases a line of credit from a financial institution is secured by the equity in the family home. This is generally referred to as a home equity line of credit, or HELOC. Where one spouse borrows funds against the HELOC to invest in a portfolio of income-producing assets, would that spouse report all the income and capital gains, or would there be attribution of the income and capital gains to the other spouse? Who would be able to deduct the interest expense?

The Canada Revenue Agency (CRA) has provided guidance in this area. This article discusses the CRA's view in applying the attribution and interest deductibility rules with respect to borrowing using joint lines of credit. Attribution rules are designed to prevent certain income splitting between non-arm's length persons including spouses. Under these rules, income earned from property transferred or loaned to a spouse is considered to be income of the spouse making the transfer or loan, not the spouse receiving it, subject to certain exceptions.

It's 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 and interest as required by the terms of the loan remains the same even if the value of the securities purchased declines.

Let's take the situation where spouses or common-law spouses acquired a home for which one spouse, Mrs. Jones, contributed most of the capital needed to acquire the home. The couple then obtained a joint HELOC which was secured by the equity in that home. The other spouse, Mr. Jones, then borrowed funds against the joint HELOC to invest in a portfolio of income-producing investments solely in his name.



The attribution rules

The fact that Mrs. Jones contributed more to the purchase of the home on which the HELOC is secured shouldn't, in and of itself, result in attribution. This is because providing collateral for a loan isn't a loan or transfer between the spouses. The attribution rules generally apply where an individual is obligated, either absolutely or contingently, to repay all or part of the loan, including any interest, should the borrower default on payments. In the case of a joint HELOC, the non-borrowing spouse would generally be obligated to ensure the repayment of the loan or interest payable if the borrowing spouse defaults and therefore the attribution rules would apply. However, these attribution rules don't apply if certain conditions are met.

The attribution rules don't apply where the interest charged on the joint HELOC is at least equal to the CRA prescribed interest rate in effect at the time Mr. Jones borrowed the money and he pays the loan interest no later than 30 days after the end of each calendar year in which the joint HELOC is outstanding (i.e. January 30). Close monitoring of the annual interest will be critical if this strategy is employed to ensure that the correct interest amount is paid by the deadline. Mr. Jones is required to use his own funds to pay the interest and any principal payments on the joint HELOC. If Mrs. Jones makes even one interest or principal payment for the year on the joint HELOC, any income earned or capital gains realized from the borrowed funds will be attributed back to Mrs. Jones in that particular year and every succeeding year that the loan is outstanding.

The interest deductibility rules

Mr. Jones should be able to deduct, for tax purposes, the interest payments he makes with his own funds because he used the borrowed money from the joint HELOC for the purpose of earning income – buying a portfolio of income-producing investments. The type of income earned in the portfolio should be considered as certain types of income can impact Mr. Jones's ability to deduct the interest. For example, interest on borrowed funds used to generate only capital gains will not be deductible as capital gains are not considered income for tax purposes. Income generally includes interest, dividends, rents and royalties. For more information on the interest deductibility rules, ask your RBC advisor for the article on this topic.

If the interest payments are made by Mrs. Jones, not only will the attribution rules apply, but neither Mr. Jones nor Mrs. Jones would be able to deduct the interest payments. Mr. Jones wouldn't be able to deduct the interest payments because he didn't pay the interest; and Mrs. Jones wouldn't be able to deduct the interest payments

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because she didn't borrow the funds and use them for an eligible purpose. In this scenario, Mrs. Jones is taxed on the income and capital gains, and no one gets to deduct the interest.

Even if Mrs. Jones borrowed the funds from the joint HELOC and used them to purchase a portfolio of income-producing investments in the name of Mr. Jones, the result would be the same. The attribution rules would apply because she transferred funds to Mr. Jones, which he used to earn investment income. Further, since Mrs. Jones didn't use the funds for the purpose of earning income but instead gifted the funds to Mr. Jones, the interest she paid wouldn't be deductible.

Conclusion

This article is a brief overview of applying the attribution and interest deductibility rules with respect to borrowing using joint lines of credit. However, it should be noted that these conclusions are based on a specific situation that was brought to the CRA for interpretation. Whether attribution applies to your situation and whether interest would be deductible can only be decided on a review of all the relevant information of your case. If you're contemplating borrowing from a joint line of credit, please confirm the implications with a qualified tax advisor.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance 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, legal, and/or insurance advisor before acting on any of the information in this article.



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