Wealth Management

the Navigator

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

Business owners borrowing to invest

Interest deductibility rules for incorporated business owners

As a business owner, you or your business may borrow money for various reasons including capital injection, purchasing capital assets, and refinancing debt. The purpose of this article is to provide information with respect to commonly asked interest deductibility issues for incorporated business owners.

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 as required by its terms remains the same even if the value of the securities purchased declines.

The direct use test

Generally, the interest expense on money you borrow is only deductible if you can directly link the use of the borrowed money to an income earning purpose. This is known as the "direct use" test. The income you earn must be from a business or from property. Business income includes any activity you carry on for profit or with a reasonable expectation of profit. Property income includes interest income, dividends, rents, and royalties. Property income does not include capital gains.

For example, if you wish to inject capital into your business, you may borrow money in order to purchase common shares of your corporation. The interest expense will generally be deductible if there is a reasonable expectation, at the time you purchased the shares, that you will receive dividends. In this case, you are directly using the money you borrowed to buy shares which will pay you dividend income.

Court decisions have consistently emphasized that a reasonable expectation of income, such as dividends, at the time the shares are acquired, is an important factor in determining whether interest on borrowed funds to acquire shares will

be deductible. In some cases, interest deductibility has been denied where there was no realistic prospect of dividends and no history of paying them. If you intend to borrow to invest in your corporation or a closely held corporation, it may be worth establishing a pattern of paying dividends to support an income-earning purpose. Given the fact that the dividend payments don't have to exceed the interest expense in respect of the shares, the dividend payments created by your company may be nominal.

Lastly, if your company expressly declares its intentions not to pay any dividends, or the class of shares doesn't allow for dividends to be paid, then the interest incurred on the money you borrowed would not 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 the interest on the new borrowed money deductible, too. Interest that's deductible doesn't cease to be deductible because the original loan was refinanced. In a situation where you borrowed money to repay your shareholder loan, the interest on the shareholder loan may not be deductible if the original use of the borrowing cannot be linked to an income earning purpose. For example, if money borrowed from your corporation was used to pay off your home mortgage, which would be an ineligible use, interest on the borrowed money to repay the shareholder loan would not be deductible.

Exceptions to the direct use test

Even though generally, the money you or your business borrows must be directly used for the purpose of earning income, the tax courts and the Canada Revenue Agency (CRA) have accepted that in "exceptional circumstances" it might be appropriate for you or your business to deduct interest on funds borrowed because of an indirect effect on your or your business's income earning capacity.

Let's have a look at some exceptions for incorporated business owners:

Borrowed money used by a shareholder to make interest-free loans and contributions of capital to a corporation

Interest expense on borrowed money used to make an interest-free loan is not generally deductible since the direct use of the funds cannot generate any income. However, where it can be shown that this interest-free loan can have an effect on your income-earning capacity, the interest may be deductible. For example, a deduction for interest would generally be allowed where you, in your capacity as a business owner, borrow money to make an interest-free loan to your wholly-owned corporation and the contribution of capital has an effect on your corporation's income-earning capacity, thereby increasing the potential dividends to be received by you. Similarly, if a partner borrows to make a capital contribution to a partnership, the partner's interest should generally be deductible as well.

If your company borrows funds to redeem outstanding shares, return capital or pay dividends to shareholders, it cannot generally be considered to be used for the purpose of gaining or producing income. However, the theory is that your company may borrow, and incur deductible interest expenses, to "fill the hole" left behind by the payment to shareholders.

Borrowed money used by a corporation to redeem shares, return capital or pay dividends to shareholders

If your company borrows funds to redeem outstanding shares, return capital or pay dividends to shareholders, it cannot generally be considered to be used for the purpose of gaining or producing income. However, the theory is that your company may borrow, and incur deductible interest expenses, to "fill the hole" left behind by the payment to shareholders. In other words, where borrowed money is used to replace the capital being repaid to shareholders, the interest may be deductible, provided the capital was previously used for the purpose of earning income from the business. A court case has also confirmed that there needs to be a material amount of capital to return that could create a hole in your business that would need to be filled by borrowing in order for your business to continue to earn income.

Where an interest-bearing promissory note is issued to redeem shares for compelling business reasons, the interest expense may be deductible if the promissory note replaces the capital that is currently being used in the business. For example, interest was deductible in a case where a company issued a promissory note to redeem shares from an existing shareholder in order to resolve a shareholder dispute that could have significantly impacted the company's ability to gain or produce income. In this case, it was demonstrated that the purpose of the redemption was to protect the income of the corporation and acquire property (i.e. shares) for the purpose of gaining income from business.

Conversely, where a promissory note is issued to return capital or pay dividends, the interest expense on the promissory note would generally not be deductible since in these situations, no property is acquired by the corporation for the purpose of earning income. This same concept is applicable where a partnership borrows money to return capital to a partner.

Borrowed money used by a corporation to make interest-free loans to employees (not shareholders)

Generally, a deduction for interest would be allowed where borrowed money is used to make an interest-free loan to you, in your capacity as an employee. This is because the value of this loan could be viewed as a form of remuneration for the services you provide as an employee. On the other hand, interest on money borrowed to make interest-free loans to you in your capacity as a shareholder would generally not be deductible. If you're both an employee and a shareholder, it's always a question of fact whether the loan arose as a result of your shareholdings or as a result of your office or employment. As a general rule, if you're both an employee and a shareholder, your shareholdings must be less than 10% to qualify as an employee for this exemption.

Conclusion

Although the specific exceptions set out above have been permitted by the CRA and the tax courts in the past, it doesn't necessarily mean that an interest deduction will be permitted in every case. 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 or your business.

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RBC Wealth Management

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