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INTEREST DEDUCTIBILITY

iA Financial Group

Deducting interest provides tax savings for individuals and corporations. When you take out a loan, and certain conditions are met, the interest can be deductible. The Income Tax Act (ITA) and related case law and technical interpretations provide a framework for whether or not interest can be deducted in different situations.

The term interest is not defined in the ITA. However, the Canada Revenue Agency (CRA) states that "An amount is considered to be interest if, in general terms:

- it represents compensation for the use of money;
- it is referable to a principal sum; and
- it accrues day-to-day."[1]

In order for interest to be tax-deductible, the loan and interest must meet the conditions prescribed by the ITA.

FIRST CONDITION

INTEREST MUST BE PAID OR PAYABLE PURSUANT TO A LEGAL OBLIGATION

There must be a legal obligation under which the borrower is required to pay the interest. In fact, the agreement between the lender and the borrower must include provisions whereby the borrower is obligated to pay the interest.

Simple and compound interest

Interest payable, charged or accrued on amounts originally borrowed is simple interest. These are deductible when the conditions are met.

Compound interest is made up of interest on interest, i.e., the additional interest to be paid as a result of non-payment of simple interest. This can be deductible as long as the simple interest on the loan is deductible. The deduction is available only in the year in which compound interest is paid. If it is not paid, it is added to the outstanding balance of the loan and cannot be deducted. The deduction will be deferred at the time of payment.

Method of accounting

When the cash method of accounting[2] is used, the deductible interest is interest paid during the year. For the accrual method of accounting, the deduction is made in the year in which simple interest becomes payable. This means that when interest is payable but not paid, it can still be deducted.

SECOND CONDITION

INTEREST MUST BE REASONABLE

Under the ITA, the amount of deductible interest is limited to the lesser of:

- the amount paid or payable;
- a reasonable amount.

In determining what constitutes a reasonable amount, it is necessary to consider the circumstances of each situation. In this regard, the case law establishes an important link between the interest rate and reasonableness. Therefore, this must be compared with market interest rates for borrowers dealing at arm's length with the lenders in comparable circumstances.[3]

In general, therefore, the valuation is limited to comparing capital market interest rates for debts of a similar nature, i.e., on similar terms and at similar risks.[4]

Nevertheless, it is important to note that beyond the interest rate, the amount of interest paid or payable must also be considered reasonable under the circumstances to be deductible.[5] The reasonableness of an amount of interest paid or payable is not dependent on the income generated by the amounts borrowed. For example, a new company that is not yet making a profit and is required to finance its day-to-day operations with loans will be able to deduct the interest on those loans if they meet the criteria. However, it would be possible to question the reasonableness of an interest deduction that is disproportionate to the income that could possibly be realized.

[1] CANADA REVENUE AGENCY, Tax Folio S3-F6-C1, "Interest Deductibility," March 18, 2016, p1.

[2] Unlike accrual accounting, where revenue and expenses are recognized as they occur, cash accounting records transactions only when there is an inflow or outflow of cash.

[3] Notably, in *Shell Canada Limited v. Her Majesty The Queen and Canadian Pacific Limited and Her Majesty The Queen*, 99 DTC 5682. (S.C.C.).

[4] *Ibid*, note 3, p. 6.

[5] *Ibid*, note 3, p. 6.

THIRD CONDITION

THE BORROWED MONEY MUST BE USED FOR THE PURPOSE OF PRODUCING BUSINESS OR PROPERTY INCOME OR TO ACQUIRE NON-EXEMPT INCOME-PRODUCING PROPERTY

This condition is critical for the deduction of interest. To meet it, interest must relate to "borrowed money used for the purpose of earning income from a business or property."[6] Business income is derived from operating activities, which are the activities of the business to market its products and services. On the other hand, income from property is earned as a result of the acquisition of an asset that generates one of the following types of income: rental income, annuities, royalties, partnership shares, dividends, interest, etc. Note that it is not possible to deduct interest paid or payable on amounts borrowed solely to generate a capital gain.

The amounts borrowed must not be used to generate exempt income, such as income generated in the various registered plans (RRSPs, TFSAs, RESPs, RDSPs, FHSAs). Similarly, the interest paid is not deductible if the borrowed money is used to purchase a life insurance policy. However, some financial strategies that involve a life insurance product may allow interest to be deductible.[7] In this regard, we refer you to our guides on retirement insurance strategy and immediate financing plan.[8]

Purpose test and expectation of profit

It is not necessary for the borrowed amounts to produce income in order to deduct interest. The intention to generate profits is more important than the profits made.[9] Nevertheless, the taxpayer must show that at the time the money was borrowed, there was an expectation of profit, i.e., that there was a reasonable probability that the taxpayer would make a profit from these activities in these circumstances.

The facts in question must be examined to determine whether the purpose test is met[10], the purpose of the loan being the original intention to generate income from it. The Income Tax Folio on Interest Deductibility refers to this test by explaining that the question is: "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made?"[11] It must be determined, based on the facts, that at the time the loan was obtained by the taxpayer, the taxpayer had a reasonable probability of making a profit on the amount borrowed, and therefore that the intention was to generate a profit.

Relationship between borrowed money and current use

In order to deduct interest, the taxpayer must establish the link between the borrowed money and the current use of that money and not its use at the time the loan was made. It must be established that the money borrowed is actually used for the purpose of earning income. Otherwise, the deduction will be denied.[12]

When the amounts borrowed are combined with other cash, the taxpayer must determine the amount that relates to the loan. It is therefore necessary to have an effective tracking method that identifies what proportion of the loan meets the criteria for interest deductibility.

When disposing of an eligible investment, in order for interest to continue to be deductible, the amounts must be reused for similar or eligible purposes. In the event that the amount resulting from the sale of a portion of the investments no longer meets the criteria for interest deductibility, it would be necessary to make a prorata calculation in order to establish the amount that remains deductible.

6 *Ibid*, note 1, n. 1.25.

7 In this regard, we refer you to our guides on the retirement insurance strategy and immediate financing plan at https://large-case-solutions.ia.ca/

8 *Ibid*.

9 Certain exceptions apply to investment income in Quebec.

10 *Ibid*, note 1, n. 1.25.

11 *Ibid*, note 1, par. 1.26.

12 For example, using a line of credit, a loan, etc. used solely for investments can make it easier to track the amounts borrowed, prove their use to the tax authorities and thus claim the deduction for the interest paid.

DEDUCTIBLE INTEREST AND INVESTMENT INCOME

Investment income may include, but is not limited to, taxable dividends from Canadian corporations, interest from Canadian sources, foreign investment income, taxable capital gains.

It is important to remember that even if investment income is less than the interest paid on a loan, it can be deductible without being limited to said income, provided that the other conditions are met[13].

Investment in common shares

Since capital gains are not considered investment income for tax purposes, an investment in common shares must generate dividends in order for a deduction to be allowed.

The test of the intention to generate income (the expectation of profit) must be met when investing in common shares. For example, if the company issuing the common shares has a policy of paying dividends, the intention test would be met. In the event that the common shares do not bear interest or dividends, the CRA may still accept the deduction if, based on the facts, it is agreed that the shareholder could reasonably expect to receive dividends at the time of purchase.[14]

[13] *Ibid*, note 1, par. 1.69.
[14] *Ibid*, note 1, par. 1.70.

Annuity contract

Interest may be deductible if the amount borrowed is used to purchase a non-prescribed annuity contract up to the maximum taxable portion of the annuity.[15]

Segregated funds

Segregated funds are treated in some respects by the ITA as life insurance policies.[16] Interest on a loan used to purchase a life insurance policy is not deductible. However, there is an exception that allows interest on non-registered segregated funds to be deducted.[17]

Specific conditions for certain provinces

In Quebec, interest is deductible from all investment income only.

In the event that the total investment income is not sufficient to deduct the interest, the deduction may be carried forward to future years. The deduction can also be used to reduce investment income from the previous 3 years.

In all other provinces in Canada, interest paid on a loan taken out for the purposes of investment can be deducted from any source of income. Therefore, it is not necessary to generate investment income in order to be able to deduct interest.

[15] Subparagraph 20(1) c) (iv) ITA.
[16] S.138(12) ITA.
[17] S.20 (2.2) ITA.

INTEREST DEDUCTION AND FINANCIAL STRATEGIES

The profitability of certain financial strategies is based in part on the interest deductibility.

Investment loan

An investment loan is the process of obtaining financing to acquire investments that have an expected net return greater than the cost of borrowing.

This strategy is mainly aimed at people with a bold investor profile. Thus, in order to achieve a high return, the volatility of the portfolio will be high and the value of the investments can fluctuate significantly. It is therefore possible that the return for a year will be lower than the borrowing rate. The borrower will get a deduction for interest regardless of whether the realized rate of return is lower or higher than the borrowing rate. In all cases, the deductibility of interest improves the after-tax return.

Immediate financing arrangement

The immediate financing arrangement is a financial strategy that provides permanent life insurance coverage while allowing those who use it to maintain access to the cash needed to support the growth of their business. All that is required is to purchase a permanent life insurance policy and make additional deposits to help grow the cash surrender value. The cash surrender value is transferred as collateral in order to obtain an investment loan from an external financial institution. The loan is used to invest in a business or to acquire qualified investments so that the interest is deductible.

Policy loan

A policy loan allows the holder of a universal or participating life insurance policy to access the cash available in the policy. Where the use of the amounts from the policy loan meets the criteria for interest deductibility, the interest received by the insurance company will be deductible by the taxpayer provided that the conditions mentioned above are met. Additionally, it is important to note that if the advance is larger than the policy's ACB, there will be a tax impact for the policyowner.

iA LARGE CASE **SOLUTIONS**

The iA Large Case Solutions program offers a support service for high-net-worth clients who need more complex financial strategies in the areas of taxation, sales concepts and optimization of individual insurance and savings products.

Our team of experts offers personalized, simple, high-performance solutions that enable advisors to meet the specific needs of affluent clients, professionals and business owners.

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