Deductible Debt and Spousal Loans

When funds are borrowed for purposes of earning investment income or to invest in a business, the interest owed on the funds borrowed can be deducted for tax purposes. Where funds are borrowed for purposes other than investing, the interest is not tax deductible.

One of the most common types of non-deductible investing occurs when a mortgage is used to help finance the purchase of a home. Borrowing to invest in an RRSP, RRIF or other tax deferred arrangement also results in the debt being non-deductible.

From a tax planning perspective then, deductible debt is obviously preferable to non-deductible debt. Being able to deduct the interest costs of borrowed money will reduce the amount of income that must be reported and therefore the amount of tax that must be paid. From a tax planning perspective, this can be very powerful. It is for this reason that financial advisors will try to encourage their clients to switch their non-deductible debt for deductible debt.

Creating Deductible Debt

Switching non-deductible debt for deductible debt should be considered by any investor who has both non-deductible debt e.g. a mortgage and a portfolio of investments. This strategy has just recently been condoned by the Supreme Court of Canada in the Singleton Case.

In 1988 (the case was just recently decided) Mr. Singleton, a Vancouver lawyer, drew $300,000 from his firm's capital account to help finance the purchase of a home. He then borrowed $300,000 from the bank to replace the funds borrowed from the capital account. In doing so, he made sure that the funds that would have otherwise been non-deductible on the mortgage were instead directed to the investment in the business and therefore would be deductible. Although the Canada Customs and Revenue Agency (CCRA) fought it all the way to the Supreme Court, the court ruled that although some cheque shuffling had taken place, the transaction of borrowing to invest in the business was legal and related to earning income from a business.

It would therefore appear that this monumental decision clears the way for investors who have non leveraged investments to liquidate their portfolios to pay down debt (mortgages) and then repurchase their portfolios with borrowed monies.

Leveraged Investing

The Supreme Court of Canada has also recently ruled on the feasibility of deducting interest owed on money borrowed to invest in shares of a corporation. When common shares are purchased, CCRA's policy has always been that deducting interest on funds borrowed for the purpose of investing in common shares was permissible. Where preferred shares were purchased, a deduction for interest was restricted to the amount of

the grossed-up dividend income from the preferred shares acquired with the borrowed money.

In the *Ludco Case*, the Supreme Court ruled that investments need not produce significant income to justify writing off interest costs. In this case, Ludco Inc. borrowed money to invest in common shares that paid a small amount of dividends. Ludco attempted to write off all of their interest costs above and beyond the amount of the dividends received.

CCRA denied the claim on the basis that there was not enough income to justify the write-off i.e. they argued that the company had not borrowed the funds for the exclusive purpose of earning income from property (capital gains do not count). The Supreme Court disagreed. It instead found that a reasonable expectation of some property income was all that was needed and that earning property income need not be the exclusive purpose of the investment.

As a result of these two recent rulings, advisors and their clients should now consider these strategies which before, may have been to tax aggressive for them.

Consider a Spousal Loan

Given the benefits of deductible debt and the fact that interest rates are at an all time low, it's once again time to consider the benefits of making a spousal loan.

The purpose of a spousal loan is to legally shift income from one spouse to the other. Under normal circumstances, a spouse cannot arbitrarily direct funds into the hands of the other spouse. However no rule or piece of legislation exists to prevent a loan from being made. Once the loan is made, the lower income spouse can then take the funds and invest them in his or her own name without the income attributing back to the higher income spouse. Attribution is avoided because the spouse loaning the funds will do so at CCRA's prescribed rate of interest. At last check this rate was set at 2% (Applicable for the period April 1, 2002 to June 30, 2002).

Once the loan is set up, it can remain in place forever. If we assume that the lower income spouse will be able to get more than 2% on the borrowed funds, then the higher income spouse will have effectively shifted income and therefore saved some tax. The savings realized will of course depend on the amount of funds loaned as well as the amount of the yield earned above the prescribed rate. To ensure this tax planning strategy is kept valid, the lower income spouse must ensure that the interest owed on the loan is paid by January 30th of the following year.

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