TAX LETTER

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INTEREST EXPENSE AND "DISAPPEARING SOURCE" RULE

Interest expense on borrowed money is deductible for income tax purposes, generally only if the borrowed money is used for the purpose of earning income from a property or business.

For example, if I take out a loan to buy mutual funds, the interest on the loan will normally be deductible. Furthermore, if I later sell the mutual funds and use the proceeds to buy another income-earning property, the interest will remain deductible. On the other hand, if I use the proceeds for personal or non-income earning purposes, such as to pay off my personal credit-card debt or take a vacation, the interest will be non-deductible from that point on.

One of the potential problems relating to these rules arises when you acquire property with a loan and then sell the property at a loss, and use the proceeds for non-income earning purposes or to partially repay the loan. For example, say I borrow $100,000 to buy some shares, later sell all of the shares for $40,000 and use the proceeds to partially repay the loan. Under a strict approach to the above rules, it would appear that $60,000 of the loan ($100,000 minus the $40,000 partial loan repayment) is no longer used for income-earning purposes. This is in fact how the courts interpreted the rules, which eventually led to a specific "disappearing source" rule in the Income Tax Act (section 20.1) that remedies this situation.

Under this provision, the amount of the original loan in excess of the proceeds of disposition of the property is deemed to be used for the purpose of earning income from property. Therefore, an interest deduction will remain for that portion.

Example

Using the numbers above, the $100,000 amount of the original loan, minus the $40,000 proceeds for the property that is used to partly pay down the loan, is deemed to be used for the purpose of earning income. Therefore, interest on the $60,000 outstanding part of the loan will remain deductible.

What if the $40,000 was not used to repay part of the loan, but rather was used for personal purposes? In other words, under this scenario, the entire $100,000 of the loan would remain outstanding. Under the above provision, interest on $60,000 of the loan would remain deductible, while interest on the other $40,000 would not be deductible.

A similar rule applies if you borrow money for use in your business, you subsequently cease to carry on the business, and the value of the business properties is less than the amount of the outstanding loan. In general terms, in this scenario, a portion of the loan is allocated to any property that you dispose of on a fair market value basis (and for this purpose, there is a deemed disposition once you begin to use the property for any other purpose). The deduction of the interest on that portion of the loan depends on whether you use the proceeds of disposition for an income-earning purpose. The remaining part of the loan, if any, is deemed used for the purpose of earning income from a business, and the interest expense on that part remains deductible.

INTEREST EXPENSE AND DIRECT USE RULE

As discussed above, interest expense is normally deductible if the borrowed money is used for the purpose of earning income from a business or property. In this regard, the courts have indicated that *direct use* of the borrowed money is required, and that an indirect use does not qualify.

To appreciate the distinction between a direct use and an indirect use, consider the following example.

Example

You have $40,000 in cash. You would like to purchase $40,000 worth of mutual funds, and you are also thinking of buying a $40,000 car for personal use.

If you borrow $40,000 to buy the car, the direct use of the borrowing is not for the purpose of earning income. You cannot successfully argue that the borrowing indirectly allowed you to acquire the mutual funds (i.e. the borrowing allowed you to use your $40,000 cash to acquire the mutual funds). Interest on the borrowing is not deductible.

If instead you borrow $40,000 to buy the mutual funds, the direct use of the borrowing is for the purpose of earning income. You can then use your $40,000 cash to buy the car. Of course, this route of action makes more sense, since now the interest on the borrowing would be deductible.

The direct-use rule leads to some tax planning options and opportunities, particularly where you own some income-earning properties and are thinking of borrowing for personal purposes. You can liquidate some of the properties, use the cash for personal purposes and then borrow to reacquire the properties.

For instance, say you already owned $40,000 worth of mutual funds and were thinking of borrowing to buy a $40,000 personal-use car. You might consider selling the mutual funds, using the $40,000 proceeds to buy the car, and then borrowing to repurchase the mutual funds. In this case, the direct use of the borrowing would be an income earning purpose, and the interest on the borrowing would be deductible. (This plan works best if the mutual funds have little or no accrued capital gain, because any gain will be triggered when you sell the funds.) This type of tax planning has been approved by the courts, and most notably by the Supreme Court of Canada in 2001 in the *Singleton* case.

TRANSFERS BETWEEN RELATED PERSONS

There are specific rules under the Income Tax Act that apply to transfers of property between persons who do not deal at arm's length, which include persons who are related for income tax purposes. When the rules apply, there may be deemed proceeds on the sale, or a deemed cost on the purchase, that differs from the actual proceeds or cost.

Related persons for these purposes include most individuals that you consider your close relatives in a colloquial sense – for example, your children and grandchildren, your parents and grandparents, your siblings, spouses and common-law partners of all of the above, and your in-laws. Interestingly, related persons do not include aunts, uncles, nieces, nephews and cousins.

In terms of corporations, you are related to a corporation if you or a related person controls the corporation, or you or a related person are part of a related group that controls the corporation. Control generally means owning more than 50% of the voting shares of the corporation.

As illustrated below, at least two of the rules involving transfers between related persons can be quite onerous.

Rule 1: If you sell property to a related person for proceeds *less* than fair market value, you will have a **deemed disposition at fair market value**. However, this rule is one-sided, in that the related person's cost of the property is not bumped up to fair market value.

Example

You sell property to your son for $4,000. The fair market value of the property is $10,000 and your cost of the property was $4,000.

You will have deemed proceeds of $10,000, resulting in a $6,000 capital gain, half of which will be included in your income as a taxable capital gain. However, your son's cost will remain $4,000. Therefore, if he sells the property to a third party for the same $10,000, there will be double taxation, since both you and your son will have been taxed on the same $6,000 gain.

Rule 2: If you buy property from a related person and pay *more* than fair market value, you will have a **deemed cost of fair market**

value. However, similar to the first rule, this rule is one-sided, in that the related person's proceeds of disposition of the property is not ground down to fair market value.

Example

You buy property from your son for $10,000. The fair market value of the property is $4,000 and his cost of the property was $4,000.

You will have a deemed cost of the property of $4,000, even though you paid $10,000 for the property. However, your son's proceeds will remain $10,000. Therefore, he will have a capital gain of $6,000 and taxable capital gain of $3,000. And if you subsequently sell the property for more than $4,000, you will also have a capital gain.

Rule 3: If you make a *gift* of property to any person, whether related or not, you will have a deemed disposition at fair market value. The person will have a deemed cost of the property equal to its fair market value.

Example

You give property to your son. The fair market value of the property is $10,000 and your cost of the property was $4,000.

You will have deemed proceeds of $10,000, resulting in a $6,000 capital gain, half of which will be included in your income as a taxable capital gain. However, in contrast to the first rule, your son's cost will equal $10,000. So if he turns around and sells the property for $10,000, there will be no double taxation.

As you can see, making a gift of property is much better than selling it to relative for a nominal price.

Transfers to Spouse

An exception to the above rules applies where you transfer property to your spouse (or common-law partner). In such case, there is an automatic "rollover", which means you have a deemed disposition at your tax cost of the property and your spouse inherits the same cost of the property.

However, if you wish, you can elect out of the rollover, in which case the above rules may apply where applicable.

Example

You give property to your spouse. The fair market value of the property is $10,000 and your cost of the property was $4,000.

Under the rollover, your proceeds will automatically be $4,000 and you will have no gain to report. Your spouse's cost of the property will be $4,000.

If you elect out of the rollover, you will have deemed proceeds of $10,000, resulting in a $6,000 capital gain. You might consider this election, say, if you had unused capital losses that could offset the gain, so that you would not pay any actual tax on the gain. The upside would be that your spouse's cost of the property would be bumped up to $10,000.

Note that the election out of the rollover cannot normally trigger a loss. That is, when you sell property to your spouse at a loss, the "superficial loss" rules under the Income

Tax Act normally apply, meaning that your loss will be denied.

Transfer of income-earning property

The above rules apply equally to personal property as well as income-earning property. However, as discussed in our May 2018 Tax Letter, for income-earning property, the income attribution rules may apply after you transfer the property (in the case of a transfer to your spouse or minor child). For example, if you simply give property to your spouse or minor child, any subsequent income from the property will normally be attributed back and included in your income.

Transfer by tax debtor

Finally, if you are considering transferring property for less than its fair market value to a family member (whether by sale or gift), make sure you don't have any debts to the CRA, from the past or the current year, that you'll be unable to pay. If you have such debts, the CRA can assess your relative to collect the net value you transferred to them, to pay your tax debt. This rule, under section 160 of the Income Tax Act, was discussed in detail in our September 2016 letter.

TAX-FREE TRANSFERS TO YOUR CORPORATION

Overview

There are special rules in the Income Tax Act that allow you to transfer property to a Canadian corporation on a tax-deferred rollover basis. The rules effectively allow you to incorporate an existing business on a tax-free basis, without paying tax on any accrued gains on your business assets. These rules can apply to most transfers of property to a private corporation, not only at the time of incorporation.

This is called a "section 85 rollover", as the rules are found in section 85 of the Income Tax Act.

There are various conditions that must be met.

You and the corporation must file a joint election with the Canada Revenue Agency ("CRA"). The due date for filing the election is your tax filing date for the year of the transfer, or the corporation's tax filing date, whichever comes first.

You do not have to be resident in Canada. However, the corporation must be resident in Canada.

In consideration for the transfer, you must receive at least one share in the corporation. You can receive other consideration as well, but you must receive at least the one share. The non-share consideration is sometimes called "boot" (think of getting the shares of the corporation, and then getting something else "to boot"), and can include money, a promissory note, and any property other than shares in the corporation.

Elected amount

In the joint election, you pick an "elected amount". This point is central to the transaction, since

1) the elected amount becomes your proceeds of disposition of the property transferred to the corporation;
2) the elected amount becomes the cost of the property for the corporation; and

3) the elected amount, minus the value of any "boot" that you receive, becomes the cost of your share(s) in the corporation received on the transfer. The amount is allocated first to the cost of any "preferred" shares that you receive, and then to any common shares you get on the exchange.

As might be appreciated, in order to get a complete tax-free rollover, you need to elect an amount equal to the tax cost of the property transferred to the corporation. If you wish, you can elect at a higher amount to trigger a gain on the transfer (say, if you have unused losses that can offset the gain).

However, there are various limits on the elected amount. The elected amount

1) cannot be greater than the fair market value of the transferred property;
2) cannot be less than the fair market value of the boot you receive, if any; and
3) cannot be less than the lesser of the fair market value of the property and your tax cost of the property.

Example

You transfer a capital property to your corporation. Your tax cost of the property was $10,000 and its fair market value is $100,000. In consideration for the transfer, you receive 10 common shares in the corporation, and a $20,000 promissory note (which is boot).

Applying the above limits, the elected amount cannot be greater than $100,000, cannot be less than $20,000, and cannot be less than $10,000. Assuming you elect at $20,000, you will have a capital gain of $10,000 and a taxable capital gain of $5,000.

Of course if you received back no boot, or boot of $10,000 or less, you could elect at $10,000, which would result in a complete tax-free rollover.

Normally, you cannot trigger a loss on the transfer by electing an amount less than the tax cost of the property (say, if the fair market value of the property is less than your cost). In particular, you cannot trigger a loss if you and the corporation are "affiliated". For these purposes, you and the corporation will be affiliated if you or your spouse controls the corporation, either alone or together, or if you are part of an affiliated group that controls the corporation.

Eligible Property

The property you transfer to the corporation must be an "eligible property", which includes depreciable and non-depreciable capital property, and inventory other than land.

If you are not resident in Canada, land that is capital property used in a business carried on in Canada can qualify, if it is transferred to the corporation along with all or substantially all of the property used in the business.

Tips and Traps

Anti-avoidance rules to consider, suppose the fair market value of the property you transfer to the corporation exceeds the value of the consideration (shares and boot) that you get back from the corporation and also exceeds the elected amount. In other words, you have given more to the corporation than you received back. A special rule says that if it is reasonable to regard the excess as a benefit that you wished to confer on a person related to you (say, a related person who owns common shares in the corporation), the elected amount will be bumped up to the fair market value of the property. This will increase your gain on the transfer because of the increase in the elected amount.

On the other hand, if the fair market value of the consideration you receive from the corporation exceeds the fair market value of the property you transfer to the corporation, the excess will normally be taxable as a shareholder benefit and will be included in your income.

To illustrate another potential problem, the property you transfer to the corporation can include shares in another corporation. This is perfectly acceptable, and the transfer will be subject to the same rules applicable to other property. However, if you receive back boot on the transfer and the value of the boot exceeds the "paid-up capital" of the transferred shares, the excess may be included in your income as a deemed dividend. The "paid-up capital" of shares is the income tax version of the legal stated capital of the shares, and in very general terms, reflects the value used to purchase the shares when they were originally issued.

AROUND THE COURTS

Interest deduction denied for return of capital of mutual funds

As discussed earlier in this letter, if you borrow money to purchase mutual funds, the interest expense on the borrowing will normally be deductible in computing your income. However, mutual funds will sometimes pay out a return of your originally invested capital (along with income earned by the funds). If this occurs, the interest deduction may be affected, depending on how you use the returned capital.

In the recent *Van Steenis* case, the taxpayer took out a $300,000 loan to buy units of a mutual fund. Over the course of several years, approximately 2/3 of this amount was paid out to him as a return of capital. He used most of this amount for personal purposes. The CRA assessed the taxpayer to disallow the interest expense on the portion of the loan reflecting this returned capital that was used for personal purposes.

The taxpayer argued that he should be allowed to continue to fully deduct the interest, since he continued to own the units in the mutual fund. He also argued that he had no choice in the matter, since he had no control over the characterization of the money distributed to him from the mutual funds (i.e. as either income or return of capital).

On appeal to the Tax Court of Canada, the Tax Court Judge sided with the CRA and upheld the assessment. The Judge held that the returned capital was no longer being used for income-earning purposes – it was no longer invested and was instead used for personal purposes. As a result, interest on the portion of the loan reflecting the return of capital was not deductible.

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