

# WHAT'S NEW

As the end of 2005 approaches, this issue of WHAT'S NEW covers two topics that may be important in your personal tax planning: interest deductibility and investing in income trusts.

Personal tax planning is important to the management of your financial affairs and should be considered throughout the year and not just late in the year. The aim of tax planning is straightforward: minimize your tax burden or defer taxes to a later tax year. Tax planning can in-

clude preventing events that could create unwelcome tax consequences.

This WHAT'S NEW will assist residents of Quebec who wish to take advantage of opportunities that exist for minimizing income taxes for 2005 and subsequent years. It is based on existing and proposed legislation and the current interpretation of tax laws by the Canada Revenue Agency (CRA), Revenue Quebec and the courts.

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## MAKE YOUR INTEREST DEDUCTIBLE

Paying interest on a loan is an unfortunate consequence of borrowing money. However, when interest becomes unavoidable you can make borrowing less expensive if the interest you pay is tax deductible.

For a resident of Quebec who pays tax at the top marginal rate of 48.22%, a \$100 interest expense deduction results in a tax savings of \$48.22. Note that a "deduction" is more beneficial than a "credit" to a taxpayer who has a high marginal tax rate.

### When is Interest Deductible?

In order for an amount to be deductible as "interest", all of the following four conditions must be met:

1. It must be paid or become payable in the year.
2. It must be paid pursuant to a legal obligation to pay interest on borrowed money.
3. The borrowed money must be used for the purpose of earning taxable income from a business or property.

4. The amount must be reasonable in the circumstances.

It is usually the third condition that proves to be the most challenging. Because of this, astute taxpayers have attempted to structure their affairs so that borrowed money is used for business expenditures and their own money is used for personal expenditures. Take, for example, the recent Supreme Court of Canada case of *The Queen v. John R. Singleton*<sup>1</sup>. Mr. Singleton, a partner in a law firm, wished to purchase a new home and realized that he would have to borrow to do so. Instead of borrowing to purchase the home, however, he acquired it using funds he withdrew from his capital account in the firm. On the same day, he borrowed a similar amount from a bank to refinance his capital account. The taxpayer claimed a deduction for interest paid on the borrowed funds.

The CRA was not pleased with Mr. Singleton's actions and disallowed the interest deduction, arguing that he had, in essence, acquired a per-

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## INCOME TRUSTS: WHAT ARE THEY ALL ABOUT?

During the past few years there has been much interest by investors in publicly-traded income trusts. For many, these trusts have replaced corporations as the investment vehicle of choice. They generally offer higher annual cash flow returns than do corporations. Furthermore, some of that return is in the form of a tax-free return of capital and this portion is non-taxable although the capital returned reduces the investor's tax adjusted cost base of the trust units and is essentially a partial liquidation of their investment.

Income trusts are generally part of a more complex structure of business entities involving a trust that issues units to investors at large. A typical income trust holds the shares of a corporation or a limited partnership that carries on a business. The advantage of the trust structure over the traditional corporation is that trusts that distribute all of their income do not pay income tax; rather the unit holders pay all of the tax. This is seen to be more efficient than the corporate-type investment since corporations pay tax on their income, whether or not it is distributed to its shareholders as dividends, and shareholders pay an additional income tax on the dividends they receive. The benefit of the income trust becomes especially clear when the units are held by entities that do not pay income tax, such as pension plans and RRSPs. In this case, the trust income flows into the plan without incidence of taxation until it is paid out to the beneficiaries of the plan.

In September 2005, the Department of Finance issued two announcements concerning income trusts. First, it stated that it would conduct a study on how best the income tax system should apply to trusts. Among the concerns it cited were the increasing annual loss of tax revenue and the notion that the income trust as the choice of the business entity is harmful to for the Canadian economy because these trusts are required to pay out all of their income each

year and this requirement does not leave businesses with enough room for growth.

The second announcement was that there would be a moratorium on the issuance of advance tax rulings by the CRA on the formation of income trusts. These rulings are the lifeblood of many trusts because they give investors the certainty that the income tax consequences to the trust and to investors will be as predicted. Nevertheless, the formation of many trusts should be able to proceed without the government's blessing.

On November 23, 2005, the government responded. It proposed to reduce the effective tax rate on dividends received by individuals from Canadian public corporations after 2005. Only time will tell if this will have the effect of levelling the playing field between income trusts and corporations.

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## MAKE YOUR INTEREST DEDUCTIBLE

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sonal residence with the borrowed funds, and as such the funds had not been used for an income earning purpose. Although the lower court sided with the CRA, the decision was later overturned on appeal. The high court stated that each of the two borrowing transactions had to be viewed independently. From this perspective, the money borrowed from the bank could be traced directly to the injection of funds into his law firm from which it was not disputed that he would earn business income subject to tax.

The importance of determining the **direct use** of borrowed funds has now been recognized by the CRA and remains the key to successful interest deductibility planning. The CRA further acknowledges its acceptance of the notion that taxpayers may plan their affairs to be

able to trace borrowed funds directly to a business use to obtain interest deductibility. Although it admits that it may allow a more flexible approach to its policy when funds from different sources are commingled, taxpayers will be served best by ensuring that they can trace a business or investment expenditure back to the borrowed funds.

It should be noted that the nature of the security given for a loan is not the determining factor for deductibility. For example, say an individual mortgages his home to secure a loan for the purpose of earning investment income. Despite the fact that a personal-use asset was pledged to obtain the loan, the direct use of the funds is nevertheless an investment asset so the interest would be deductible.

When the direct use of the funds changes, the current use of the funds, and not the original use, will be determinative. For example, say the original direct use of the funds was to purchase an investment that is expected to generate taxable income. Subsequently, the investment is sold and the proceeds of sale are reinvested in a vacation home. In this case, the current use is no longer to earn income and any interest paid thereafter on the loan will cease to be deductible. When the proceeds of sale are less than the amount originally invested, the result is less obvious however. Some of the borrowed money will have clearly disappeared. The general rule of thumb is that interest on the portion of the borrowed money that has evaporated will continue to be deductible until repaid but there are exceptions and each case has to be looked at carefully.

### **The Government Responds**

In October 2003, the Department of Finance proposed an amendment to the *Income Tax Act* designed to take effect in January 2004. Under this proposal, interest and other expenditures would cease to be deductible in the absence of a "reasonable expectation of profit" from the business or investment. The test was to be

applied annually and would look to the net expected profit over the entire life of the business or investment. In other words, if it were reasonable in one year to expect a profit from a business or investment project over its entire life, a net loss from the project in that particular year would be deductible. However, if circumstances changed the following year such that there was no longer an expectation of profit, a net loss incurred in that year would not be deductible.

What may come as a surprise to many is that the expected net profit used in this test excludes any anticipated future capital gains when the investment is sold.

The government's response was in large part a reaction to another Supreme Court decision in *Ludco Enterprises Ltd. vs. the Queen*<sup>2</sup> in which the court concluded that the term "income" does not refer to net income, but to "income subject to tax". In this case, the taxpayer earned far less income than what he paid as carrying costs of the loan, although he did realize a substantial capital gain when he sold it. As he had earned at least some income, the high court sided in his favour.

The government's proposed amendments were heavily criticized and were never passed into law. The latest overtures from the Department of Finance indicate that a future amendment to the *Income Tax Act* will focus on the issue raised in the Ludco case, namely that expenditures will be deductible only to the extent that they were intended to generate a net profit.

### **Quebec's Approach to Interest Deductibility**

In its March 2004 budget, Quebec proposed its own limitation to the deductibility of interest payments. Under these rules, investment expenses, including interest, would be deductible only to the extent of investment income. Any excess of investment expenses

over investment income could henceforth be carried back to any of the three preceding taxation years or carried forward indefinitely to be applied against net investment of those other years. This measure would not apply to interest incurred to earn business income or rental income. This new limit applied on a transitional basis for 2004 and will apply fully in 2005.

As Quebec usually harmonizes its legislation with federal legislation, it will likely adopt the federal rules as well as its own. Therefore, interest expenses that do not meet the federal standard for deductibility will not be deductible and, for those that do meet the federal standard but that exceed investment income, the deduction will be deferred to another year.

Whereas the federal approach is designed merely to prevent taxpayers from deducting interest where there is no net profit motivation, Quebec's approach may unfortunately discourage legitimate risk-taking by investors whose motivation may have depended in part on the ability to deduct their interest payments before an investment bears fruit.

### **Make it Deductible**

Taxpayers who must borrow should try to arrange their affairs to ensure that interest payments can be deducted. For example, when faced with both a business expenditure and a personal expenditure with a borrowing requirement, they should ensure that available funds are used first for personal expenditures and so that borrowed funds can be used for business expenditures.

Sometimes it may be necessary to go to greater lengths to achieve this goal. Say an individual owns a portfolio of marketable securities and has no outstanding debt. Say also

that the individual wants to purchase a personal residence and has little cash available with which to do it. If he borrows to buy the home, the interest will not be deductible. On the other hand, he could sell the portfolio to generate the cash he needs to buy the home and then later borrow money to repurchase the securities. However, he may not want to do so because he does not want to trigger any capital gains on the securities. An effective strategy would be for the individual to sell his portfolio to his spouse. The spouse could borrow to finance the purchase of the securities and eventually use the home as collateral for the borrowing if necessary. Interest payments should be deductible in this case. Meanwhile, the sale of the portfolio for cash would leave money in the individual's hands and if this were sufficient to buy the home he would not need to incur non-deductible interest. The sale of marketable securities between spouses would be eligible for a spousal rollover such that no gain or loss would be recognized on the transfer although spousal income attribution may apply thereafter.

<sup>1</sup> 2001 SCC 61

<sup>2</sup> 2001 SCC 62

#### WHAT'S NEW

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