# A warning on interest deductibility

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If you have borrowed money to invest, and hope to write off interest expenses come tax time, you need to be particularly careful when you invest those borrowed funds in mutual funds that distribute return of capital (ROC). This scenario typically arises when a fund distributes more cash than its combined income and realized capital gains in a particular year.

An ROC distribution is not immediately taxable, but it reduces the adjusted cost base (ACB) of the units held, thus generally increasing the capital gain (or reducing the capital loss) that will be realized when the units are redeemed. The amount of any ROC is shown in Box 42 of the T3 information slip.

If the total amount received as ROC ever exceeds the ACB of the units you acquired (which includes not just the original cost but also reinvested distributions), the tax rules deem the excess (the negative ACB) to be a capital gain, which must be included in your income for the year in which the excess arose.

A decision of the Tax Court (*Van Steenis v The Queen,* 2018 TCC 78) concerned a taxpayer who borrowed $300,000 to purchase units of a mutual fund. Each year from 2007 to 2015, the taxpayer received an ROC from the fund, which totaled $196,850 over those years.

The taxpayer used some of the ROC to reduce his loan’s outstanding principal, but used the majority for personal purposes. Each year on his return, the taxpayer deducted 100% of the interest paid on the loan.

The Canada Revenue Agency reassessed his 2013, 2014 and 2015 tax years and denied a portion of the interest deducted, saying he was not entitled to deduct interest relating to the returns of capital that had been used for personal purposes, “as the money borrowed in respect of those returns of capital was no longer being used for the purpose of gaining or producing income.”

Under the *Income Tax Act*, interest is only deductible if “paid on borrowed money that is used for the purpose of gaining or producing income.”

Years ago, in a seminal decision, the Supreme Court of Canada summarized the four requirements that must be met for interest expenses to be tax deductible:

1. the amount must be paid in the year;
2. the amount 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 non-exempt income from a business or property; and
4. the amount must be reasonable.

In the case, the Tax Court had to decide whether, under the third requirement, there was “a sufficient direct link between the borrowed money and the current use of that money to gain or produce income from property.”

The taxpayer argued he had met this requirement since the money was borrowed for the purpose of buying the mutual fund units. He maintained that, since he continued to own all the units, “his current direct use of the borrowed funds is still [the] … same … [and] … that he is therefore entitled to deduct all of the interest payments on those funds.”

The judge disagreed, finding that almost two-thirds of the money that he invested over the years was returned to him and more than half of that returned money was put to use for personal purposes. In the tax years under review, as the judge wrote, “that was its current use. As a result […] there was no longer any direct link between those borrowed funds and the investment.”[1]

The judge distinguished between income distributions and an ROC, saying the taxpayer would have continued to be able to deduct 100% of his interest payments if he had received income distributions that he used for personal purposes.

In other words, unless ROC distributions are reinvested in either the same fund or another investment, the interest on the portion of the borrowed money that relates to those distributions would no longer be tax deductible since the funds are no longer being used for an income-earning purpose.

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1 The taxpayer attempted to appeal this decision to a higher level court, but leave to appeal was not granted.