VIEWPOINT 2015 JAN 14

LEVERAGED LIFE INSURANCE

TIPS FOR DEDUCTING PERSONAL LOAN INTEREST

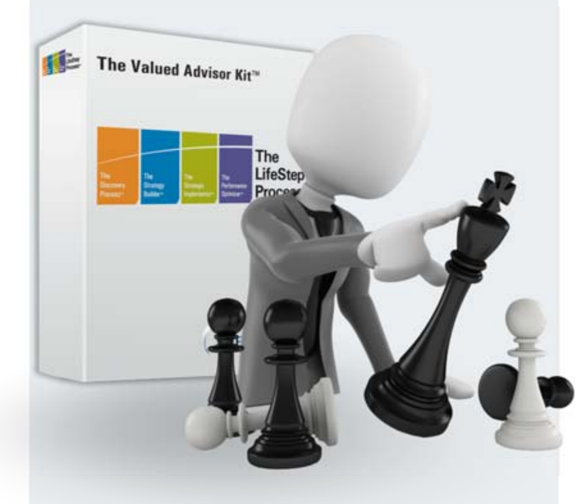
WESTWARD'S VIEW

Private corporations and their shareholders often struggle **balancing the competing demands** of (1) financing the business, against (2) financial security and retirement planning.

These competing demands are often resolved with **leveraged life insurance**. The life insurance policy's death benefit provides financial protection against the potentially catastrophic losses that might arise on the death of the shareholder. The policy enables tax deferred cash accumulation for retirement planning. And the policy can be used as a financial asset to secure immediate loans to finance the business. This flexible tool helps bridge the entrepreneur's current business cash flow demands with the financial needs of the future.

When leveraging life insurance, it is wise to plan ahead to **ensure interest on the loan remains tax deductible** while the loan is outstanding.

This Viewpoint discusses planning for **two key interest deductibility requirements**, and what we generally suggest to clients who are leveraging life insurance.



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Money Borrowed Personally to Finance the Company
Shareholders of private corporations often draw personal loans from third party lenders to finance business and investment activities. The interest on such loans is generally tax deductible because the borrowed money is typically used for the purpose of earning income from a business or property.[1] The property in question may be shares or debt of their private corporation. The characteristics of shares or debt issued to the borrower should be planned to preserve interest deductibility for the borrower. This Viewpoint addresses two key deductibility requirements:

1) Continuous tracing of the borrowed money to the property while the loan is outstanding; and
2) Evidence that the property is held for the purpose of earning income.

Continuous Tracing
Several decisions of the Supreme Court of Canada **(SCC)**, notably *Canada Safeway*, *Bronfman Trust* and *Shell*, have made it clear that the relevant use is the current use and not the original use of borrowed money.[2] Therefore, the borrower must be able to show that the borrowed money was used to hold the property *continuously* if the interest deduction is to succeed. The onus is on the borrower to establish continuous tracing when queried by the Canada Revenue Agency **(CRA)**. When planning what type of property to issue for the financing, bear in mind that some properties are better able to show this continuous tracing than others. Continuous tracing of borrowed money to a dedicated class of shares will probably be far easier than continuous tracing of borrowed money to a shareholder loan account that fluctuates throughout the year.

Income Earning Purpose
Whether the purpose of holding the property is to earn income is a question of fact. Such purpose may exist despite the absence of any income earned on the property in a taxation year. The SCC decision in *Ludco* clarified that the purpose test is *"whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment is made" and "income refers to income generally, that is an amount that would come into income for taxation purposes, not just net income."* [3]

Leveraging Life Insurance
Shareholders of private corporations often leverage life insurance policies to finance their corporations. When assisting clients in this, we often suggest acquiring the following property to most easily satisfy the two deductibility requirements discussed above:

1) ***A dedicated class of preferred shares*** to make it easy to continuously trace the borrowed money to the property being held; and
2) ***A non-cumulative flexible dividend rate*** as declared by the directors from year to year so that the property produces income for the shareholder within the financial means of the corporation.

There must be a reasonable expectation at the time of acquisition that the preferred shares will indeed pay *some* dividends, and a history of paying dividends will go a long way to supporting that expectation.

Audit Support
Westward's *Performance Optimizer*™ service for clients includes assistance to support interest deductions claimed on leveraged life insurance. If queried by the CRA, we assemble a document package tracing the borrowed money to the property acquired and the related interest expense, and deliver the package to our clients' tax advisors for review and delivery to the CRA.

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[1] See 20(1)(c)(i) of the *Income Tax Act.*

[2] See paragraph 17 of *IT-533 - Interest Deductibility and Related Issues*, October 31, 2003.

[3] See paragraphs 9 and 10, *Ibid,* and 2001 SCC 62 *Ludco Enterprises et al v. The Queen*.