Occasionally I get asked about borrowing to invest. Or, when an inheritance or other windfall comes along, whether it is better to pay off debt with the proceeds, or invest it. My answer is usually not a so much calculated as personal. Sure, interest rates have been very low for several years, while market returns have been higher on average, but can you sleep at night with the debt hanging over you?

If that question doesn't spur an answer, and it is still a tossup, just pay down the debt and don't look back. Nearly all my clients are debt free, except maybe a modest mortgage here and there.

It is important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines.

Occasionally the right combination of risk appetite, age and personality result in a decision to hold personal discretionary debt in one hand, and investments in the other. Some tax considerations follow.

How to avoid the attribution rules and keep your interest deductible

In many cases a line of credit from a financial institution is secured by the equity in the family home. This is generally referred to as a home equity line of credit, or HELOC. Where one spouse borrows funds against the HELOC to invest in a portfolio of income-producing assets, would there be attribution of the income earned or capital gains generated on the invested assets? Who would be able to deduct the interest expense?

The Canada Revenue Agency (CRA) has provided guidance in this area.

Let's take the situation where spouses or common-law spouses acquired a home for which one spouse (Mr. Jones) contributed the majority of capital needed to acquire the home. The couple then obtained a joint HELOC which was secured by the equity in that home. The other spouse (Mrs. Jones) then borrowed funds against the joint HELOC to invest in a portfolio of income-producing investments solely in her name.

The Attribution rules

In order to avoid the attribution rules, it is important that the interest charged on the joint HELOC is at least equal to the CRA-prescribed rate in effect at the time Mrs. Jones borrowed the money. It is also essential for Mrs. Jones to use her own money to pay the loan interest within 30 days after the end of the year (i.e., January 30th). If Mr. Jones makes even one interest or principal payment for the year on the joint HELOC, any income earned or capital gains generated from the borrowed funds will be attributed back to Mr. Jones in that particular year and every succeeding year that the loan is outstanding.

The fact that Mr. Jones contributed more to the purchase of the home on which the HELOC is secured should not, in and of itself, result in attribution. The attribution rules generally apply where an individual is obligated (either absolutely or contingently) to repay all or part of the loan, including any interest, should the borrower default on payments. Where an individual provides security for a loan, co-signs a loan, or guarantees a loan, they are generally obligated to repay all or part of the loan should the borrower default. In our example, even if Mr. Jones guarantees the repayment of Mrs. Jones' loan by virtue of providing the loan security or being joint on the loan, attribution would not apply to the income earned or capital gains generated on the invested joint HELOC funds, provided Mrs. Jones pays the interest on the joint HELOC loan within 30 days after the end of each year.

The interest Deductibility Rules
Provided attribution does not apply, Mrs. Jones should also be able to deduct her interest payments for tax purposes if the borrowed money from the joint HELOC is used for the purpose of earning income in her own hands - buying a portfolio of income- producing investments. On the other hand, if Mr. Jones borrowed the funds from the joint HELOC and used them to purchase a portfolio of income-producing investments in the name of Mrs. Jones, the attribution rules would apply because that would constitute a transfer of funds from Mr. Jones to Mrs. Jones. Further, since Mr. Jones would not be using the funds for the purpose of earning income in his own hands, the interest he paid would not be deductible for tax purposes.

Conclusion
This article is only a very brief overview in applying the attribution and interest deductibility rules with respect to borrowing using joint lines of credit. However, it should be noted that these conclusions are based on a specific situation that was brought to the CRA for interpretation. Whether attribution applies to your situation and whether interest would be deductible can only be decided on a review of all the relevant information of your case. If you are contemplating borrowing from a joint line of credit, it is crucial that you confirm the implications with your qualified tax advisor.

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