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Joint Lines of Credit and the Attribution Rules

IT'S LIKELY THAT HUNDREDS OF THOUSANDS OF Canadian families have one or more lines of credit, and in many cases the family's line of credit is secured by the equity in the family home – generally referred to as a home equity line of credit, or HELOC. With interest rates continuing to be at historic lows and the stock market once again making gains, many of those taxpayers may once again be tempted to use that HELOC as a source of investment funds. Where both spouses have access to the HELOC, questions can arise as to the allocation for tax purposes of investment gains and/or interest deductions on such HELOC funds used for investment purposes.

The Canada Revenue Agency was recently asked about the application of the tax rules where one spouse contributed the bulk of funds needed to purchase a home, a joint line of credit (HELOC) was obtained and secured by the equity in that home, and the other spouse then planned to borrow against the HELOC to obtain funds that were invested in the investing spouse's name.

The Canadian Income Tax Act contains a relatively complex set of rules, known as the attribution rules, that generally seek to prevent related taxpayers, including spouses, from transferring or loaning property between them in order to reduce the tax payable on any investment returns or capital gains earned on the transferred property. The question put to the CRA was whether, on the facts outlined above, the fact that one spouse had contributed most of the capital needed to buy the home (thereby creating the home equity that was used as security for the HELOC) would result in the application of the attribution rules when the non-contributing spouse

subsequently used HELOC funds to invest and earn investment income.

The CRA's basic response was that the fact that one spouse had made a disproportionate contribution to the acquisition of the property on which the HELOC was secured would not result in the automatic application of the attribution rules. The reasoning behind its conclusion is that the basic rule with respect to spousal attribution requires that there be a "transfer or loan" between spouses. In the Agency's view, where one spouse does not contribute any funds to the purchase of a property, but ownership is jointly registered to both spouses, there has been a transfer of property from one spouse to the other at the time of purchase. However, the provision of collateral (in the form of home equity) for a loan does not, in the CRA's view, constitute a loan or transfer of property. Therefore, the fact that the joint HELOC was secured by the family home for which one spouse contributed most of the capital would not, in and of itself, result in the application of the attribution rules.

While the CRA's response was qualified good news for taxpayers, the Agency did also say that with respect to the actual use of the joint HELOC as a source of investment funds, it was a question of fact whether the attribution rules would apply. It went on to give examples of circumstances in which investment of funds borrowed from the HELOC could attract the application of the attribution rules – for example, where the contributing taxpayer borrowed funds and used them to buy a portfolio of income-producing investments in the name of the

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other spouse, or where the contributing taxpayer paid or was obligated to pay any portion of principal or interest with respect to funds borrowed by the spouse from the HELOC. The Agency also invoked the spectre of the possible application of the general anti-avoidance rule. In other words, each borrowing, investment, and repayment arrangement would have to be structured very carefully both to ensure strict compliance with the specific requirements of the attribution rules and to stay clear of any anti-avoidance rules that the CRA might view to be applicable in the circumstances.

It seems clear that while the creation of a joint HELOC in the basic circumstances outlined above would not run afoul of the attribution rules, the CRA will examine very closely any arrangements that involve the use of

such funds for investment purposes by spouses, and will invoke the attribution rules where it can. Taxpayers who are considering utilizing such arrangements will need to be painstaking in ensuring that each spouse's borrowings, repayments, and repayment obligations are kept entirely separate and that documentation is thorough and detailed. They would also be well advised to consult with a tax professional prior to implementing any such arrangement.

The information presented is only of a general nature, may omit many details and special rules, is current only as of its published date, and accordingly cannot be regarded as legal or tax advice. Please contact our office for more information on this subject and how it pertains to your specific tax or financial situation.