
Many of you are already deducting mortgage interest on your investment properties, but what about mortgage interest on your principal residence? Tax lawyer Marshall Haughey answers.

For most of us, a mortgage is an inevitable part of owning real estate. But this is not all bad since leveraging your investment is how you earn superior returns on your money. From a tax perspective, the most important quality of a mortgage is that the interest charged is deductible.

## INTEREST DEDUCTIBILITY

The Income Tax Act allows you to deduct interest paid on money borrowed for the purpose of earning income from a business or property. Canadian courts have interpreted this rule to mean that interest on borrowed money will be deductible where its "direct use" is to acquire business or property assets.

An important Supreme Court of Canada case called Singleton gave us the "direct use" test. The case involved a taxpayer, who was a partner in a law firm, that devised a clever way to deduct mortgage interest. The taxpayer wanted to purchase a home as a personal residence, but knew that the interest on the mortgage would not be deductible. Instead of getting a mortgage to buy the home, he removed $300,000 of equity from his law firm to pay for the house.

Then, on the same day, he mortgaged the house and invested that money back in the law firm. The CRA argued that all the taxpayer did was shuffle cheques, and the economic realities of the transactions were that the taxpayer borrowed money to buy a house so the interest should not be deductible. However, the Supreme Court disagreed, allowed the interest deductions, and gave us the direct use test to determine interest deductibility.

## SCENARIOS

Let's examine four different scenarios involving borrowed money and investment properties.

### 1 MORTGAGE TO BUY AN INVESTMENT PROPERTY

This is the most straightforward scenario that many will be familiar with. When you take on a mortgage to buy a rental property, the direct use of the borrowed funds will be to earn investment income. Thus, the interest will be deductible for tax purposes.

### 2 REMORTGAGE INVESTMENT PROPERTY TO BUY ANOTHER INVESTMENT PROPERTY

In this situation I am assuming you already own one rental property (Property No. 1) and would like to buy another rental property (Property No. 2). You can remortgage Property No. 1 (or take out a HELOC) and use that money to finance the purchase of Property No. 2. Borrowing against Property No. 1 in this manner is done in order to come up with a down payment to buy Property No. 2 since you are generally only allowed to borrow up to 80 per cent of the value of a rental property. In this scenario, the interest paid on the mortgages on Property No. 1 and Property No. 2 will be deductible since the direct use of these funds was to buy Property No. 2.

It should be stressed that just because you remortgage or take out a HELOC on a rental property, this does not automatically mean the interest will be deductible for tax purposes. Again, it comes down to the direct use of the borrowed funds. I have heard people say that it is better to borrow money by mortgaging a rental property instead of your personal property because the interest will be deductible. This is not correct.

### 3 MORTGAGE YOUR PERSONAL RESIDENCE TO BUY A RENTAL PROPERTY

This is similar to scenario two, except that instead of using a rental property to secure a mortgage to buy another rental property, use your principal residence as collateral. As long as the borrowed money is used to purchase an investment property, the direct use test will be satisfied and the interest will be deductible.

### 4 MORTGAGE ON A NEW PERSONAL RESIDENCE

The Singleton case shows that if you want to purchase a new personal residence, and you have some other income producing assets, you can withdraw capital from or sell those assets to buy the new personal residence then mortgage the residence to reacquire the income-producing assets. Such a series of transactions will satisfy the direct use test and the interest on the mortgage on your home will be fully deductible. It is advisable to make sure no tax consequences will result from withdrawing capital from or selling the income-producing assets.

What about the situation where a person with a personal residence (Property No. 1) wishes to buy a new personal residence (Property No. 2) and will turn Property No. 1 into a rental property? This is more difficult. If you take on a mortgage to buy Property No. 2, the direct use test will not be satisfied. Similarly, if you remortgage Property No. 1 to buy Property No. 2, the direct use test will still not be satisfied. How does one solve this predicament?

**It is advisable to make sure no tax consequences will result from withdrawing capital from or selling the income producing assets**

The following steps could be undertaken to ensure that the mortgage interest is deductible:

On day one, purchase Property No. 2 and take out a mortgage to finance the purchase (Property No. 2 mortgage).

Also on day one, sell Property No.1 to a friend or relative (the temporary purchaser) at fair market value. The temporary purchaser will pay the purchase price by giving you a promissory note.

On day 2, purchase Property No. 1 back from the temporary purchaser and take out a mortgage to finance the purchase (Property No.1 mortgage).

The proceeds of the Property No. 1 mortgage will be paid to the temporary purchaser to satisfy the purchase price of buying back Property No. 1.

The temporary purchaser will then transfer these funds back to you to pay off the promissory note.

You will then take these funds to pay off the Property No. 2 mortgage.

All of these steps can be completed without tax consequences to you or the temporary purchaser and actual transfers of land between the parties should never need to be registered.

The foregoing steps allow you to effectively finance the purchase of Property No.2 while satisfying the direct use test. This is so because the direct use of the proceeds from the Property No. 1 mortgage will be used to purchase Property No. 1, which is now a rental property.

If you decide to undertake this process, engage legal counsel to ensure every step is properly documented. Depending on which province Property No. 1 is in, the transfers between you and the temporary purchaser may be subject to land transfer tax. It is advisable that this be confirmed by your real estate lawyer before undertaking these transactions. ■

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