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It's in Your Interest to Make it Tax Deductible

Tax strategies for individuals and businesses are aimed at minimizing income taxes using the allowed rules and regulations.

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What else is available to an employee whose income is generated just from employment?

In my 20 years of public practice, I have seen individuals starting small businesses without a reasonable expectation for profit or investing in rental properties with negative cash flows so they can write off the losses against their employment income. In the end, they are spending $100 to save at most $43 in income taxes, leaving them with a negative cash flow of $57. I joke with my clients, telling them they can write me a cheque for additional accounting services so they can save more taxes!

The typical family today

- owns a home that was purchased using mortgage financing,
- has RRSP funds that are purchased on a monthly basis to dollar cost average, and
- owns nonregistered investments that pay regular dividends.

Unfortunately, the interest paid on the mortgage of the principal residence is not deductible for income tax purposes.

- Paragraph 20(1)(c) of the *Income Tax Act* specifies that for interest to be deductible, the amount must be pursuant to a legal obligation and the amount must be reasonable.
- Further, borrowed money must be used for earning income from business or property.
- The *Income Tax Act* requires tracing the use of the borrowed funds to a specific eligible use. There must be a direct link between the borrowed money and an eligible current use; the money must be used for the purpose of earning income from a business or property. For example, if a taxpayer borrows money to invest in rental property or in the stock market, the interest paid is deductible.

What strategies are available to convert mortgage interest to tax-deductible interest?

Debt Conversion

- If you have nonregistered investments, you can sell them and pay down the mortgage with the proceeds.
- Immediately re-borrow the same amount to invest. The interest payments on the new loan will now be deductible because the funds are used directly to earn income.

Are there other tax consequences with that strategy?

- The sale of the investment may trigger a capital gain; that can be a good thing, if you have available capital losses from other years.
- There could also be transaction costs involved with the sale of the investments, but the benefit of the interest tax deductibility may outweigh the cost.

The Smith Manoeuvre

- This strategy involves borrowing from the available equity in the home.

- As you gain equity with each mortgage payment, you re-invest the money.

For the Smith Manoeuvre, the current mortgage must be linked with a credit line. With each mortgage payment, the principal is paid down; that provides more available credit on the credit line, which can now be invested.

For example, if the mortgage payment is $2000 per month and the principal portion is $1000, you can borrow $1000 from the credit line to invest. That strategy achieves some objectives.

1. The mortgage payments are slowly converted from non-tax-deductible to tax deductible, as you re-invest the principal repayment.
2. Funds are invested to provide for retirement.
3. Investments are purchased regularly on a monthly basis (or biweekly), benefitting from the dollar cost averaging rather than investing one lump sum.

The downside of that strategy is you still have to pay interest on the line of credit. You can, however, borrow from the credit line to pay the interest on the credit line; that requires zero cash flow.

If the bank does not allow borrowing from the credit line to pay its interest, then you can pay the interest from your chequing account and borrow the same amount from the credit line to replenish your bank account.

Debt Consolidation

If you have other personal debts and home equity available, you can consolidate all the debts into your mortgage so that, over time, you can convert all the personal non-tax-deductible debt to tax-deductible interest. That is done using the same Smith Manoeuvre strategy.

Some key tax issues must be considered to maintain the tax deductibility of the interest.

a. It is critical that the money borrowed can be traced to the investment purchased.

b. Nondeductible debt must be kept separate from deductible debt.

c. There must be a current use of the money borrowed for investment purposes. If the leveraged investment is sold and the proceeds are not used to pay down the loan, the interest on the loan is no longer deductible because the current use of the money is no longer for investing.

d. The investment purchased with borrowed money cannot be in RRSPs or TFSs.

e. There must be a reasonable expectation of income—the investment is expected to pay some dividend or interest at some time. All the stocks and mutual funds would meet that requirement unless the prospectus prohibits paying dividends.

f. When the investment is sold, the lower **of the original cost** or **the proceeds** must be used to pay down the loan—or the interest on that amount becomes nondeductible.

g. When dividend or interest income is received on the investment, that income does not have to be used to pay down the loan. If, on the other hand, the payment from the investments is considered return of capital, that amount must be used to pay down the loan or the interest on that amount is no longer deductible.

Borrowing to invest is inherently risky and should never be done only for the tax deductions. It is generally suitable for more aggressive investors with a long-term view. It is highly recommended that you consult professional advisors before embarking on those types of strategies. ▲

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