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USE OF LOAN KEY TO TAX DEDUCTION

Home-equity lines of credit (HELOCs) are popular for financing not only the equity in your home but also to fund a variety of other things, including "boats and cars and big-screen TVs."

Tax planners are often besieged with questions from clients who have taken out a HELOC or a mortgage and are wondering whether, given their own set of circumstances, some or all of their interest expense is tax-deductible.

The ability to write off interest paid on a loan has its origins in the Income Tax Act, which states that if funds are borrowed for the purpose of earning business or investment income, the interest paid on such funds is tax-deductible.

The Canada Revenue Agency has frequently been asked to comment about restructuring arrangements and whether interest could be tax-deductible.

In one particular case posed to the CRA, the taxpayer, who we'll refer to as Joey, wanted to buy a new home and rent out his current home, valued at $700,000, which was fully paid off and thus unencumbered by a mortgage.

If he simply went to his lender to secure financing on his new home, the interest on his new mortgage wouldn't be tax-deductible since he was not borrowing for the purpose of earning income but rather was borrowing to purchase his new principal residence – a personal property.

Instead, Joey, with the advice of his astute tax advisor, decided to sell his principal residence to his parents for the fair market value of $700,000. His parents, not having the $700,000 cash lying around to cover this purchase, paid him by way of a promissory note.

Joey then obtained a mortgage or HELOC and used the proceeds from this loan to buy back the house from his parents, to use as a rental property. His parents used the proceeds of the loan to pay off the promissory note. Joey, then flush with cash, used the re-acquired property for rental purposes and purchased his new principal residence with the cash.

The reason for these complex manoeuvrings was to ensure Joey met the "direct use test" as outlined in the CRA's interpretation bulletin on interest deductibility, which states that in determining what borrowed money has been used for, the onus is on the taxpayer "to trace or link the borrowed money to a specific eligible use, giving effect to the existing legal relationships. " The bulletin goes on to say that "a taxpayer may restructure borrowings and the ownership of assets to meet the direct use test."

As a result, the CRA blessed Joey's proposed transactions and said the mortgage or HELOC interest would indeed be tax-deductible.

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