

# Investment loans can still be used to write off mortgages

'Smith Manoeuvre' holds up in CRA challenge

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Last week the Supreme Court clarified that interest on investment loans is tax deductible, but that doesn't apply to certain complex schemes designed to make mortgages tax deductible.

My first impression when I heard this was that the so-called Smith Manoeuvre--described in a book of the same name -- might be in jeopardy. It is the one popular scheme to make Canadian mortgages tax-deductible.

However, author Fraser Smith says that is not the case, a stance confirmed by tax experts.

As I've written in the past, the Smith Manoeuvre is perfectly legal. Whether it's advisable or not is another question. I've always advocated what I call a "half Smith," which is the age-old principal of paying down a mortgage as quickly as possible. The real "manoeuvre" arises with the second part, which involves borrowing to invest in stocks, deducting the interest cost on that loan and pumping the resulting tax refund into mortgage paydowns. The net result lets Canadians achieve what Americans enjoy as a matter of course: tax-deductible mortgage interest on a principal residence.

While the Smith Manoeuvre may still fly, some variants that fall afoul of the Canada Revenue Agency's General Anti-Avoidance Rule (GAAR) may not. In reviewing complex transactions made by Earl and Jordanna Lipson in 1994, the Supreme Court upheld the Tax Court of Canada's earlier denial of their attempt to deduct interest on a \$562,500 mortgage. The tax authorities objected to Jordanna Lipson first borrowing that amount to buy her husband's shares in the family investment company at fair market value. The tax rules allowed the shares to automatically roll over from Earl to Jordanna, and no capital gains were realized or reported.

Earl then used the \$562,500 received from Jordanna to buy the home. They got a mortgage for the same amount to repay the share loan in full. The couple tried to deduct the mortgage interest in tax returns filed between 1994 and 1996, and reported the taxable dividends on the shares as income.

The Income Tax Act lets Canadians deduct interest expenses on loans when funds are borrowed for the purpose of earning income, but "the twist in this case was that the interest expense attributed back to Earl under the attribution rules," says Jamie Golombek, managing director, tax and estate planning for CIBC. This "misuse" of the attribution rules left the couple vulnerable to the anti-avoidance rules, undermining what was otherwise a legitimate set of transactions.

The other part of the Supreme Court's take on the Lipsons is more positive for investors. The narrow four-to-three decision affirmed that Canadian investors can still borrow money against the equity in their homes, use the proceeds to invest in stocks (or equity funds or ETFs), then write off the interest for tax purposes.

The Lipson case was a variant of an earlier case involving lawyer John Singleton, whose "Singleton Shuffle" was upheld by the Supreme Court in 2001. Golombek describes the shuffle as a "plain-vanilla debt swap" strategy. It's the basis for the common move of selling off non-registered investments, using the proceeds to pay off a mortgage, then borrowing (with the loan secured by the home) to repurchase the securities. The effect, as with Smith, is to make the interest on the investment loan tax deductible.

"If I borrow and invest, I get a tax deduction," Smith says. "In my manoeuvre, I prefer to use the house as a vehicle to get the money to make the investment. But it has nothing to do with tax deductibility per se. To this day, I've not seen any client attacked by the CRA on the Smith Manoeuvre, and I've been doing it 24 years."

Doug Carroll, vice-president of tax and estate planning at Invesco Trimark, says the Supreme Court's ruling shouldn't impact either "the simple kind of Smith Manoeuvre or the Singleton Shuffle, whichever you call it." He says Singleton succeeded because a clear tracing of each step occurred.

Even with the Lipsons, the court said it had no problem with the Singleton-type transactions. The Lipsons got into hot water only because they tried to go the extra step and attribute the interest expense to husband Earl. That stirred up the GAAR, but according to Carroll, "it only meant that portion of it was offside. The other part, interest deductibility for investing in the shares she bought from Earl, is OK. She can deduct that."

The more investors move away from the basic Singleton or Smith framework, the more they invite scrutiny from the tax authorities, Carroll says. - Jonathan Chevreau, author of *Findependence Day*, blogs at [www.wealthyboomer.ca](http://www.wealthyboomer.ca).