Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Interest deductibility when swapping your principal residence and rental property

Suppose you own a home that is free and clear of any mortgage as well as a rental property on which there is a mortgage. Let's assume the interest payments on your rental property mortgage are currently tax-deductible. What would happen if you wanted to switch the properties so that you would now live in the rental property and rent out your principal residence? How could you ensure that the interest on your mortgage continues to be deductible? This article discusses the interest deductibility rules as they relate to swapping your principal residence and rental property.

The direct use test

In order to deduct the interest on your mortgage, the direct use of the money you borrowed must generally be for income-producing purposes. If you are currently deducting interest relating to a mortgage on your rental property but you change the use of your rental property to a principal residence, you will no longer meet the direct use test. The money borrowed will now be directly used for non-income producing purposes (i.e. the mortgage was used to purchase your principal residence) and the interest will no longer be deductible.

Even if you refinance your holdings and mortgage your principal residence (which you will be turning into a rental property) and use the funds to pay off the mortgage[1] on your rental property (which you intend to be your new principal residence), the interest would no longer be deductible. This is because the newly borrowed money is directly used to pay off a mortgage on your new principal residence and cannot be viewed as being used to purchase a property to earn income.

1 Subject to your financial institution's lending rules and guidelines. Prepayment charges may apply.

The strategy

It's possible to maintain the interest deductibility of the interest payments on your mortgage when swapping your principal residence and your rental property. The 2009 Tax Court of Canada case *Sherle v. The Queen*[2] examined such a situation and concluded that it's possible to maintain interest deductibility following the swap of a principal residence with a rental property if steps were taken to meet the direct use test. A taxpayer could consider the following:

- Sell Property A (the principal residence which will become a rental property), to a trusted friend, in exchange for a promissory note
- Arrange for a new bank loan[3] (i.e. mortgage) to buy back Property A from the friend. This bank loan would be secured by Property A
- Use the proceeds of the bank loan to pay the friend as consideration for the buyback. The friend uses the proceeds to pay off the promissory note previously issued to the taxpayer on the purchase of Property A
- The proceeds from the promissory note are used to pay off the mortgage on Property B (the rental property that is becoming the principal residence)

Afterwards, the only remaining loan would be the mortgage used to acquire Property A, the rental property. The direct use of the borrowed money is to buy an income-producing rental property, and as such, the interest may be deductible for tax purposes.

If you're contemplating implementing such a strategy, you should consult with a legal or tax advisor. Please note that in addition to income tax implications on the sale of a property, there may also be land transfer tax implications.

An alternate situation

In the situation examined in the previous section, you owned your principal residence free and clear of any mortgage. In order to make the interest deductible after the swap, you needed to restructure your financing arrangements.

Instead, take the situation where you have a mortgage on your principal residence and the interest paid on that mortgage is not deductible. You decide you want to move to a different house that would better satisfy your needs, but you still want to keep your former principal residence and rent it out. In this situation, interest on the mortgage would begin to be deductible once you change the use of the property from personal to rental. This is because it's the current use of the borrowed funds (and not the initial use) that determines whether the interest paid is deductible for tax purposes. If it's determined, following a change in use, that the borrowed money is linked directly to an income-producing property, the interest payments will generally be deductible.

Where you own a principal residence and decide to start using the property as a rental property, you should be aware of the change in use rules. Similarly, where you own a rental property and decide to start using it as your principal residence, you have changed the use of the property and may be affected by the change in use rules.

Tax implications of a change in use

Where you own a principal residence and decide to start using the property as a rental property, you should be aware of the change in use rules. Similarly, where you own a rental property and decide to start using it as your principal residence, you have changed the use of the property and may be affected by the change in use rules. Where these rules apply, you're considered to have disposed of the property at its fair market value and to have immediately reacquired it for the same amount. You may realize a gain or loss in the year the change of use occurs.

Where you convert your principal residence to a rental property, any resulting capital gain on the deemed disposition can usually be eliminated or reduced by the principal residence exemption. If you're unable to eliminate the gain, you may be able to make an election to not recognize the deemed disposition. This allows you to defer the recognition of any gain until you sell the property. If you make this election, you'll still have to report the net rental or business income you earn from the property and cannot claim capital cost allowance (CCA) on the property. Even if you're able to eliminate the gain using the principal residence exemption, you may still want to file this election. In addition to deferring the gain, the election allows you to designate the property as your principal residence for up to four years, even if you don't use the property as your principal residence. However, you can only do this if you don't designate any other property as your principal residence for this time. This election should be made and filed with your tax return for the tax year in which the change of use occurred.

Where you convert your rental property to a principal residence, you may also elect to not recognize the deemed disposition and defer the recognition of any

2 2009 TCC 377

3 Subject to your financial institution's lending rules and guidelines.

capital gain until you actually sell it. You cannot make this election if you claimed CCA on the property for any tax year ending after 1984. If you make this election, you can designate the property as your principal residence for up to four years before you actually occupy it as your principal residence. However, you can only do this if you don't designate any other property as your principal residence for this time. This election must be made and filed with your tax return for the year in which you sell the property, or 90 days after the date that the CRA (Canada Revenue Agency) asks you to make the election, whichever is earlier.

Conclusion

Being able to deduct your interest payments can be an important wealth preservation strategy. This article explores the interest deductibility rules with respect to two situations where you wish to swap your principal residence and your rental property. The arrangement mentioned in the previous section for restructuring your borrowings has been accepted by the courts and the CRA at the time of writing. However, whether interest is deductible in your situation can only be determined with a review of all the relevant information of your case. If you're contemplating swapping your principal residence and your rental property, speak with a qualified tax and legal advisor to determine whether restructuring your borrowings is appropriate in your circumstances.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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