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Investments

Tax consequences to watch out for when tapping into your home's equity

Frank Di Pietro, CFA, CFP
Assistant Vice President
Mackenzie Tax & Estate Planning

Interest deductibility may be at stake

The appreciation in the real estate market over the past few years across Canada has significantly increased equity for many Canadian homeowners, some of whom have looked for ways to tap into some of that equity, for a variety of purposes. In some cases, the consequences could have unexpected, significant tax implications.

The following examples illustrate scenarios that may be all too common for Canadians who were unaware of the tax predicament they could create for themselves.

Case 1 – The Nestors

Mr. and Mrs. Nestor are in their 50s and **own a primary residence** as well as a **rental property** that has enjoyed **significant appreciation** in value over time.

They have small **mortgages on both** their primary residence and the rental property.

Mortgage interest on the rental property is **tax deductible**, while the mortgage interest on the primary residence is **not.**

The Nestors have a son, **George** (aged 25), who is **having a hard time buying his first home** in an expensive real estate market.

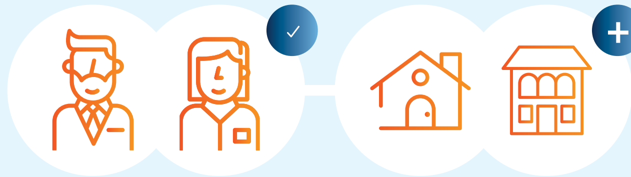
The Nestors want to help George with a down payment for his first home.

They're **considering refinancing** either the primary residence or the rental property to **fund the down payment**.

Without any professional advice, they choose to refinance the rental property to provide George with the down payment. The Nestors chose this option because they thought they could deduct the increased interest costs from the larger mortgage.

Case 2 – The Devis

The Devis moved to Canada and bought a home 20 years ago. Since then, they've **worked extremely hard to pay down the mortgage** and are **now mortgage free.**



They'd **like to upgrade** and **buy the dream home** they've always wanted. However, they'd **also like to keep their current home** and so have decided to convert it into a **rental property**.

Without any professional guidance, the Devis refinanced their current home and used the funds to make a significant down payment on their dream home. They believe that since the mortgage is on the home that has been converted into a rental property, they will be entitled to an interest deduction against the rental income generated from the property.

Interest deductibility

The rules for interest deductibility are found in paragraph 20(1)(c) of the Income Tax Act. There are four conditions that must be met for interest to be deductible:

1. There is an obligation to pay the interest costs
2. The interest costs must be paid or payable during the year
3. The interest costs are reasonable
4. The borrowed money must be used to earn income from a business or property

The first three conditions are easy to meet and straightforward. The fourth condition is the key to interest deductibility: to ensure that the money borrowed is used to earn business income or income from property (which includes interest, dividends, rent and royalties). This condition has caused much confusion and led to some controversy over the years. The CRA has published Income Tax Folio S3-F6-C1, Interest Deductibility to provide an in-depth summary of its position under a variety of circumstances (based on past court decisions), to help taxpayers understand how and when interest is tax deductible.

One of the key elements to interest deductibility is a concept of "tracing" or "linking" the borrowed money to an income-producing purpose. More specifically, the CRA will base interest deductibility on the current use, rather than the original use of the borrowed money. It is therefore up to the taxpayers to establish a link between the borrowed money and its current use. This means that borrowed money, which was tax deductible in the past, may not necessarily be tax deductible in the future.

How does the tracing or linking concept impact the Nestors and the Devis?

The Nestors

The Nestors refinanced their rental property to help their son George buy his first home. Using the tracing or linking principle established by the courts and the CRA, the current use of the money determines whether interest is tax deductible.

Since the current use of the money is now linked to George's residence — which provides no income — interest on the borrowed money is not tax deductible. The fact that a rental property was used as collateral is irrelevant.

The Devis

In the Devis' situation, a similar result occurs. The Devis used the equity in their current home to help fund the purchase of their dream home. Although the current home was converted to a rental property, interest deductibility is not allowed because the borrowed money was used to buy a new principal residence (which is not an income property).

Note: The conversion of the principal residence into a rental property can also create further tax implications. Click here to learn more about tax traps you may encounter when converting a home into an income property.

Summary

These examples highlight how easy it could be to fall into a trap where Canadian taxpayers believe there is an interest deduction where there isn't. More importantly, they highlight the need to obtain advice from a tax professional before making these kinds of decisions. They can advise you on whether you can take steps to maintain the link between the borrowed money and the income purpose, so that you keep your interest tax deductible.

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