

Debt-Swap Strategy

Paragraph 20(1c) of the income tax act allows interest to be deducted where borrowed money is used for the purposes of earning income from a business or property. In the past, when CCRA has not agreed with a taxpayer's intentions under this tax law, they have often denied the interest deduction.

You may recall two such cases back in the Fall of 2001 whereby CCRA disallowed interest deductibility, however, the Supreme Court of Canada found in favor of the taxpayers:

- ◇ Singleton Case—Mr. Singleton borrowed \$300,000 to make a contribution to his law firm. This itself would have been eligible for deduction of interest costs since the funds were borrowed for business purposes. However, Mr. Singleton then withdrew \$300,000 from the law firm as a tax-free withdrawal of capital and used these proceeds to purchase a home. If he had borrowed directly to purchase a home, the interest would not have been deductible. CCRA argued that the purpose of the loan which was contributed to the law firm was to buy a home, and not to refinance his business. They disallowed the interest deduction.
- ◇ Ludco Case—Ludco is a company that borrowed money to purchase common shares designed to provide capital growth over time, however, not much in the form of “income”. Since the interest costs for the loan exceeded any income derived from property received, CCRA disallowed the interest deduction.

Due to SCC findings in these cases, investors who have taken advantage of this popular “debt-swap” strategy can breathe a sign of relief that their interest costs will in fact be tax deductible. This strategy generally involves a taxpayer selling non-registered investments to pay down certain debt on which interest costs are not deductible (mortgage, personal line of credit), then, borrowing the money back and using the new loan for investment purposes. Because there is a direct link from the bank loan to the investment account, the interest becomes deductible for tax purposes.

However, you must be aware that when investments are disposed of to pay a debt, the client will trigger a capital gain if those investments have appreciated in value. You must weigh this potential tax bill against the tax savings from interest deduction.

At this time, CCRA is creating a formal bulletin outlining the rules of interest deductibility which is expected to be released in 2003. In the meantime this strategy could be worth investigating for some of your clients.