

## Mortgage interest deductions under scrutiny

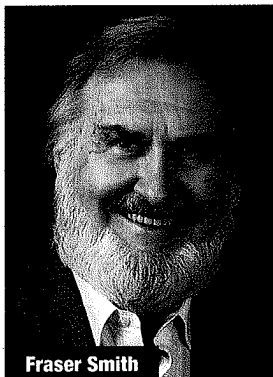
**A husband and wife tried to make their mortgage interest tax deductible, and the Minister of National Revenue has pursued them all the way to the Supreme Court of Canada. If this couple loses the case, should financial advisors who have recommended this kind of leveraged investing be worried?**

In April of 1994, Earl and Jordanna Lipson agreed to buy a home in Toronto for \$750,000. On August 31, Jordanna went to the **Bank of Montreal** and gave the lender a promissory note in exchange for a \$562,500 loan, which instead of using to purchase the home, she gave to her husband in exchange for shares in Lipson Family Investments Limited. One day later, they went back to the Bank of Montreal and obtained yet another \$562,500, this time as a mortgage on their new house. These funds were then used to pay off Jordanna's initial loan.

The point of this complex routine was to give the impression that the funds had been borrowed in order to pay off a loan that had been taken out to buy shares. Earl Lipson certainly wrote off the interest he paid on the mortgage, as one would normally do in the case of an investment loan, but as Chief Justice D.G.H. Bowman noted in his judgement when the case was before the *Tax Court of Canada*, the purpose of the loan wasn't really to buy shares, but rather "it was borrowed to buy a house and to allow Earl to deduct the interest on borrowed money used to buy the house."

The Tax Court of Canada, and later the Federal Court of Appeal, accepted the *Canada Revenue Agency's* (CRA) application of the *General Anti-Avoidance Rule* (GAAR), and the argument that the transaction was not made for the bona fide purpose of earning income from a business or property, but simply to avoid taxes, and therefore the interest could not be allowed as a deduction. The Lipsons are now appealing to the Supreme Court of Canada, and a hearing is scheduled to take place on April 23.

The concept of arranging one's financial affairs in such a way as to make mortgage interest tax deductible has grown in popularity. It is sometimes referred to as "The Smith Manoeuvre", named after **Fraser Smith**, who wrote a book explaining how investors could



Fraser Smith

use leverage to make their mortgages tax deductible. In very simple terms, the Smith Manoeuvre involves paying down a mortgage as quickly as possible, and then turning around and using the repaid principal as collateral for an investment loan.

In an interview with *The Insurance Journal*, Mr. Smith said he doesn't blame the CRA for going after the Lipsons, and supports the tax authorities in their fight to cut off abuse.

"The moving of the money in a circle was very creative, and perhaps technically was legal

in its execution, but the only ones to benefit were the Lipsons. There was nothing back to the rest of Canada's tax payers because there was no offsetting investment to create new tax targets for the CRA," he said, expressing doubt that the CRA wants to deny deductions to legitimate investors. "If you will borrow to invest, which is good for Canada, then the government will allow you to deduct the interest on your loans."

But should advisors and clients who are borrowing against their homes to invest be worried? "I am convinced that the CRA is not after the plain Jane Smith Manoeuvre," says Mr. Smith. "In the 24 years I have been putting clients into the Smith Manoeuvre, there has not been one case that I am aware

of where any client has been attacked by the CRA nor RevCan before them. I am not aware of even a single client being audited."

He does say, however, that if the Lipsons lose their case, what he calls "the classic debt swap" might come into question. This is where an investor sells his or her current investments, uses the proceeds to pay off non deductible debt (e.g., credit cards), and then obtains a new loan to repurchase the assets. He is also reconsidering the "cash flow dam" strategy he discusses in chapter 7 of his book. In the cash flow dam, someone uses income from a rental property to pay down a first mortgage, thereby speeding up the rate at which principal is repaid and the tax-deductible investment loan can grow. "To be true to my opinions, I intend to quit promoting the cash flow dam as an accelerator for the Smith Manoeuvre on the grounds there is a tax advantage for the user, but no quid pro for the tax payers of Canada."

But the idea of simply borrowing to invest? That, he says, is not under attack.

One of Mr. Smith's biggest concerns about these kinds of court cases is that they may discourage people from using financial leverage. "I call it GAAR chill, as in libel chill," he comments. "And it is unfortunate indeed that people who should borrow to invest as wealthy people do, decide not to because of a fear of potential fundamental changes in tax law. That's not good for them nor for Canada."

**Andrew Rickard**