<u>How to Switch Mortgage From Non-Deductible Residence to Deductible Rental Property</u>

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We often find clients in a situation where they have a rental property with the mortgage almost paid off and the personal property with a large mortgage. The rental property mortgage interest is tax deductible, but the personal home mortgage is not. This is obviously not the ideal situation to be in, and up till now I would have said it is difficult if not impossible to rectify. A recent court case may provide a method however. Although the taxpayer lost the case, the judge in his ruling described a method that would have worked if it had been done the way he suggested. Since he is a tax court judge, this is likely a very good way to accomplish this.

The case in question was Sherle v. The Queen and the judge was the Honourable J.E. Hershfield of the Tax Court of Canada. I'm going to paraphrase his scenario, using a hypothetical person, Jane, and her friend Mary. Jane owns two properties, her home on Maple Street (Maple Home) and a rental property on Pine Street (the Pine Rental). The Maple Home has a mortgage of $200,000 and the Pine Rental has no mortgage. Jane would like to see the situations reversed somehow, so this is what she does:

Step 1. On day 1, Jane sells the Pine Rental to her friend Mary for its fair market value. Mary pays for it with a promissory note.

Step 2. On day 2, Jane arranges for a bank loan of $200,000 to discharge the mortgage on the Maple Home. The bank loan (First Bank Loan) could be a "daylight-bookkeeping entry" but there is plenty of security for the loan because it would be secured by the Maple Home property after the mortgage is paid off.

Step 3. Also on day 2, Jane buys back the Pine Rental from Mary. She finances this acquisition by borrowing money from the bank and this loan (Second Bank Loan) is secured by a mortgage on the reacquired Pine Rental property. She pays these proceeds to Mary who uses them to pay off her promissory note to Jane. Jane uses the proceeds from the repaid promissory note to pay off the First Bank Loan. The Second Bank Loan is the only loan left and it is on the Pine Rental property, which is what we wanted.

Everything is done at fair market value so there are no tax consequences and the actual transfers of land need not be registered. The direct use of the funds from the Second Bank Loan are to finance the rental property so, in the words of Justice Hershfield "*applying the Singleton test (a Supreme Court decision) of direct use would most likely result in the interest on such borrowing being deductible. In light of Singleton, it would be difficult to suggest that this series of transactions would be considered artificial or lacking commercial reality in some fatal way. Considering the Supreme Court decision in Lipson it would be difficult to even suggest that this hypothetical series of transactions could be found to be offside the General Anti-Avoidance Rule in section 245 of the Act*."

The tricky part of this strategy would be to find a willing banker (and a good friend like Mary).