The ability to write off interest expense for tax purposes is often critical to the success -or failure- of leveraged investment plans. Most investors who borrow money for the purposes of investing are counting on their ability to deducts that interest exceeds for tax purposes. Absent the tax deduction, the leveraged investment may not make financial sense.

"Remember, 'accounting' and 'accountability': nothing in common."

Under the Income Tax Act, investors who borrow money for the purpose of earning investment or business income can deduct the interest they pay on that debt for tax purposes. This holds providing four requirement are met. First, the interest amount must be paid every year. Second, there must be a legal obligation to pay interest on borrow money. Third, the borrowed money must be used for the purpose of earning income from a business or property and finally, the amount of interest paid must be reasonable.

But what exactly is a "reasonable" rate of interest? A new Canada Revenue Agency (CRA) warning sheds some light on when a claim for interest expense may be deemed unreasonable, and therefore not tax deductible. In May, the CRA issued a warning to Canadians about participating in tax schemes where promoters claim that investors can transfer funds out of their out of their RRSPs or RRIFs into a TFSA without paying taxes and without any regard to the annual TFSA contribution limit.

Typically, the scheme is marketed by promoters to sophisticated investors who have large balances in their registered plans, have a TFSA and significant equity in their home. The promoter operates a special-purpose mortgage investment company (MIC) that "invests" only in mortgage loans to scheme participants. The MIC issues two classes of shares: one pays dividends at a low rate and other pays dividends at a high rate. The investor buys the low-dividend share of the MIC in their RRSP or RRIF and the high-dividend shares in their TFSA. The MIC then lends

the share proceeds back to the investor in the form a first and second mortgage, secured by the investor's personal residence and TFSA balance. The rates on the loans correspond to the dividend rates on the two classes of MIC shares.

The investor then invests the loan proceeds with the promoter and earns taxable investment income. The investors makes annual taxable RRSP or RRIF withdrawals and claims a fully offsetting interest deduction relating to the interest expense of the loans -which is significant. The result is that after several years of participating in the scheme, the investor is supposedly able to shift their entire RRSP or RRIF balance to their TFSA in a a way that the promoters claim is "tax free" and not subject to the annual TFSA contribution limit. The key assumption to making this strategy work is that the promoter claims that the high interest rate paid on the second MIC loan, typically 15%, is "normal" for second residential mortgage and explains the corresponding high dividend rate on the second class of MIC shares.

According to the CRA however, the entire arrangement is "commercially unreasonable" since the lender's actual credit risk is low because the investors are all wealthy participants who are unlikely to default on their own mortgages. In addition, the second high-interest rate mortgage (15%) is secured both by the participant's residence and by the growing TFSA balance. According to the CRA, "the high rate of interest on the second Mortgage and the high dividend rate on the second class of shares are not justified as the participants are essentially borrowing from themselves. The bottom line is that the interest paid of the MIC loan may not be fully deductible as the rate is not reasonable and, more significantly, any increase in the value of the investor's TFSA would be considered an advantage subject to the 100% advantage tax.

This is **for information purposes** only and **we cannot offer this investment** nor **we endorse such investment strategies** and prefer the more tried and true way of building wealth through a diversified portfolio of investment funds that is based on our client's investment profiles. Before investing always keep in mind that slow and steady wins the race and that if something sounds too good to be true, it is!

Be safe, be well!

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