

OPPORTUNITY KNOCKS

Looking for new business? Show clients how they can make their mortgages tax-deductible.

By Fraser Smith

WE ALL KNOW Canadian homeowners don't have the option to write their mortgage interest off their taxes. Or do they? What if your clients could convert their mortgage debt to an income stream that would fund their investments and was also tax-deductible?

A few thousand Canadian homeowners have opted to try the Smith Manoeuvre, a debt-conversion strategy which lets them change non-deductible interest debt to the deductible-interest debt of an investment loan. The strategy relies on the fact the CRA deems interest on money borrowed to invest tax-deductible. In other words, every mortgage loan is in reality a potential investment loan.

The first step is to help clients understand the difference between good debt (loans on which interest is deductible) and bad debt (loans on which interest can't be deducted). Next, cut through generations of assumptions and explain a client's goal should not be

to merely eliminate bad debt, but to actually convert that bad debt to good debt and take the interest deduction off his or her taxable income.

Putting it in Place

The mechanics of setting up the manoeuvre are not complicated. Say an average Canadian family, the Blacks, has a new house appraised at \$266,667. Their five-year, 7% mortgage covers 75% of the value of the house and totals \$200,000. Assume the cost to borrow to invest is 5%.

The first step is to ask the bank for a readvanceable mortgage for 75% of the value of the house. It's important to have the existing mortgage, Segment A, under the coverage of the readvanceable mortgage. There also needs to be a 75% line of credit for investment purposes, Segment B. The bank will lend \$200,000 to invest, minus the current balance of Segment A. Initially, the homeowner can't

borrow any money. But as soon as he or she starts making mortgage payments, all that changes.

After the first \$1,500 payment is made on the mortgage, the principal is reduced by \$400, so the balance on Segment A drops to \$199,600. This means \$400 is available through the line of credit to invest. The process repeats in the second month, but the paydown is a bit larger, about \$420.

That doesn't mean the homeowner has \$420 to invest, though, because he first must fund the 30 days worth of interest on the \$400 taken from the line of credit. The interest for that period will be around \$2, so he'll borrow and invest the difference—\$418. Month by month, the homeowner is building an investment portfolio without increasing the total debt, and no new money is required from the family's bank account.

The Blacks' debt remains constant at \$200,000, because as they reduce Segment A, they reborrow the identical amount, pay off the deductible interest expense on Segment B, and invest the difference. No leverage takes place because the debt never moves above the \$200,000 starting point. The Blacks did borrow to invest, but they first reduced the debt by the same amount that was invested.

When the exercise is complete, the Blacks have a \$200,000 investment loan that replaces their \$200,000 mortgage. But because the borrowed money was used to purchase equities, they will realize investment gains over the life of the amortization period of the mortgage (see chart, page 28). Those gains either allow them to pay off the debt or use salary and dividend income to continue

Home Investment

Converting mortgage debt to investment capital creates lucrative opportunities for homeowners and advisors.

- ❶ The \$500 billion spent on housing could be used a second time to purchase \$500 billion worth of investments—stocks, bonds, mutual funds, investment real estate or family businesses.
- ❷ After debt conversion, those 3.5 million homeowners would be receiving tax deductions of \$35 billion a year, assuming an average mortgage interest rate of 7%. If the average homeowner is at the 40% marginal tax rate, then \$14 billion would be refunded to homeowners for every subsequent year the debt was maintained. Tax refunds could be used to pay down additional mortgage principal and then be immediately reborrowed and invested. Those prepayments also would shorten the amortization of the mortgages.
- ❸ The house is the security for both the house mortgage and the investment loan. Real estate is a favoured form of loan security and banks will allow both loans to co-exist under the same charge. The high quality of the security also keeps the cost of borrowing to invest low, as well as tax-deductible.
- ❹ In the event of job loss, the homeowner has the option to sell some of his investments to meet the monthly mortgage payments until he gets back to work.
- ❺ In exchange for the tax refunds, Canada gains 3.5 million families who have \$500 billion invested for a second time. A large portion of the investments will be in Canadian companies, and that will create new jobs. Taxes generated by those new jobs will allow the CRA to recoup the outflow from the refunds.
- ❻ Families with both a home and investments are less likely to need government assistance in their retirement because those investments will perform as a personal pension plan.
- ❼ Such personal pension plans will render reverse mortgages obsolete. And that's good because those products aren't friendly to the heirs of retired persons since they suck up potential inheritances.

—F.S.

to make payments on the loan and take the tax deduction on the interest. It's up to the homeowner, but unlike a person who chooses to systematically pay off a mortgage, the client who adopts this strategy will have an investment portfolio that is greater in value than the original mortgage balance. Further, income gained by being able to write off loan interest allows the homeowner to

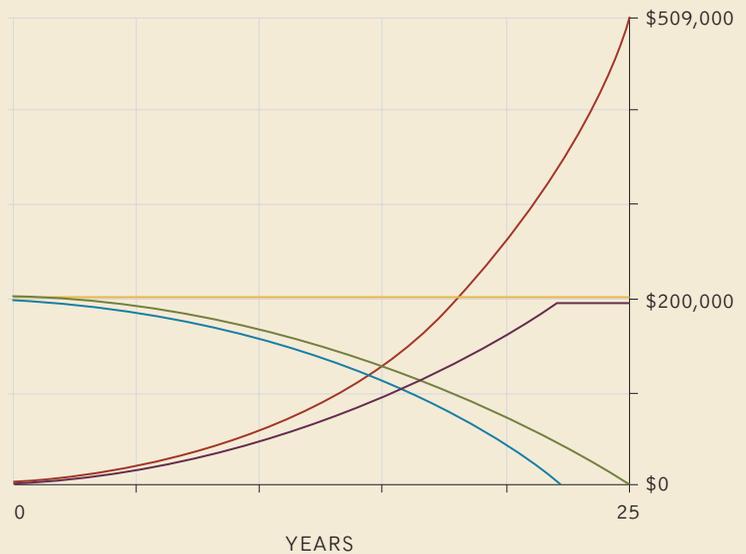
pay off the Segment A mortgage nearly three years sooner.

Investment risk is minimized because most investment classes are eligible. That allows maximum diversification. However, advisors encouraging clients to use this method to fund investments must take care to ensure respectable returns, or at least protect the capital.

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Quantifying the Result

A strategy like the Smith Manoeuvre could shorten the amortization period of a home mortgage and generate significant investment returns.



- Standard amortization of a \$200,000 mortgage at 7% for 25 years.
- Mortgage amortization is shortened by tax refunds under the Smith Manoeuvre
- Investment loan grows at the same rate at which the first mortgage is reduced. Line runs flat for the last 2.75 years because the mortgage is paid off.
- Mortgage debt remains constant at \$200,000
- Value of investment purchased*

*The 54-year annual average rate of return for the TSE is 10.4% according to Andex. Using 10%, the total investment pool would be \$509,000 and would likely have tax ramifications if liquidated. At 8% it would be \$384,000. At 12% it would be \$688,000.

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They will, after all, be working with borrowed money.

The first example uses a 75% mortgage as the start-up position, but most clients won't be carrying mortgages at exactly 75% of their home's value. Say another family, the Browns, has a \$150,000 mortgage. To implement the manoeuvre they'd only borrow \$150,000, right? Wrong. They should still borrow \$200,000 and begin converting the \$150,000 segment in the manner described earlier.

But since they have a \$200,000

re-advanceable mortgage in place, they now can leverage the \$50,000 remaining under Segment B. Assuming that much leveraged borrowing is suitable for this client, the financing would be in place to allow him or her to use that money for investing. **AE**

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