Peter Kinch
MORTGAGE TEAM
Our goal is to help you achieve yours

THE RE-ADVANCEABLE MORTGAGE STRATEGY

How to Make Your Home Mortgage Tax-Deductible

There's been a lot of talk recently about how to make your principle residence tax deductible...

Our American counter-parts have been able to use the interest that they pay on their homes as a tax deductible expense for years and many Canadians would like to have the same privilege. Well we can't get Revenue Canada (CRA) to change their rules, but there is a way to structure your mortgage to take advantage of tax savings if you plan to make an investment over the next 5 years.

KNOW THE RULES:

The key is to know the rules. The CRA states that anytime you borrow money against your own home for the purpose of an investment that *has the intention of making money,* then the interest paid on that loan is tax deductible. Simply put, if you borrow money from your line of credit to use as a down payment on a rental property, then the interest you pay on the line of credit is a tax deductible expense – it's that easy!

A number of years back, Fraser Smith wrote a book on various ways to accelerate this process called 'The Smith Manoeuvre'. Its a great book with many great ideas, but I found that a number of clients think that it is a very complex financial manoeuvre that they need to study. As such, the process is often passed over as something that sounds good, but 'I'd need to study it more to understand it'. This often times can lead to analysis paralysis and nothing gets done. My job in this article is to demystify the process so that you will actually use it! To do so, you have to start with the right tools. And that begins with the mortgage on your principle residence.

START WITH THE RIGHT TOOL:

The key to making the mortgage on your principle residence tax deductible is to convert it into a re-advanceable mortgage/line of Credit combination. This might sound complicated, but it's really just a slight spin on something that home owners have been doing for years.

A typical home owner will have a standard mortgage on their house. After building up some equity, they may choose to place a Line of Credit (LOC), as a second mortgage, on the home as a way of accessing that equity. I call this a simple 'static' LOC. It's static, because once you have set it up; you cannot change the maximum amount you can borrow regardless of how much equity continues to build in the property. Let's say for example that you have a house worth $400,000 and the current mortgage balance is $250,000. A lender will establish what we call a 'Global Borrowing Limit' on the house. This limit will typically be 75 – 80% of the value of the home (assuming that the loan remains a 'conventional mortgage'). In the above example, if the 'Global Borrowing Limit' was 75% of the value of the home, the bank would lend a maximum of $300,000. Since the first mortgage is only $250,000, you would be allowed to attach a Line of Credit (LOC) for up to $50,000 onto that mortgage as long as you can qualify to service the potential debt. However, if you subsequently paid off an additional $25,000 of equity over the next year, the amount of money you could access in the LOC would remain $50,000. This is why I refer to this type of loan as 'Static' – it doesn't grow with your mortgage.

A re-advanceable mortgage/line of credit combination on the other hand is not static. The basic difference lies in the structure of the product – the LOC is set up in such a way that it can take advantage of the equity created from the mortgage being paid off. Every time you make a payment on your mortgage you are paying off a little debt and thereby creating some equity. With a re-advanceable mortgage structure, the line of credit component of the mortgage would be increased by the amount of equity that was created. In other words, as the mortgage is paid off on one hand, the line of credit is increased on the other.

Let's take a look at the difference using the above example again. If the client who was able to pay down or make a lump sum payment of $25,000 had done so with a re-advanceable line of credit component to their mortgage, the $25,000 would have been available as accessible equity in their Line of Credit and the LOC would have been increased from $50,000 to $75,000.

Moving forward, as the equity is paid off on the mortgage on one side; it is re-advanced to the LOC on the other side. The ultimate goal is to have the entire $300,000 converted into accessible equity

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in the LOC. Not every bank offers this product and not all lines of credit are created equal. Again, the key is to have the 're-advanceable' component to your Line of Credit.

WHY IS THIS IMPORTANT?

This is where the Smith Manouevre comes in. The strategies discussed in the book outline several ways you can accelerate the process of "making your mortgage tax deductible". As I mentioned above, this is when the analysis paralysis sets in. The strategy is excellent, but I've found the process is what ends up challenging the client.

Let me take a moment to identify the 4 key components of a Smith Manoeuvre when used with a re-advancable Mortgage in order to simplify the overall strategy:

1. Every regular monthly or biweekly payment will create additional equity in your home as a portion of that payment is being applied to the principal balance. The portion applied to the principal balance is now re-advanceable.

2. Any additional cash assets or savings outside of your RRSP, can be applied as a prepayment to the principal balance of the mortgage. Any prepayment on the mortgage will then be re-advanced on the LOC, which can then be accessed for investment purposes.
It is important to recognize the prepayment policies of your institution. The standard is 15% of the original principal balance per year.

3. As you implement these strategies, you will be receiving a tax refund cheque each and every year (depending on your marginal tax bracket). The refund from CRA is considered cash and therefore, can be applied as a prepayment to your mortgage, in turn creating further equity in your home.

4. As a self employed person or a real estate investor, there are additional ways to accelerate the prepayment process of your mortgage. Every commission cheque, fee for service, or rent cheque you receive is considered cash. You will be paying income tax on this money at some point. The money received can be applied against your principal balance of the mortgage, and then re-advanced as an investment in your business.
Make sure you consult with your accountant before implementing any advanced strategies

To summarize, the Smith Manoeuvre can be broken down to 2 steps:

1. Find any and every way to accelerate the prepayment of the mortgage on your principal mortgage

2. Advance the equity you've just created, and use the money to invest

Now we can see why it is so important to structure it as a readvanceable mortgage. Remember the goal is to make our principle residence mortgage tax deductible. As you accelerate the prepayment process of your mortgage, you in turn are accelerating the availability of additional home equity for investments. When you access the money available to you in your LOC for the purpose of making an investment that has the intention of making money, then the interest on the money borrowed becomes tax deductible (again, please consult you accountant prior to rearranging your finances to ensure they are on board).

This investment could be a down payment on a rental property or it could be an investment in stocks, bonds or mutual funds. It cannot, however be used to fund a home improvement or for purchasing your RSP's, as CRA deems you to have already received a benefit by virtue of the fact they are tax deferred.

If you are a real estate investor, this is a critical tool for the simple reason that one of the two major obstacles that you will encounter in the process of developing your portfolio is finding enough money for future down payments. Using the re-advancable mortgage strategy will allow you to build up funds in your LOC every time you make a mortgage payment. If in addition to your regular monthly payment you can find any source of funds to accelerate this process, and stay steady with it, you will wake up one day and realize that you have built up enough equity in the Line of Credit component to use as another down payment – and best of all – the interest will be tax deductible.

Happy Investing

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