Money

A tax-deductible mortgage?

Article By: Ian MacNeill

There are two kinds of debt in this world, good debt and bad. Good debt, you say? Well, okay, fair enough. In an ideal world, we'd all be living debt-free. For that matter, in a perfect world we'd all be living debt-free and have a pile of assets expanding at an exponential rate, thanks to the miracle of compound interest.

Of course, for most of us, life's not like that. Occasionally, we have to borrow money. We borrow it to buy our cars and pay for our vacations – and we borrow it to buy our homes. When we do, we pay for it dearly. Even at today's bargain-basement mortgage rates, a $200,000 home costs more than $400,000 over the 25-year term of a mortgage. Toss in the fact that most middle-income earners are paying half of what they earn to the government in the form of taxes, and our struggling homebuyer is forced to earn in excess of $800,000 in order to pay off his or her $200,000 loan.

But what can you do? That's the way the world works, so most of us knuckle down, make our payments and dream about the day we actually "own" our home. At the end of the process, we find ourselves house-rich, cash-poor and desperately behind in our retirement savings plans.

The Smith Manoeuvre

Is there another way? Fraser Smith, a retired financial adviser living in Saanichton, B.C., and author of a little book entitled *The Smith Manoeuvre*, says there is. All you have to do is make your mortgage tax-deductible. This will do two things:

1) free up capital you can use to pay down your mortgage faster, and
2) allow you to supercharge your retirement savings program. Here's how it works.

In Canada, banks will typically lend you 75 per cent of the value of your home. If you own a home worth $100,000, the bank may lend you $75,000 to invest in something else. If you have a mortgage outstanding, it's 75 per cent less whatever you owe. For example, if you still owe $75,000 on the mortgage, then you're at break even. However, if you only owe $74,000, there's $1,000 sitting in your home you could borrow to invest.

And, according to Smith, that's precisely what you should be doing. Borrowing it and using it to buy interest-bearing investments for your retirement. But wait a minute, you say, isn't that just robbing Peter to pay Paul? No, and here's why.

In Canada, when you borrow money to invest, the interest on the loan is tax-deductible, a bonus that gets you a tax refund cheque if you're employed or reduces your taxes if you're self-employed. You then take that refund or excess income and plunk it down on your mortgage.

This has the virtue of increasing the equity in your home, equity you can then capitalize on by borrowing on it and using the money to buy more investments. Once again, the interest is tax-deductible, generating an even bigger refund cheque next year or reducing your taxes even further, allowing you to pay off your mortgage that much faster. And so it goes.

At worst, this plan reduces the time it takes to pay off your mortgage by about 2.5 years, while at the same time getting you started on the road to retirement savings.

Is it legal?

It may sound complicated at first, but once you get your head around it, it's deceptively simple, and before you ask, it's also entirely legal. We know this because Canada Customs and Revenue went to great pains a few years ago (when it was known as Revenue Canada) to prevent a Vancouver lawyer from utilizing the procedure and lost the case.

In 1991, John Singleton borrowed money from his firm and used it to pay off his house mortgage. He then went and re-borrowed the money from the bank to pay back his law firm. Because he was now investing the money in the firm instead of the house, the interest on the loan became tax-deductible. Revenue Canada got wind of the scheme, cried foul and reassessed him.

“They won in the tax court, but then we won in the federal court of appeal,” recalls Singleton. “They then appealed to the Supreme Court, and we won there. The Court said the act said I can do what I did, and [Revenue Canada] had no right to look behind what I did to see whether or not it was a sham, which is what they kept calling it. If the act says you can do it, then you can do it and deduct it. End of story, nice and simple, which was our position throughout.”

It’s worth noting that Singleton had no idea that he was performing a variation of the so-called Smith Manoeuvre. He’d never even heard of the Smith Manoeuvre. And the truth is, Fraser Smith did not invent the strategy he promotes in his book (and CD). In fact, it’s been around a long time. It’s called “leveraging,” and smart Canadians have been doing it for donkey’s years. What Smith has done is uncover the process and explain how average folks can use it as well. And an increasing number of average folks are doing just that.

Brian Pillipow is a glass shop estimator in Sydney, B.C. He’d heard about Fraser Smith and read about his “manoeuvre” in the local papers and decided to give him a call. Smith helped him set up a line of credit with an amenable credit union, and Pillipow started borrowing and investing on the equity he had in his home. He’s never looked back. Not only has he freed up money to pay off his mortgage faster, he’s started building an investment portfolio.

“What’s more, the deduction put me in a lower tax bracket and this year I got a $3,000 tax refund,” he says happily. He promptly plunked down the refund on his mortgage, freeing up more capital to borrow, etc. “It’s worked very well for me. I would recommend it to anyone.”

Will it work for you?

Something of an evangelist on the subject, Smith says he came up with the idea of writing the book after years of watching wealthy Canadians get away with the trick while the vast majority laboured for years to pay off their mortgage and wound up entering retirement with empty pockets. “This is for all those people who would like to be wealthy but who are getting killed both by their mortgages and by income taxes,” he says.

And, by the way, as long as you pay the (tax-deductible) interest to the institution that loaned you the money to invest, you never have to pay back the principal. It’s a debt you can die with if you want (at which point the money will be paid back out of your estate).

So, is the Smith Manoeuvre right for you? According to Fraser Smith, it is if: a) you own more than 25 per cent of your home, b) you’re capable of living within your means and using your tax savings to pay down your original mortgage.

Obviously, the earlier you get a program like this up and running, the more benefit it can be. If you’re close to retirement and the house is paid off, it’s not for you. However, if you’ve got some idle equity in your home and you’d like to free up some cash up to do some investing, the time might be right to do a little manoeuvring.