



NEWS RELEASE

THE CASH FLOW DAM II

*A Smith Manoeuvre accelerator for Canadians
who own revenue property*

House Rentals

Statistics Canada advises us that of the 10.5 million families in Canada, about 3.5 million live in rental accommodations. A large portion of the rental property industry is operated on an unincorporated basis by families who have decided to get into the business of supplying a home for someone else. They have an unincorporated rental business. Any of these entrepreneurs who have a mortgage on their own home may enjoy free tax deductions and rapidly growing investment portfolios simply by implementing *The Smith Manoeuvre*, and they should. But if they also own a house or apartment that they rent to others, they are entitled to a significant and incremental financial opportunity that costs them not much more than the time it takes to reorganize their financing.

When most small businesses get started, part of the excitement is going to the bank to open a business account. You order chequebooks and deposit books for your new business. The money starts to flow in to your new bank account and at the end of the month you pay the bills for the rental property. If there is anything left, you write a cheque to yourself, call it draw, and deposit it to your personal chequing account.

If you don't have a house mortgage on your principal residence, this is a fine and efficient setup. But if you do have a mortgage (or other non-deductible debt), then there is a much better way to structure your banking. It is called the Cash Flow Dam and it is so little known that Google can't find it.

Rationale

You live in your own house with a mortgage that does not yield tax-deductible interest. You also own one or more rental units, which are operated as an unincorporated business.

We will rely on the tax fact that money borrowed personally to invest in a business in order to generate income gives rise to deductible interest on that loan.

Further, nothing in the tax act says that you have to pay company expenses with revenue generated by the unincorporated business. You may pay your expenses with borrowed money.

Being unincorporated means that for tax purposes, you and your rental business are the same person. Your accountant will total your annual rental revenues, subtract company expenses and the difference, the profit, will be added to your other personal income for the calendar year.

The Smith Manoeuvre increases in power if the first mortgage can be paid down faster. That will obviously happen if we can divert a portion of the revenue stream from your rental business against the first mortgage. The Cash Flow Dam makes that happen.

The amount of cash available from the renter to apply against the first mortgage monthly will be an amount equal to the expenses of the business for the month. (Note that your monthly draw is not classified as an expense of the business.) Capital expenses as well as operating expenses qualify for the tax-deductible interest treatment if this expense is paid with borrowed money.

Mechanics

1. At the end of each payables interval, tally all qualifying expense relating to your rental business. Keep good records each month. Be precise.
2. Write a cheque against your *Smith Manoeuvre* investment line of credit for the same amount, notate it "*Company Expenses*" and make it payable to your business. Pay the expenses with this money.
3. Write a cheque from the business payable to yourself for the total amount of the expenses. Notate it as "*Draw – re: expenses*".
4. Deposit the cheque into your personal chequing account. From there, pay down your first mortgage by the same amount. This will be a lump sum payment in addition to your regular monthly payment. If your bank won't accept lump sum overpayments put the money in a separate savings account until you are eligible to make an overpayment.

Payoff

Using *The Smithman Calculator* example in Figure 3.2 of the book *The Smith Manoeuvre*, we determined that a Canadian family, The Blacks, doing The Plain Jane version of *The Smith Manoeuvre* would reduce their tax bill by \$41,980, knock 2.75 years off of their 25-year mortgage and have an investment portfolio of \$309,882, net of the investment loan. This assumes investments grow at an average of 10% per year, which is the average annual growth of the TSE for over 50 years. No resources are required from the family to effect this result. The portfolio may be taxable if liquidated.

If perchance the Blacks also had an unincorporated business, such as a revenue house, the value of *The Smith Manoeuvre* leaps ahead if the Cash Flow Dam strategy is employed. Here is an example of the tax saved/reinvested, the years knocked off the mortgage, and the increased net worth for The Blacks in two cases. In the first example, the Blacks rent out a condo, which averages expenses of \$1,000 per month. The second example has the Blacks operating a six-plex with expenses of \$5,000 per month.

	Figure 3.2 Plain Jane	Expenses of \$1,000 per month	Expenses of \$5,000 per month
Taxes saved at 40%	\$41,980	\$79,598	\$93,919
Years saved	2.75	16.00	22.08
Net worth improvement	\$309,882	\$613,197	\$828,046

Summary

The basic Plain Jane version of *The Smith Manoeuvre* gives this average family with a \$200,000 mortgage an improvement of more than \$300,000 in their net worth. Adding the little known strategy of the Cash Flow Dam doubles and nearly triples the already spectacular benefits of *The Smith Manoeuvre* for the Blacks in these two examples.

The Cash Flow Dam requires no new money and no new resources of any kind from the taxpayer. The benefits are free, and accrue as a result of reorganizing finances, just like wealthy people do.

The Cash Flow Dam does not work for incorporated businesses because unlike unincorporated entities, the business is essentially considered another person for tax purposes. There are other ways an incorporated company can augment the performance of *The Smith Manoeuvre* but this is a discussion beyond the scope of this article. I can do no better than to once again suggest that you do yourself a disservice if you do not seek the advice of a financial planner or an accountant who is familiar with *The Smith Manoeuvre*.

My special thanks to Brian Dougherty, CA and Paul Winstanley, CA who taught me the Cash Flow Dam. Brian has been my beleaguered accountant for about a quarter of a century.

Brian Dougherty, CA and Paul Winstanley, CA perfected their tax skills at the prestigious accounting firm Thorne Riddell in the 70's. Each now is in private practice and if you need the best, contact Paul in West Vancouver at (604) 922-3930 and (604) 986-7307 for Brian in North Vancouver.

Fraser Smith is a retired financial strategist in Victoria, B.C. and is the author of the best selling book The Smith Manoeuvre.

The Smith Manoeuvre and The Smithman Calculator are both available online at www.smithman.net.

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