

MANOEUVRE MONEY FROM YOUR **house**

No, The Smith Manoeuvre is not a new military strategy or yoga position. It's a method for making your mortgage interest tax deductible and Smith is the guy that wrote the book on it. *by Jeff Sanford*

You need a complicated technique like *The Smith Manoeuvre* to make your mortgage interest tax deductible for the simple reason that if the taxman wanted mortgage interest to be tax deductible, he'd have made it tax deductible. Maybe that's why there's a somewhat subversive air about Fraser Smith's eponymous book, which is self-published and available through a website rather than chain bookstores. Smith argues in the language of revolutionaries (albeit financial planning revolutionaries) that he's offering members of the Canadian middle class a way to achieve financial emancipation, allowing "the mass population to use tools usually available only to the richest 5 per cent of the population."

The manoeuvre is essentially an agreement by a bank to loan one dollar for every dollar paid on the principal of a mortgage, which allows a homeowner to convert home equity into an investment loan as they pay down their mortgage. Because the interest on loans for investment is tax deductible, there's a bit of a kick when it comes to paying down the

mortgage. Canadians have seen this kind of thing before. It's similar to what Garth Turner has long advised them to do (create a retirement portfolio out of the equity in your home), except that Smith moves the point at which that conversion begins forward. Nevertheless, the goal is the same. "My objective is for my clients to die at age 130 still owing that \$100,000 to the bank but also controlling \$2 million worth of assets," says Smith. "This is what the rich have always done."

Smith came up with the idea for the manoeuvre some 15 years ago when he left real estate for financial planning at the end of the eighties, just as the real estate boom ended and the big boom in the mutual fund industry was beginning. "Everyone thought I was a genius, but it was really just luck," says Smith. He was fascinated at the time with the idea that Americans could deduct the interest on their mortgages while Canadians could not. "I was obsessed with that. And as I searched through the Tax Act I came up with the manoeuvre," says Smith.

It's premised on the deduction allowed for interest on investment loans, but the conversion is

dependent upon a banker willing to do the conversion. Not an easy find in the early days.

"I tried the big guys. One was interested at the branch level, but not any higher. They said it was irregular and bankers like regular," says Smith. He kept searching and found the door ajar at the Vancouver City Savings Credit Union (VanCity). A new president at the time liked the possibility of luring mortgage clients from the big five and eventually gave Smith the go-ahead. "We had a breakfast meeting and the president said, 'Okay Smith, you're on. Don't let me down.' And we didn't. We went on to light that branch on fire."

Over the years, Smith trained eight other financial planners in the technique and the group has offered the manoeuvre around the lower B.C. mainland for more than a decade, albeit quietly. The only advertising was a repeat ad in the *Victoria Times Colonist*, which brought in business but allowed Smith to maintain a low profile. "I would turn down interview requests. I couldn't very well give this away too soon. It was my territory and I wanted to stay beneath the radar," he explains.

But along with retirement – Smith is now 65 – came the chance to complete a final mission, the big one: Bring the manoeuvre to the masses. "I have always been fully determined to give this idea out once I was finished my own career.

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Most people don't have the wherewithal to pay down their mortgage any faster and this is a way to help Canadians get ahead. That's what appeals to me about this."

As Smith brought more business into that VanCity credit union they created what's called a readvanceable mortgage to facilitate the manoeuvre. (For details see facing page.) "In the old days I had to do it by what's called a collateral second mortgage, which was a pain in the neck and expensive. But the credit unions have led the march and now we have this new mortgage that allows you to have the equity building (in the house) on one side given back on the other side for investment purposes, which gives us the proper documents," says Smith.

He's convinced the rest of the industry will eventually follow. "This solves one of the biggest problems banks have. Your liability is their asset, which is why they spend so much money trying to steal your mortgage business away from the competitors," says Smith. "But if you do *The Smith Manoeuvre* the money stays with the bank and simply shifts over to the securities side of the institution." The client will be paying (deductible) interest on the loan until they die, and according to Smith that means the bank will be happy to convert since they get a steady stream of income. "They also have a client who is well put together and has a whole bunch of assets," says Smith.

The idea behind the manoeuvre – making mortgages deductible – is a popular one. So popular, in fact, that the Ontario Conservatives, desperate to be re-elected, have floated the idea in their current campaign. Exactly 67.8 per cent of Ontarians are homeowners, so it seemed to be a vote getter. But the idea was quickly criticized as being too expensive. All those refund cheques would soon add up, draining government coffers (which is a criticism that could also apply to *The Smith Manoeuvre* if it were widely adopted). Which brings up the really big question: What would the tax people do?

"If everyone starts doing it I think you can expect CCRA to start taking a look at it," says Margaret Rintoul, of Aylesworth Thompson Phelan O'Brien LLP in Toronto. She concedes, though, that cracking down on the manoeuvre might be difficult because the deductibility of interest on loans for investment purposes is a well-established precedent in law. "I would think it would be scrutinized by Finance but the deductibility of investment loans has been challenged many times and is allowed on a broad basis," says Rintoul. "To stamp it out you might have to change the Act as it now stands."

For Smith, this is the beauty of the manoeuvre. "This is something that has always been done by the rich so the precedent is there," he says, confident the government would see the benefit. "Even if the Finance Minister came out against us, the benefit to the rest of society,

I would think, would provoke other ministers to say it's okay to let this money start leaking back to the taxpayers." (Of course, taxpayers here means "homeowners," not society at large.)

Smith tells the tale of how a tax official came around years ago after he first opened shop. Rather than make a case against Smith, the investigator asked if the manoeuvre would work for him. "I knew I was on to something at that point," he says.

Certainly Smith's book is eliciting interest. Despite being self-published, it has appeared on the bestseller list at Booksforbusiness in Toronto and there are now 25 advisors listed on Smith's website who will do the manoeuvre. As if to make the author's point about the middle class's desire for financial emancipation, during my meeting with Smith in a Toronto restaurant, a woman approached our table and told us that her husband had overheard our conversation. He wanted to know where to go for more information. Smith directed the woman to his website, www.smithman.net. The conspiracy grows.

MANOEUVRE MECHANICS

The plain-jane Smith Manoeuvre is an agreement with a bank to loan a dollar to the client for every dollar paid down on the principal of the mortgage, converting home equity into an investment loan – essentially the same thing that a number of financial writers and speakers have been telling Canadians to do for some time now.

“The part that’s new,” says Smith, “is to do this conversion in small increments – by the amount in which you pay off your mortgage each month.”

This allows more time for the investment portfolio to grow. “Don’t wait another 15 years to start investing,” says Smith. “Canada is set up to do this sequentially: Pay off the mortgage and then start investing. But that goes against the idea that you should invest as soon as possible. I’m telling Canadians to take the equity out of their home at the front of your life rather than at the back.”

You’ll also realize some tax benefits. Because the interest on loans for investment purposes can be written off on your taxes, as you convert your home equity into an investment loan you’re turning the debt into one in which the interest is deductible. (This is why Smith bills his system as a way to make your mortgage tax deductible.)

The power of the manoeuvre, according to Smith, is in this tax deduction. By applying any money saved to the principal on your mortgage you can pay it off more quickly. In his book, Smith claims that a family with a \$200,000 mortgage that cashed in savings of \$50,000 to put toward the mortgage would realize a tax benefit of \$36,160 over 25 years. By putting the

tax savings toward the principal of the mortgage, they would eventually realize a total tax benefit of \$41,980. Altogether, assuming a return of 10 per cent on their new investment portfolio, the family will realize a net increase of value of \$309,000 above what they would expect by paying down the mortgage and then investing, says Smith.

Of course, there are catches. You need to have that initial \$50,000 or at least 25 per cent equity in your home to pay toward the principal right away. Not to mention that a 10 per cent a year return is pretty high considering current markets.

Smith also concedes that the manoeuvre only really starts generating results once it’s been running for a couple of years, which means you have to be disciplined to do this and not let the savings disappear into daily cash flow. If everything goes according to plan, however, at the end of the conversion you’ll have a place to live and an investment portfolio that, presumably, will be throwing off income to help in retirement.

So what’s the difference, then, between this method and simply borrowing money to invest in a portfolio at the same time you pay off your mortgage? Smith says that by just converting the equity in your house, you’ll have less total debt in the end, since you’re not taking out another loan. And for people who can’t afford a loan on top of their mortgage, it’s a way to acquire a retirement portfolio.

Brian Pillipow is an estimator and project manager at a Victoria-based glass company and recently began the manoeuvre through VanCity. He’s convinced it’s the only

way he’s going to retire. “I couldn’t have borrowed this money before the readvanceable mortgage. But with the manoeuvre I’ll have a large investment portfolio that’s generating income, plus the house.”

Pillipow cashed in some investments to begin the process and later bought them back with the loan, which now allows him to write off the interest on them. That knocked him into a lower tax bracket, which was a big help. “That’s the big thing for me, dropping down a bracket,” he says.

He’s now invested in a condo in Victoria, which he says he can move into, sell, or rent out when he retires. He also bought \$20,000 in mutual funds as well as a stake in a private equity investment. (Diversification, obviously, is also important. If you had done the manoeuvre three years ago and dumped all the money into tech stocks you’d be out home and portfolio!)

Smith absolutely recommends that anyone considering doing it get the help of an advisor. He also suggests asking an advisor if it would make sense to cash in RRSPs and use that cash in the conversion. “There are some particular situations where that makes sense. The math is complicated though.” Keep in mind also that manoeuvre skeptics point out that for someone with the money to do the manoeuvre it might be better to put any extra cash straight into RRSPs.

Smith has a software calculator available for \$39.95 that he says will help you figure that out. But remember, leveraging is always a high-risk proposition and anyone who’s interested should hear a variety of opinions before opting for a plan that, if things go badly, could result in the loss of their house and more.

Dear Editor;

Thank you for bringing the benefits of *The Smith Manoeuvre* to the attention of your readers in the June edition of *IE:Money*. I would like to respectfully point out that your cautions about leveraging are misplaced, to the extent that *The Smith Manoeuvre* is a *debt conversion* strategy, not a leveraging strategy.

The Smith Manoeuvre deals with leveraging that a person is already engaging in. The homeowner has already borrowed money – as much as 95% of the value of the house in some cases – in order to own a home. That person has leveraged as little as 5% of his or her own money to take on a huge debt, which is the worst kind – the interest is not deductible against income. *The Smith Manoeuvre* corrects the disadvantage of borrowing non-deductible money to buy a house by converting *existing* mortgage debt to the tax deductible variety.

As described so well in your article, *The Smith Manoeuvre* is a financial strategy that is designed to make a silk purse out of a sow's ear. Your reader has a non-deductible mortgage. Using legal techniques employed by wealthy people and businesses, *The Smith Manoeuvre* details the steps that ordinary Canadians can take to convert a "bad debt" house mortgage to a "good debt" investment loan, which will yield free tax refund cheques every year into the future.

As the article outlines, it is a poor outcome for any family to pay off the mortgage first and then start to invest. *The Smith Manoeuvre* provides a solution by freeing up new financial resources that can be used by the homeowner to build up an investment portfolio now, instead of later. It actually *reduces* financial risk, and does so in a far superior way than if the homeowner were to spend 20 years paying off a mortgage without simultaneously building an investment portfolio.

There are many other important benefits that accrue when a homeowner adopts *The Smith Manoeuvre*:

1. The homeowner cannot avoid building up an investment portfolio, starting now, that will be diversified.
2. The interest expense on the investment loan will be tax deductible, starting now and every year in the future.
3. The investments will be bought at the lowest possible cost – prime or better – because the home is the best collateral for the bank.
4. The investments will be purchased over time to yield the well-known benefits of dollar-cost averaging.
5. Best of all, the investments that are purchased will be owned free and clear.
6. If the investments are free and clear, then there will be no margin calls.
7. These financial assets are available as a backup in case of future financial stress such as job loss.

In summary, Canadians would be better served to challenge traditional advice that advises them to pay off the mortgage and then invest. Instead, I advise them to convert the mortgage from a bad debt to a good debt, and start investing now. Garth Turner, Talbot Stevens and other financial strategists have been advocating debt conversion for many years. I join them in extending this advice to Canadians, and am pleased to go one step further by demonstrating the power of simultaneous, rather than serial, debt conversion.

The Smith Manoeuvre secures both home ownership and investment income. Its benefits are remarkable and impossible to ignore, and outweigh the risks for any Canadian with a mortgage, under almost any circumstance.

Fraser Smith
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