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End Run 'Round The Tax Man

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It is possible to make your mortgage interest deductible in Canada

Fraser Smith is a big burly fellow with some big burly ideas. He's been described as a cross between a biker and Santa Claus, but when it comes to personal tax planning-he's much more like Santa Claus than anyone else.

Mr. Smith, who hails from British Columbia, is the force behind the so-called Smith Manoeuvre. In a nutshell, it's a financial strategy designed to turn "bad" debt into "good" debt. How? By transforming a residential mortgage from a liability into an asset by doing something that's allowed in the United States, but not in Canada: making mortgage payments tax deductible.

The key is to find a financial institution that's prepared to loan you one dollar for every dollar paid down on the principal of your mortgage. That converts home equity into an investment loan, which grows as the mortgage is paid down. The interest paid on the investment loan qualifies-as all do-as a tax deduction under Canadian law.

Mr. Smith characterizes mortgage debt as "bad" because the interest is paid with after-tax income which, over the long-term, impedes financial flexibility. And that, in turn, puts too many eggs into one tax-inefficient basket.

He also insists that programs that offer to reduce the total cost of a mortgage by switching to bi-weekly from monthly payment, simply encourage you to use even more of your after-tax dollars to make overpayments on the mortgage.

So, by way of example, here's what Mr. Smith has in mind: If you have a new $200,000 mortgage at seven per cent interest and a $200,000 portfolio of mutual funds scraped together over the years, Mr. Smith would argue you should sell the funds to pay off the mortgage. The, return to the bank and borrow $200,000 to buy back those funds, posting the mortgage-free house as collateral.

While you may incur some charges for the trades and for the planning advice, at seven per cent, you also qualify for an annual tax deduction of about $14,000.

Any tax refunds, furthermore, can be applied to your mortgage, allowing you to re-borrow, to invest further, to earn even more deductions.

(It's also important to note that those who don't have excessive confidence in admittedly-jumpy equity markets can put anything-from real estate to treasury bills-in the investment bundle.)

What about finding a financial institution that's willing to play ball in the first place? Mr. Smith concedes that it was a tough sell when he first started advising his Manoeuvre. Eventually, he sold the concept to the Vancouver City Savings Credit Union (VanCity), which in turn used it to build it's own mortgage and investment business.

When it comes to the dynamic with retail bankers, his argument is this: because your liability is their asset, they spend a lot of money and effort trying to win your mortgage away from competitors. But if you deploy his strategy, the money stays with the bank, it just moves to the securities side of its business. Because the client will be perpetually paying (deductible) interest on the loan, the bank gets a nice steady income flow from the transaction.

As for any disapproval from federal tax officials, Mr. Smith says he was visited by one auditor who asked him to explain precisely how he the whole Manoeuvre worked. The man left, and he surmises, was thinking about doing it himself by the time he walked out the door.

According to Smith, in summary, it should be the objective to die owing the bank the original amount of the home mortgage, offset by a multi-million portfolio. And he's adamant that Canada's refusal to make mortgage interest payments tax deductible, has been the single most significant contributor to the gap in the standard of living between Canada and the United States.

He also feels strongly that in the past, these tax techniques have been the exclusive preserve of the very wealthy, who can afford costly advice. Mr. Smith wants to ensure that all Canadians have that same sort of access-hence his self-published book, The Smith Manoeuvre. (www.smithman.net).

So who's afraid of the taxman? Certainly not Santa.