Financial planning manoeuvre allows deductibility of home mortgage interest

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Posted September 12, 2006 (Special) - Do you want to make your home mortgage interest tax deductible?

Fraser Smith, a retired West Coast financial planner, knows the way to do it and is actively promoting the technique, known as the Smith Manoeuvre, through seminars, books and a website (www.smithman.net).

The benefits of tax deductibility are straightforward. If you can pay less income tax, you will have more money with which to build your wealth.

In the past, tax specialists frequently talked about the concept (advising homeowners to take out mortgages to invest, which would allow the deduction of interest), but they didn't give the step-by-step technique that would allow homeowners with mortgages still outstanding an effective way to do it.

Smith says he saw wealthy families using techniques allowing deduction of interest and he worked on developing a system for his financial planning clients of turning non-deductible mortgage interest into deductible interest.

"I was initially turned down by several large banks because my request was irregular, which was true. I finally realized I needed to deal with the president of a bank and the closest one was Larry Bell, then president of Vancity, a major B.C. credit union.

"I always remember that first meeting with Larry Bell when I had the chance to show him my stuff. As I finished explaining my strategy, he pushed his chair back and asked me, 'Why isn't every Canadian doing this?' What a great question."

Smith used the technique extensively in his financial planning practice and took to promoting it when he recently retired. Now several banks and credit unions are offering the "readvanceable mortgage" that is necessary for it to work.

In his seminar presentation, available on his website, Fraser provides an example of the manoeuvre, supposing a homeowner has a $200,000 mortgage at 7 per cent mortgage rate for 25 years.

If this is a readvanceable mortgage, as the homeowner pays down the principal with monthly payments, he or she then immediately has that amount readvanced in order to invest in stocks, bonds or other real estate.

The interest on the amount that is readvanced is tax-deductible because it is used for investing purposes.

It amounts to splitting the mortgage into two sides; as the principal on one side is lowered, the principal on the other side goes up, keeping the total principal outstanding at $200,000.

Every time you get some extra cash to invest, especially with the tax refunds coming to you as you claim more and more interest as an expense, you first pay down the non-deductible side of the mortgage and then increase the deductible side as you funnel the money into investments.

Smith calculates that at the end of 25 years, assuming your investment rate of return came to 10 per cent annually (equivalent to the long-term return on Canadian stocks), you will have an investment portfolio of just over $509,000 and an "investment loan" mortgage of $200,000 on which interest being paid is fully tax-deductible. (Your investment return would have to be only 3 per cent to build the investment portfolio to match the $200,000 mortgage.)

"All that is required is that you arrange to have your financial planner reorganize the way your mortgage operates," Smith states, although he acknowledges that many financial planners still don't know about the Smith Manoeuvre.

If you wait to invest until after you've entirely paid down your home mortgage, which most people now are doing, you lose valuable compounding time for your investments and you won't build your retirement funds as fast as you should, he says.

Smith claims the Smith Manoeuvre is legal, having "been reviewed by Canada Revenue Agency and endorsed by economists, financial planners and financial institutions. It is a legal and common practice to deduct interest when you borrow to invest to produce income."

His website has a "Find a Planner" tab for those wanting to contact a financial planner in their area who knows about the technique.

One you figure out exactly how to do it and get the right mortgage, it shouldn't be difficult to implement. However, a disciplined approach will be needed to ensure that all readvanced monies go to investments, not the cars, boats and vacations that some banks are promoting with their readvanceable mortgages.

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