Tax-deductible mortgages

Your home's mortgage can be set up to save taxes while you invest equity in a business or property

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So many times in life when we have a problem we stumble across a solution that has been staring us in the face for some time. A simple shift in thinking — the unlocking of a mindset — is sometimes all that is needed to discover the answer.

One of our current problems is the troubled economy and the havoc it is wreaking on the financial health of Canadians. The solution I propose, remarkably simple in concept, relies on the removal of one of those mindsets: the sacredness of a paid-off mortgage.

Far too many Canadians make their last mortgage payment just as they are about to retire, only to realize that their house produces no income. As a result, thousands of seniors are heading back to the banks to get reverse mortgages. But if they had taken the equity out of their house many years earlier, they could have retired with a large, free and clear investment portfolio, as well as the house.

There is a realistic opportunity for the approximately 7 million families who own homes in Canada to take some equity out their houses — long before they retire — and to invest it. Those new investments will not only improve their net worth by many thousands of dollars to build a larger retirement nest egg, they will create new businesses and jobs to provide relief for a troubled economy.

The tax department has done its part to provide incentive for investors by allowing interest expense on money borrowed to invest with an expectation of profit to be tax-deductible. Business people utilize this benefit every day: the money they borrow to improve their companies generates deductible interest. Wealthy people also take advantage of the government's fine offer, routinely leveraging their own assets, including the family home, to borrow money to invest. They pay expensive tax lawyers and tax accountants to show them how to take advantage of these tax benefits. But what about the people who need the tax deductions the most — the 90 per cent of Canadians who are not wealthy?

Swap bad debt for good debt

Ordinary taxpayers can tap into these same benefits by turning their mortgage into a tax-deductible investment loan. The technique builds on an old strategy called debt swapping, used by accountants and financial advisers to save their clients tax dollars and increase their portfolio value.

With a debt swap, if you have a mortgage and also own $20,000-worth of mutual funds out-

side of your RRSP, you can benefit from selling those funds, paying the commission and taxes, using the residue to reduce your first mortgage and then immediately borrowing back the same amount of money — using the new equity in your house as collateral — to re-purchase equivalent assets to those you just sold. Your total debt is the same and you still have your assets, but the interest on $20,000 has just been changed from nondeductible interest (the first mortgage) to deductible interest (an investment loan). During this process, there are some expenses incurred, such as an appraisal and legal expenses to create a collateral mortgage.

The Smith Manoeuvre

My technique, The Smith Manoeuvre, works a little differently. Instead of swapping a portion of the debt and paying associated expenses every time you want to do the procedure, it establishes a 75 per cent re-advanceable mortgage. This allows a homeowner to convert the whole mortgage over a period of time, without repeat credit applications, appraisals or legal expenses. Since this is a new and improved twist on the traditional debt swap, I recommend that people get help from a qualified adviser. The advantages are immense if you set up the process correctly from the beginning. (Some institutions will suggest arranging a typical home equity loan, but it is not enough.)

Once the re-advanceable mortgage is in place, the manoeuvre begins to work its magic. Every time you pay off a dollar on the mortgage, the financial institution will lend it back to you immediately, to be used to purchase investments. If you pay off $1,000 on your principle, the bank will immediately lend $1,000 back to you to invest. If you borrow to invest at 5 per cent (a low rate of borrowing because your house is the security for the investment loan), then your actual rate of borrowing will be 3 per cent after you receive your tax refund (if you are in the 40 per cent tax bracket, for example).

Your new investments — which could range from real estate or mutual funds to investing in a business — might be taxable or partly taxable, but if you invest in equities and hold them, they will grow, tax-free. The spread between the 3 per cent after-tax cost in this example and the rate of return you earn on your investments represents the increase in your net worth.

The debt stays constant — changing only in character (from "bad debt" to "good debt") — which generates free tax refund cheques, every year. Those refunds are used to reduce the mortgage even faster, which allows you to invest even faster.

As an example, a typical Canadian family, after converting their $200,000 nondeductible mortgage to a deductible investment loan, can improve their net worth by over three-quarters of a million dollars by employing The Smith Manoeuvre (the benefit will vary according to individual circumstances).

The tut-tuts will say: "You are taking a risk if you use the equity in your house to invest." But the arithmetic demonstrates that the risk is far greater if you don't put that equity to work to leverage your wealth.

With a good adviser, a cooperating tax department, motivated financial institutions and knowledge of how to make home mortgages tax deductible, I hope that more ordinary Canadian homeowners will adjust their way of thinking enough to move closer to the ranks of the wealthy.◆

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