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***TAX*STRATEGY**

Convert your mortgage to tax-deductible interest

Maximize tax savings

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"Other than the standard deductions and RRSP/TFSA, what else can I do to pay less tax?" This is a question I get asked quite often.

In most cases, the query is posed by a salary earner i.e., someone with limited available deductions. And I usually respond by noting that one of the simplest deductions available is the interest deduction on money borrowed to invest.

If you borrow to invest in tax-efficient investments, you can claim your interest deduction every year and hopefully minimize or defer any tax on the investments.

Most Canadians would like to deduct their mortgage interest, like our American cousins. Borrowing to buy your home is not deductible in Canada, but borrowing against your home to invest is tax deductible.

In addition, long term returns on the stock market have been far higher than typical borrowing rates, so you could earn a significant investment gain over time.

Borrowing to invest is inherently risky and should never be done only for the tax deductions. The risks decline considerably with time, however.

The stock market fluctuates widely in one-year periods, but, according to Standard and Poors, the worst 25-year return, of the S&P500 in the last 80 years has been a gain of 5.6 per cent a year.

It is best to see borrowing to invest as an aggressive RRSP alternative – a way to invest for your retirement that provides a significant annual tax deduction. However, it is generally only suitable for aggressive investors with long-term horizons.

Let's take a closer look at the various leverage strategies and their risks – and how to maximize your tax savings.

The Smith Manoeuvre

Many Canadians find it difficult to invest enough to have the retirement they want while maintaining their lifestyle today. However, the Smith Manoeuvre can make a retirement plan work.

It is an elegant strategy for retirement that doesn't require dipping into your cash flow.

Instead, it involves borrowing the available equity in your home to invest bit by bit as you gain equity with each mortgage payment.

To implement it, you need a readvanceable mortgage, which is a mortgage linked with a credit line.

Readvanceable mortgages are available from most banks. The credit limit for your mortgage, plus the credit line, is normally 80 per cent of the appraised value of your home.

With each mortgage payment you pay down some principal, which immediately becomes available credit in the credit line. In addition, you can borrow this amount to invest.

For example, if your mortgage payment is $1,000 bi-weekly and the principal portion is $500 bi-weekly, then you could borrow $500 bi-weekly from the credit line to invest.

If you invest bi-weekly or monthly in this way, you get the "dollar cost averaging" benefit of a lower average cost, which makes this a safer way to invest than investing one lump sum.

Your investment credit line interest is tax deductible, so you should start receiving tax

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refunds. These may be very small in the early years.

In the classic Smith Manoeuvre scenario, you would use your tax refunds to pay down your mortgage and then immediately reborrow the same amount from your credit line to invest.

If you use only tax refunds from the Smith Manoeuvre to pay your mortgage more quickly, you generally pay off your 25-year mortgage three years sooner.

The expected benefit of the basic Smith Manoeuvre over 25 years is typically about twice your mortgage (and higher for some of the enhanced versions).

Note: Smith Manoeuvre Calculator. Assumes starting mortgage at 80 per cent of home value, 25-year amortization, three per cent mortgage, four per cent credit line, 10 per cent long term investment return (similar to stock markets), and 46 per cent marginal tax bracket.

Capitalizing the interest

The Smith Manoeuvre, like any leverage strategy, can be done without using your cash flow if you "capitalize the interest." This means you borrow from your credit line to pay the interest on the credit line.

The tax rule is that if interest on a credit line is tax deductible, then interest on the interest is also tax deductible. The key issue here is tracking; you need to be able to track that the money borrowed was used to pay the interest.

Banks generally will not allow you to automatically use the credit line to pay its own interest, so you would need to "guerilla capitalize," which means you do it as a manual transaction.

Have the interest paid from your chequing, but then withdraw the exact same amount (to the penny) from your credit line to replenish your chequing account. A better way is to have a dedicated separate chequing account that is used only for these transactions.

Strategies

The variations of possible strategies are limited only by your imagination, but here are the main ones:

"Plain Jane" Smith Manoeuvre: This is the basic original Smith Manoeuvre starting with zero and investing bi-weekly or monthly the principal portion of each mortgage payment.

Instant debt conversion: You can convert part of your mortgage to a tax deductible credit line instantly if you have non-registered investments by selling the investments to pay down your mortgage and then immediately reborrowing the same amount from the credit line to invest.

Variations of possible strategies are limited only by your imagination

We met a couple that had a $100,000 mortgage and $100,000 investments at the same bank branch. We sold the investments to pay off the mortgage, then immediately borrowed $100,000 to invest again. The new mortgage interest is now tax deductible, since the money was used to buy the investments.

It is usually a good idea to use any non-registered investments to convert part of your mortgage to tax deductible as you start the Smith Manoeuvre.

Top-up: If you have additional equity in your home, you can borrow that to invest as you start the Smith Manoeuvre. This still requires no cash flow, since you can capitalize the interest.

"Debt Miracle": If you have other non-deductible debts and some home equity available, you can merge all the debts and the payments into your mortgage, so that you are effectively converting all the debts to tax deductible interest over time. This can make your monthly Smith Manoeuvre investment very large.

For example, if you have a $1,000 monthly mortgage payment and you're also paying $500 per month on a car loan, $250 per month on a credit line and $250 per month on a credit card, you can merge them all into your mortgage and pay $2,000 per month.

This is the same payment, but now likely close to $1,500 per month is the principal portion, which means you can invest $1,500 per month with the Smith Manoeuvre.

Smith Manoeuvre with dividends: If your objective is more about paying down your mortgage than maximizing your benefit, you can invest entirely in dividend-paying investments. You can use the dividends to pay down your mortgage more quickly and then immediately re-borrow the same amounts to invest.

Using mutual funds from one specific company, Nexgen Financial (as discussed in the December 2012 issue of *The TaxLetter*) can give you a six per cent eligible dividend from any investment, including global equity, balanced or bond funds. This can pay your non-deductible mortgage off a lot more quickly, but the tax on the dividends reduces your tax refunds each year.

Smith/Snyder: One tax-deferred option for taking income from your leveraged investments after you retire is to invest in "T8" mutual funds that pay out eight per cent of the balance each year. Most of this payment is "return of capital" (which is tax-free), but reduces the amount of your credit line that is deductible.

This strategy was heavily marketed as a way to pay off a mortgage very quickly, but actually has no benefits unless you need the income. The "return of capital" means the original loan or credit line becomes non-deductible. For tax purposes, paying a return of capital payment onto your mortgage is the same as cashing in your investment and spending it.

Rempel Maximum: I created this strategy for the very small number of clients that want the maximum possible wealth building they can do with their given cash flow. Instead of investing the principal portion of each mortgage payment, we borrow a lump sum to invest either from a credit line or an investment loan so that the interest-only payments are equal to the principal portion.

For example, instead of investing $500 per month, we could take out an investment loan of $150,000 at four per cent, which would have interest payments of $500 per month.

Benefits and Issues

With leverage investing, investing tax-efficiently can significantly increase the benefit.

Capital gains and dividends are taxed at preferred rates, but the lowest tax by far is on deferred capital gains. Investing in corporate class mutual funds, or buying and holding growth stocks, can defer most or all of your gains far into the future when you start withdrawing in retirement. Meanwhile, you can still claim your interest deduction each year.

The key tax issues for maintaining deductibility are:

Tracking: It is critical to always be able to trace any amount borrowed to the investment purchase.

Keep tax deductible credit line separate: Do not co-mingle deductible and non-deductible debts.

Current use: CRA is concerned with the "current use" of money borrowed, not the original use. If you borrow to invest and then cash in the investment to spend, your credit line is no longer deductible because the current use of the money is for spending.

Non-registered investments: The investments cannot be in an RRSP or TFSA.

"Expectation of income": Your investments should be reasonably expected to pay income. This is often misinterpreted as the investments must pay dividends or interest.

In general, almost any stock or mutual fund is fine (even if it does not pay a dividend) as long as its prospectus does not prohibit ever paying a dividend. All that is necessary is a reasonable expectation that the investment could pay a dividend or interest at some point.

Selling investments: If you sell any investments, the lower of either the amount invested (book value) or the proceeds of selling must be paid down on the credit line, or the interest on that amount of the credit line becomes non-deductible.

Taxable investment income: The general rule is that if you receive taxable income from your investments, such as dividends or a capital gains distribution, you can use that cash for any purpose without affecting the deductibility of the credit line.

Return of capital: If you receive any payments from the investments that are tax-free because they are "return of capital," such as from a T8 fund or a REIT, that amount must be paid onto the credit line. If it isn't, the interest on that amount of the credit line is no longer deductible.

If you invest for 20 years or more, the range of historical returns (standard deviation) of stocks is actually lower than bonds*. ❐

* "Stocks for the Long Run,: 2008, Prof. Jeremy Siegel.