



Can you make your mortgage tax deductible... without moving south of the border?

What if, like our American friends to the south, you could deduct your mortgage interest payments? Well, truth be told, you can – by converting your “bad debt” into “good debt.”

Accumulating debt is easy. Managing debt takes focus. Profiting from debt takes a whole different approach to financial management. You can equate it to driving in Britain: the cars move people exactly the same way they do in Canada, but everything seems to be coming at you from the wrong direction.

Debt conversion can be profitable and isn't difficult; it's simply a matter of thinking long term, keeping an open mind and knowing how.

“GOOD DEBT” VERSUS “BAD DEBT”

First, let's dispel the myth that all debt is bad. Borrowing to buy a depreciating product (a car, television or sofa) will always be considered bad debt.

However, when money is borrowed to buy something that can earn you income, the amount of interest you pay to service that debt can be deducted from your income before you pay your taxes. Now that's “good” debt! Good debt may be referred to as leveraged investing or borrowing to invest but, in basic terms, it is borrowing money to make money.

NEXT STEP: CONVERTING YOUR BAD DEBT INTO GOOD DEBT

The concept of not “eliminating” your debt but rather “converting” it from non-deductible to deductible debt is gaining popularity in Canada. There are a number of vocal proponents of the concept, each believing that every Canadian should be aware of their ability to convert their debt – more specifically, the ability to convert their mortgage into a tax deductible debt.

Most Canadians are oblivious to the real cost of their mortgage. In fact, a few years ago, a survey by Maritz Research¹ showed that over 75 per cent of Canadians surveyed either underestimated the amount of interest they would pay on a mortgage or had no idea of the total cost. For example, a \$150,000 mortgage at seven per cent paid over a 25-year period would cost the



homeowner more than the original mortgage amount (\$165,000) just in interest alone. At a 40 per cent tax bracket, the mortgage holder would need to have earned \$525,000 to pay off that \$150,000 debt. That's why more and more Canadians are investigating tax-deductibility as an alternative option.

THE CONVERSION

The first step is for the homeowner to switch to a "re-advanceable" mortgage. Essentially, it's a secured line of credit based on the value of their home. As the term "re-advanceable" suggests, every time a portion of the principal is paid down, it's borrowed back. The re-advanced money is then used to purchase an investment.

As an example, a \$200,000 mortgage at seven per cent would cost the homeowner about \$1,400 a month. In the first month, roughly \$1,150 would go towards interest and \$250 towards the principal. To convert that debt to tax deductible borrowings, the homeowner should then take that \$250 back out of their home equity and invest it.

By the end of the first year, the homeowner will have re-advanced and invested about \$3,100. Borrowing back the money and investing it creates an investment loan, the interest on which may now be tax-deductible. This process is repeated year after year.

Although the debt level remains at the original \$200,000, more and more of it is being systematically

converted to tax-deductible debt. In addition, ever-increasing tax refunds received by the happy homeowner could also be applied against their mortgage, and then re-borrowed and invested. Also, the homeowner could take any non-registered investments and apply those dollars against their mortgage, enabling them to borrow the money back for tax-deductible investing (assuming the costs and potential capital gains triggered by selling the non-registered investment to pay down the mortgage are not prohibitive).

There are three significant advantages to applying this strategy:

- 1 The homeowner is accumulating an investment portfolio over several years enjoying compounding growth
- 2 Interest deductions are generated, providing the possibility of tax refunds
- 3 By applying any tax refunds back into their mortgage, the homeowner is able to accelerate the paying down of their non-deductible debt

SO, SHOULD EVERYONE HAVE A TAX DEDUCTIBLE MORTGAGE?

There is no question that if you must have debt, having tax-deductible debt is preferential to having non-deductible debt. However, there are risks involved and it should be remembered that the program is based on current Canada Revenue Agency (CRA) rulings, which can change over time.





The best thing homeowners can do is to speak with their financial advisor. Advisors understand risk tolerance, can assess the appropriateness of the strategy to the client's specific situation and, most importantly, will be able to implement the necessary investment component of the program. Of course, they'll need to speak with a mortgage specialist to find the right mortgage.

Even if the homeowner chooses not to convert to tax-deductible debt, moving to a re-advanceable mortgage still affords the homeowner some key benefits: the ability to apply any excess dollars against the mortgage to pay it down (whenever and by whatever amount they choose) and the opportunity to borrow that money back out if it's ever needed in the future.

There's an adage in the financial planning world that states: The first step to wealth creation is the elimination of non-deductible debt. Perhaps the new call to action should be: The first step in wealth creation is the conversion of non-deductible debt to deductible debt.

Borrowing to invest is suitable only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans since losses as well as gains may be magnified. The value of your investment will vary and is not necessarily guaranteed, however, you must meet your loan and income tax obligations and repay your loan in full. Please read the terms of your loan agreement and the investment details for important information and discuss with your financial advisor before deciding to borrow to invest.

¹ Maritz Research polled 2,006 Canadians aged 18 and older between August 9th and August 15, 2001. The results have a margin of error of +/- two per cent, 19 times out of 20.

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