Ease into savings with tax ploy

Put your mortgage interest to work

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Buying a house and paying off the mortgage as quickly as possible is the traditional Canadian way.

But with climbing house prices and new mortgage products that give homebuyers as long as 40 years to pay off their debt, the Canadian way isn't always the right one.

And for some homeowners, it leads to a house-rich-cash-poor retirement.

"People usually pay their mortgage down first, then think about their life goals later," said Alim Dhanji, a certified financial planner with HC Financial and Assante Financial Management Group in Vancouver. "The Smith Manoeuvre is a way to start investment savings earlier -- 10 or 15 years before the mortgage is paid off."

Named -- and recently popularized -- by Victoria-based financial strategist Fraser Smith, the Smith Manoeuvre (www.smithman.net) is a plan to legally turn the non-tax-deductible interest on a mortgage into a tax-deductible investment loan.

Homeowners pay down their mortgage, but instead of seeing the size of the debt shrink, they set up an investment line of credit with a lender so that every dollar paid off the mortgage principal becomes available for investing.

The mortgage is paid down while the line of credit is used to build an investment portfolio.

The interest is deductible, and because the investment loan is secured by the property, the interest rate will be the bank's prime rate, so the homeowner will see a growing portfolio even with conservative investments, Dhanji said.

"You take advantage of compounding -- the sooner you start saving, the quicker you can accumulate savings," he said. "There are some risks; the portfolio could have some investments in the stock market [that] could lose value.

"The asset mix should meet your own risk profile, and it's important to sit down with a financial planner or chartered accountant to understand the numbers and be sure it's the right decision for you. I wouldn't recommend people do this on their own."

Dhanji said the strategy works for homeowners who have conventional mortgages where they have made a down payment of 25 per cent of the purchase price. A lender or mortgage broker sets up the line of credit attached to the mortgage. The line of credit can only be used for non-registered investments, and there must be a clear paper trail to ensure the interest is tax-deductible.

A return of seven to eight per cent on the investments over a 25-year period will provide the homeowners with a substantial portfolio.

The line of credit can be repaid with income-tax refunds or with the profits from investments.

"This would be appealing for somebody with enough cash flow that they could handle the interest payments on the line of credit and can take a bit of risk," said Dhanji.

Matthew Chan, a mortgage broker and chartered accountant with the Richmond office of The Mortgage Centre, said people are becoming interested in the Smith Manoeuvre, but it requires a shift from the traditional approach to mortgages and savings.

"The problem for some people is they never pay down the total debt -- it's not increasing, but it's not going down," Chan said.

"But there is opportunity for growth with the line of credit, and it's tax-deductible debt, which is good. With our market, the problem is that, by the time people pay off their mortgage, it's too late to build up savings for retirement."

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