# Make your mortgage tax deductible

## Homeowners shown how to put 'bad' debt to work

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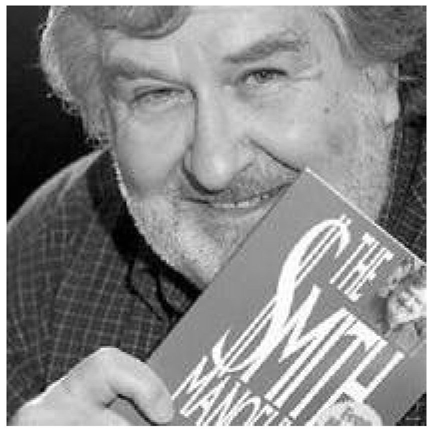
The Smith Manoeuvre is both the title of a best-selling Canadian book and the enigmatic epithet for a cunning approach to simultaneous debt management and wealth creation. The clever "how to" book describes the steps required to make non-deductible mortgage interest fully and legally deductible by regularly re-borrowing monthly principal payments for investment purposes.



CREDIT: Bruce Stotesbury, CanWest News Service

Fraser Smith's book explains how homeowners can use the principal part of their mortgage payments to make investments.

This ingenious system is the brainchild, and handiwork, of Fraser Smith, a "retired" British Columbia-based financial consultant. Far from retiring, the energetic 67-year-old has kicked into high gear in recent months with a second career -- lecturing on his tax-saving/wealth building techniques and selling books and calculators on the strategy.

Conventional wisdom advises you to pay off your mortgage before you start saving for retirement. The rationale is that since you are paying your mortgage with after-tax dollars you should make it go away before you do anything else. This would give you a financial cushion -- the free and clear equity in your house -- as a starting point from which to apply future earnings to amassing your investment nest egg.

Smith, on the other hand, advises you to swap the "bad" debt for a deductible source of investments that puts the equity in your house to work.

Smith's system requires a mortgage that permits re-borrowing of the paid-down principal seamlessly and regularly -- what Smith refers to as a "re-advanceable mortgage."

A survey of Canadian financial institutions and mortgage banks, with Vancity Credit Union the pioneer back in the 1980s, indicates that almost all of them offer many of the features required to put the Smith Manoeuvre into effect. Examples are Scotiabank's STEP program, TD's HELOC and BMO's Readiline.

The main feature is the ability to re-borrow principal repayments right away to invest, but Smith would also like the "perfect" Smith Manoeuvre mortgage to capitalize interest, at least on the investment portion, track interest costs monthly, particularly on the deductible portion, and have credit limits up to 100% for dedicated and qualified investors.

Ed Rempel, a Brampton, Ont., financial planner and a dedicated proponent of Smith's system with "about 70" Smith Manoeuvre clients, gives a powerful example of how he has used it to help one average Canadian family break out of the debt cycle and get ahead.

"Last year I met a delightful couple in their mid-40's with a combined income of less than $80,000 who were struggling to meet monthly mortgage payments of $964 and payments on other debt of $1,300, including several credit cards, two credit lines and an RRSP loan," explains Rempel.

"Without the Smith Manoeuvre it would be difficult for me as a financial advisor to help them very much. We had them pay a penalty to refinance their mortgage at a lower rate and then roll in all their other debt. The credit line linked to their other mortgage still had $55,000 available credit. With the Smith Manoeuvre we were able to invest a lump sum of $55,000 plus $1,335 a month [by re-borrowing monthly principal payments from their credit line], throw in the annual tax refund on the deductible interest, and still contribute to annual RRSP's!"

Rempel describes how at the same time they reduced the amortization of their "bad" (non-deductible) debt from 19 years to seven years.

"The result for them was truly miraculous," says Rempel. "They went from struggling with debt and hardly saving to being on a fast track to a significant investment portfolio and a fully deductible mortgage."

The key to the long-term Smith Manoeuvre, however, is that incremental equity is put to work for you rather than just accumulating, regardless of any other investments you may be able to make. Without having to spend any more money monthly, anyone can potentially harness the power of compounding tax-efficient investments and deductible mortgage interest. The difference between the after-tax mortgage interest and the average investment yield can clearly grow quite dramatically over time, if historical spreads continue into the future.

Importantly, Smith has provided an "open platform" approach to his system, providing access to everyone. He also offers, via his Web site (www.smithman.net), access to financial planning professionals like Ed Rempel who understand and can apply his Manoeuvre for individual clients.

Getting a professional involved will spread the responsibility between client and advisor for maintaining discipline in paying down non-deductible debt, prepaying principal with tax rebates, and for investing in solid prospects.

It also reinforces what I believe is the real payoff of the Smith Manoeuvre: it will turn an average borrower into an active investor years ahead of the traditional route. In my humble opinion it is far better to be an experienced investor with a portfolio and a deductible mortgage than an inexperienced investor with neither.