

A hand in a dark sweater sleeve is shown from the left, dropping a gold coin into a clear glass piggy bank. The piggy bank is positioned at the bottom of the page, and the coin is captured mid-air just above its opening. The background is plain white.

# BEATING

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As sophisticated homeowners search for new ways to get the most from their mortgage strategy, *Sandy Aitken* explains how you can separate yourself from the pack and offer them what was once unthinkable – a tax-deductible mortgage

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**S**ince the publication of the *Smith Manoeuvre* six years ago, homeowners have become seduced by the notion of tax-deductible mortgages and lured by the possibility of paying off their mortgages in half the time.

As a result, the tax-deductible mortgage strategy, in its variety of forms, has become a rapidly emerging marketing opportunity – and one that is truly exclusive to mortgage brokers, allowing them to separate themselves from the banks.

The simple fact is that any mortgage strategy that involves leveraged investing and tax advice for the middle class is a tough bundle to sell, and no major financial institution in Canada is currently organized for the challenge.

And given the recent credit crunch, combined with the financial institutions' collective inability to adapt quickly to new product offerings, it's quite possible that this will be an area of growth exclusive to the mortgage broker channel, at least for the next few years.

But before you jump on board, it's important to do your research – both in learning the associated risks of this mortgage strategy, as well as how to identify your ideal client.

## The basics

A properly structured mortgage-centric tax strategy has several key elements – the most important of which is a multi-component, re-advanceable mortgage or line of credit.

# THE TAXMAN

It's best to have a single charge with at least two components – usually a fixed-term mortgage and an open line of credit – that can track and report interest independently. This is absolutely essential under Canada Revenue Agency (CRA) rules and guidelines.

Second, the strategy must employ conservative leverage-investment techniques – which is why a mortgage broker must team up with a financial advisor in order to comply with federal regulations. The financial advisor should be a Certified Financial Planner (CFP) who is experienced in leveraged investing, and able to actively monitor a homeowner's portfolio on an ongoing basis.



Sandy Aitken

## FEATURED PRODUCT

National Bank's All-In-One product is well suited to tax-deductible mortgage strategies because it enables clients to create up to 99 sub-accounts under one main account. These sub-accounts make the transferring of funds easy because, as the funds are separated, clients can reserve the money for investment-related transactions and avoid accidentally violating Canadian Revenue Agency regulations.

If you choose not to partner with an experienced CFP, you run the risk of becoming the de facto financial advisor to the homeowner – and managing the back-end work on your own. Not only is this time-consuming, but it's also not an appropriate situation for the mortgage brokerage.

Due to conflict of interest regulations, CFPs are rarely licensed to sell mortgages as well as investments, so the CFP needs the mortgage agent as much as the mortgage professional needs the CFP – and the homeowner needs the advice of both.

### Finding the ideal client

Ideal borrowers for an advanced mortgage and tax strategy are typically professionals or other high-income earners who have owned a home for five to 15 years and have built up substantial equity. They are usually between 35 and 55 years old, and in their peak earning years.

As high-income earners, their total debt-servicing ratio will be quite low and they always have excellent credit (700+ Beacon scores). These borrowers are financially sophisticated homeowners that are keenly interested in establishing a secure financial future and comfortable retirement.

They understand that financial security is more than merely paying off their home – it also involves saving enough cash so that they won't be faced with the prospect of a minimal cash flow when they are 80 years old.

For the most part, they already fully expect to pay off their mortgage before retiring, but saving enough money to retire comfortably is another story. These borrowers are acutely aware that if they don't do something different in their financial plan, they will not have enough money for retirement.

### The risks

The financial benefits of a tax-deductible mortgage are irrefutable and justify the risks to the right borrower.

A 40-year-old professional couple, for example, should expect to pay off their mortgage in half the time and generate up to three times the mortgage amount in incremental net wealth over 20 years without changing their cash flow. In addition, the first year's tax refund for an average client is in excess of \$4,000 and these benefits assume that all tax refunds, generated by the strategy, are reinvested.

These considerable financial benefits, however, come with certain long- and short-term financial risks. The long-term financial risk is market performance. In order to qualify for this strategy, homeowners should be paying taxes of at least 35% at the margin, which means that their long-term return on investment needs to be at least two-thirds of their cost of borrowing for the strategy to make sense.

In reality, as the mortgage broker, you have little or no influence over market risk, as it's simply not your job. You can choose what CFP you work with, however, and it's recommended that you select the financial advisor very carefully to mitigate risk. A CFP who has a reputation of proactively managing his clients during volatile markets and has a good track record for conserving investor capital during down markets is best.

Short-term financial risk is liquidity risk (sometimes referred to as cash flow risk). Cash flow risk addresses the possibility that interest rates will sharply drive up the cost of borrowing at the same time as markets falter, resulting in a negative client monthly cash flow for a brief period of time.

This short-term risk is typically only prevalent in the first two to four years because, after several years, the homeowner has stockpiled enough equity through annual tax refunds that other liquidity options exist and the risk is fully mitigated.

Liquidity risk varies widely based on the balance sheet strength of the homeowner. Highly qualified homeowners are easy to manage as these borrowers have no difficulty meeting the short-term cash flow demand should the need arise.

## A 40-year-old professional couple should expect to pay off their mortgage in half the time and generate up to three times the mortgage amount in incremental net wealth over 20 years

In order to properly manage this risk, it's important that inexperienced mortgage agents who choose to advise homeowners on this strategy stick to very well qualified deals – namely, those that have at least one year of leverage loan interest payments in liquid assets, a total debt servicing (TDS) ratio under 41% and a minimum of 35% equity in the home. As the mortgage agent, you should resist working with marginal clients altogether and take a conservative approach to barely qualified prospects by advising them to wait a year or two.

### Play nice

Any taxpayer that fails to actively plan to avoid paying taxes is unnecessarily over-contributing to the federal coffers. It's worth noting, therefore, that tax avoidance in Canada is not only legal, it's a moral imperative – and any mortgage broker that doesn't structure debt with a keen eye to tax efficiency is doing a serious disservice to his or her client.

It is important to note, however, that there is a very fine line between what the federal government calls abusive tax

avoidance under the CRA General Anti-Avoidance Rules (GAAR) and what good advisors would call 'successful tax planning'.

The key thing to remember is that, as long as the homeowner is borrowing for the primary purpose of investing in income-generating assets, there is zero risk under GAAR.

The other CRA risk is co-mingling tax-deductible interest with personal funds. Fully mitigating risk to a federal government clawback of tax benefits requires a rigorous administrative regimen of monthly cash flow management that ensures maximum tax efficiency and provides a bullet-proof audit trail.

Mortgage brokers that manage only a handful of clients should seriously consider advising their clients to use a third-party service for the cash flow management part of this strategy and also encourage homeowners to have a certified accountant file their tax returns.

In the end, obtaining a tax-deductible mortgage isn't easy. The stakes are high and sophisticated borrowers will not tolerate anything less than a confident and knowledgeable mortgage professional. This advanced financial strategy is not for every qualified homeowner, nor is it for every mortgage agent, but significant rewards abound for those who make the commitment.

*Sandy Aitken is CEO and founder of [www.tdmp.com](http://www.tdmp.com), an online portal for mortgage brokers, financial planners and homeowners interested in the accelerated Smith Manoeuvre and other advanced mortgage strategies* **CMP**

### FEATURED PRODUCT

TDMP.COM offers full training and support to mortgage professionals interested in offering tax-efficient mortgage strategies. The training program – eligible for 8.5 CAAMP continuing education credits – focuses on the TDMP.COM Web Portal where registrants learn how to select a lender (FirstLine or Merix), structure mortgage components for CRA compliance, select a local TDMP.COM Certified Financial Planner and submit deals for Client Cash Flow Management. Certified brokers/agents retain 100% of all lender commissions and bonuses, and can earn up to \$1,000 per deal as an additional TDMP.COM volume bonus.