

Creating a tax-deductible Canadian mortgage

by Ayton MacEachern, CFP, for Investopedia.com

Friday, April 16, 2010 provided by 

The way that mortgages are treated in the Canadian tax code is slightly different than in the U.S. One main difference is that the interest on a mortgage for a principal private residence in Canada is not tax deductible. However, no taxes are payable on any capital gains upon selling the home. But what if there was a way to take advantage of the capital gains exemption, and make the interest tax deductible? Keep reading to find out how to make your Canadian mortgage tax deductible.

Your Net Worth and Cash Flow

An individual's net worth is his or her assets minus liabilities. To increase your net worth, you must either increase your assets, decrease your liabilities, or both.

An individual's free cash flow is the amount of cash that is left over after all expenses and debt payments have been made. To increase your cash flow, you must spend less, get a better paying job, or pay less tax. Let's take a look at a strategy to help you increase your assets by building an investment portfolio, decrease your debts by paying off your mortgage faster, and increase your cash flow by paying less tax; effectively increasing your net worth and cash-flow simultaneously.

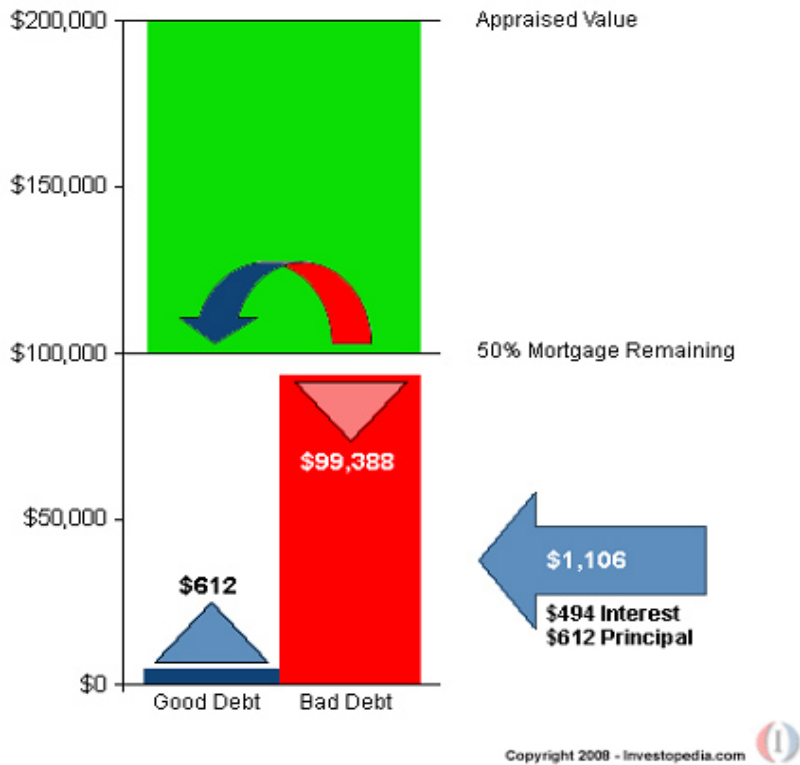
The Strategy

Every time you make a mortgage payment, a portion of the payment is applied to interest, while the rest is applied to principal. This principal payment adds equity to the home and can be borrowed against (often at lower rates). If the borrowed funds are then used to purchase an income-producing investment, the interest on the loan is tax deductible, which makes the effective interest rate on the loan even better.

This strategy calls for the homeowner to borrow back the principal portion of every mortgage payment, and invest it in an income-producing portfolio. Under the Canadian tax code, interest paid on monies borrowed to earn income is tax deductible. As time progresses, your total debt remains the same (as the principle payment is borrowed back each time a payment is made), but a larger portion of it becomes tax deductible debt (good debt), and less of it remains as "old" non-deductible debt (bad debt).

To explain this better, refer to Figure 1 below, where you can see that the mortgage payment of \$1,106 per month consists of \$612 in principal and \$494 in interest.

Figure 1

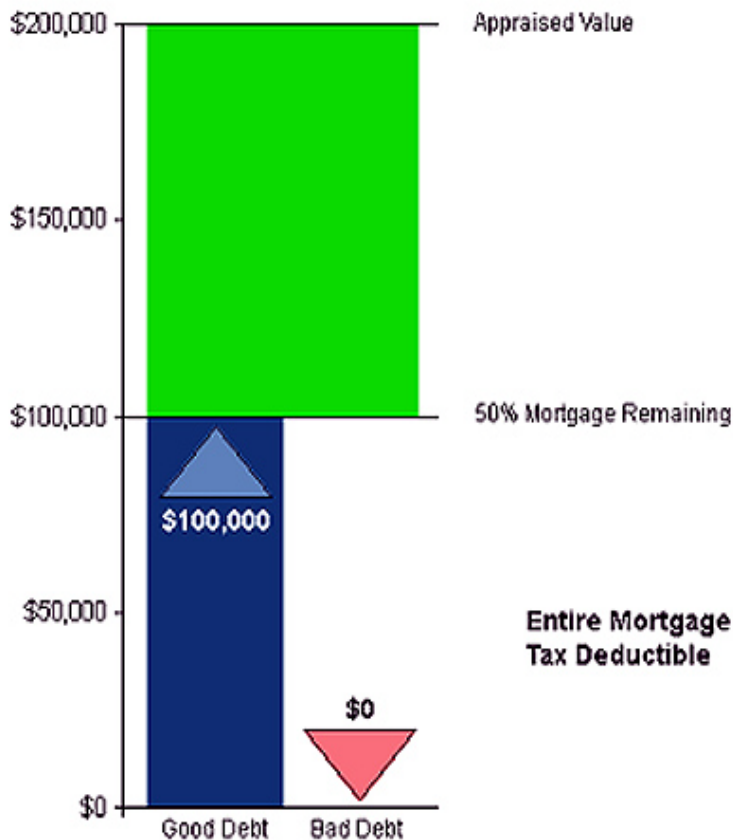


As you can see, each payment reduces the amount owing on the loan by \$612. After every payment, the \$612 is borrowed back and invested - this keeps the total debt level at \$100,000, but the portion of the loan that is tax deductible grows by each payment. You can see in Figure 1 that after one month of implementing this strategy, \$99,388 is still non-deductible debt, but \$612 is now tax deductible.

This strategy can be taken a step further: The tax-deductible portion of the interest paid creates an annual tax refund, which could then be used to pay down the mortgage even more. This mortgage payment would be 100% principal (because it is an additional payment), and could be borrowed back in entirety and invested in the same income-producing portfolio.

The steps in the strategy are repeated monthly and yearly until your mortgage is completely tax deductible. As you can see from the previous figure and the next figure, the mortgage remains constant at \$100,000, however, the tax deductible portion increases each month. The investment portfolio, on the side, is growing also, by the monthly contribution and the income and capital gains that it is producing.

Figure 2



Copyright 2003 - Investopedia.com 

As seen in Figure 2, a fully tax deductible mortgage would occur once the last bit of principal is borrowed back and invested. The debt owed is still \$100,000, however 100% of this is tax deductible now. At this point, the tax refunds that are received could be invested as well, to help increase the rate at which the investment portfolio grows.

Benefits

The goals of this strategy are to increase cash flow and assets while decreasing liabilities. This creates higher net worth for the individual implementing the strategy. In addition, this strategy also aims to help you become mortgage-free faster, and to start building an investment portfolio faster than you could have otherwise.

Let's look at these a bit closer:

* Become Mortgage-Free Faster: The point at which you are technically mortgage free is when your investment portfolio reaches the value of your outstanding debt. This should be faster than with a traditional mortgage because the investment portfolio should be growing at the same time as you are making mortgage payments. The added mortgage payments from the tax returns can pay down the mortgage even faster.

* Build an investment portfolio while paying your house down: This is a great way to start saving. It also helps free up cash that you might otherwise not have been able to invest prior to paying off your mortgage.

Now, let's compare a traditional mortgage to that of a person using this tax-deductible technique.

Case Studies

Dick and Jane's House - Bought the Traditional Way

Dick and Jane bought a \$200,000 home with a \$100,000 mortgage amortized over 10 years at 6% with a monthly payment of \$1,106. After the mortgage is paid off, they invest the \$1,106 that they were paying for the next five years earning 8% annually.

After 15 years, they own their own home, and have a portfolio worth \$81,156

Dick and Jane's House - Bought Using the Tax Deductible Strategy

Dick and Jane bought a \$200,000 home with a \$100,000 mortgage amortized over 10 years at 6% with monthly payments of \$1,106. Every month, they borrow back the principal and invest it. They also use the annual tax return that they receive from the tax deductible portion of their interest and pay off the mortgage principal. They then borrow that principal amount back and invest it. After 9.42 years, the mortgage will be 100% good debt, and will start to produce an annual tax refund of \$2,340 assuming a marginal tax rate (MTR) of 39%. After 15 years, they own their own home, and have a portfolio worth \$138,941 - a 71% increase.

A Word of Caution

This strategy is not for everyone. Borrowing against your home is psychologically difficult, and if the investments don't yield expected returns, this strategy could yield negative results. By re-borrowing the equity in your home, you are also removing your "cushion" of safety if the real estate (or investment) markets take a turn for the worse. By creating an income-producing portfolio in an unregistered account, there can also be additional tax consequences - so always consult with a professional financial advisor to determine whether this strategy is for you, and if it is, have it tailor-made to you and your family's personal financial situation.

Copyright © 2010 Yahoo! Canada Co. All rights reserved. [Privacy Policy](#) - [Terms of Service](#)

Quotes and other information may be supplied by independent providers. All information is provided on an "AS IS" basis, for informational purposes only, and is not intended for trading purposes, advice or planning. It would be unreasonable for you to make any trade without first consulting an authorized financial advisor and verifying the accuracy of all information. Yahoo! and its independent providers do not warrant the accuracy, completeness or timeliness of any information provided herein, and expressly disclaim any and all liability for any decisions made in reliance thereon. The information is not an endorsement or recommendation by Yahoo! of any trade, even where the information relates to Yahoo!. Notwithstanding anything herein, Yahoo! does not hold itself out as an advisor or planner of financial services of any kind. By accessing the Yahoo! site, you agree not to redistribute the information found herein, and to be otherwise bound by the Yahoo! [Terms of Service](#).