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How to transform personal debt into tax-deductible business debt

An Overview of the “Cash Damming” Strategy

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If you own an unincorporated business or professional practice, you may be able to take advantage of a tax-saving strategy called “cash damming.” This is when you convert your personal debt into business debt, in order to benefit from tax-deductible interest. In other words, you can use your business’ gross revenue to pay off your personal debts and a separate line of credit or loan facility — used exclusively for your business — to cover your ongoing business expenses..

This article shows you how cash damming may work and what to consider before deciding on this strategy.

Who can use this strategy

You are eligible for cash damming if you

- Generate professional or business income through an **unincorporated** entity
- Incur professional or business expenses in order to generate your income; and
- Have personal debt

What you need to get started

- **A separate bank account** for depositing your gross business or professional income and paying off your personal debts
- **A second separate bank account** for paying business expenses
- **A line of credit or other loan facility** for replenishing the second account as needed

How it works

Let’s look at an example. Dr. Green is the owner of an unincorporated dental practice with two employees. She owns a house with a $220,000 open mortgage. This year, the gross annual income from her practice is $300,000, and her business expenses are $125,000.

Dr. Green decides to use the cash damming strategy and pay her business expenses with a separate (business) line of credit instead of her revenue. This gives her an extra $125,000 in net cash flow from her business that she can put toward her mortgage.

	Before cash damming	**After cash damming**
Gross revenue	$300,000	$300,000
Expenses paid from business revenue	$125,000	$0*
Net business revenue before income tax	$175,000	$300,000

* The $125,000 of business expenses is paid by the line of credit instead of from business revenues. Excludes the associated interest expense.

Unlike a corporation, which is subject to restrictions on paying personal debt, Dr. Green is allowed (under tax law) to pay off her personal debt with her business revenues. This means she can use the extra cash flow from cash damming ($300,000 – $175,000 = $125,000) to pay down her home mortgage.

	Before cash damming	**After cash damming**
Mortgage balance	$220,000	$95,000
Line of credit balance	$0	$125,000
Total debt	**$220,000**	**$220,000**

Income tax savings

As you can see, after cash damming, Dr. Green’s mortgage shrinks as much as her line of credit grows, making her total amount of debt before and after cash damming the same.

However, since the interest on the business line of credit is tax-deductible, and the interest on her personal mortgage is not, she will be able to reduce the amount of taxes she owes at year-end.

	Before cash damming	**After cash damming**
Gross revenue	$300,000	$300,000
Business expenses	$125,000	$125,000
Approximate deductible interest expense	**$0**	**$7,500**
Taxable income	$175,000	$167,500
Income tax liability (assumed rate of 35%)	**$61,250**	**$58,625**

This strategy will save Dr. Green $2,625 ($61,250 – $58,625) in income tax in the first year alone. As long as she uses her tax savings to make extra mortgage payments, she will be able to pay off her mortgage much faster.

Alternatively, she could use the savings to grow her business, pay off some of the business line of credit, save for retirement or treat herself to a vacation — the savings are hers to do as she sees fit.

Is this strategy right for you?

Before making a decision, you should review all the potential benefits and costs to determine if cash damming is the best strategy for you. Here are some potential pitfalls to keep in mind:

- Paying off your mortgage or other debt ahead of schedule may trigger a prepayment penalty from your lender. Make sure you discuss your prepayment options with your lender well in advance.
- You may have difficulty securing a large business line of credit if you don't have sufficient collateral.
- If the interest rate on the line of credit is higher than your mortgage rate, you will need to determine if the income tax savings outweigh the incremental borrowing cost.

No matter what your situation, it's always a good idea to discuss your options with your tax advisor. They can help you decide what is the best strategy for you.

CRA's current position on cash damming

At least for now, it seems unlikely that this tax-planning strategy will be challenged under the Income Tax Act's General Anti-Avoidance Rules. In an income tax ruling, published in February 2003 (F2002-018052), the Canada Revenue Agency (CRA) acknowledged cash damming as a legitimate strategy that would not be challenged. However, as with all tax planning strategies, there's a possibility that tax legislation will change and render the strategy less effective.

In the meantime, to successfully employ this tax-planning strategy, meticulous bookkeeping is essential. Each bank account, credit line and debt instrument must be administered accurately in order to demonstrate to the CRA that they are being used for business purposes.