Reducing taxes by restructuring debt

Carrying debt is a way of life for most Canadians, whether it is a mortgage to buy a house, a car loan or a loan to invest in a business. But people often overlook a simple strategy to restructure their debt to create significant tax deductions.

You should consider this strategy if:

- You have accumulated significant equity in your home, as well as registered and non-registered assets
- You have current or anticipated liabilities with interest payments that are non-deductible
- You have a time horizon of 10 years or more until you need to access the non-registered funds used in this strategy

KEY BENEFIT

- Reduce annual income taxes

Strategy in action

The issue: non tax-deductible debt

You have non tax-deductible debt such as interest payments on your home mortgage or line of credit.

The strategy: investment loan strategy

Make your interest payments tax-deductible by following these steps:

Step 1: Identify your current non-registered assets and any non-deductible interest payments on your debt(s). Ideally, the non-registered assets should not be required for income or spending for 10 years or more to reduce the risks associated with borrowing to invest as outlined in Step 3.

Step 2: Sell the appropriate amount of your non-registered investments to pay off the non-deductible debt(s). If you are paying off a mortgage, you need to take into account any related fees or penalties. You must also consider the tax implications of selling a non-registered account so as to minimize any capital gains that may have accrued. You should review your Notice of Assessment to see if there are any capital losses carried forward to offset any capital gains. Contact your accountant or tax advisor prior to this step to minimize the tax consequences.

Step 3: Re-borrow the equivalent amount of the assets that were sold to pay off the debt, effectively replenishing the non-registered investments. Bear in mind the superficial loss rules if you are buying back identical securities within 30 days that were in a loss position at the time of the sale. Contact your Investment Advisor and accountant about the superficial loss rules prior to buying back identical securities. Ideally (but not required) the loan would be set up with similar terms as the original debt(s) to replicate the cash flow prior to implementing this strategy.

The net result: Your assets, liabilities and cash flow are the same after implementation of this strategy as they were before. But now that you have re-borrowed, or "leveraged" for investment purposes, the interest on the loan is tax deductible.† Although your balance sheet may be identical after restructuring the debt(s), you must be aware of the risks of borrowing to invest as both the gains or losses are magnified with this strategy. Please ask your Investment Advisor for more information about borrowing to invest.

†Canada Revenue Agency (CRA) must be satisfied that the leverage investment strategy has been implemented to produce income and was implemented over a reasonable timeframe. There are different rules that limit interest deductibility in Quebec that must be examined before implementing this strategy. The courts recently denied the interest deductibility in the Lipson General Anti Avoidance Rules case (currently being appealed) so contact your accountant or tax advisor prior to implementing this strategy.

The following example illustrates these steps:

Assume you have the following financial assets:

- Home valued at $800,000
- Mortgage valued at $500,000
- Non-registered assets valued at $500,000
- RSPs valued at $400,000

This illustration assumes that you are in the highest marginal tax rate and that you plan to retire in 10 years or more.

1. You sell the non-registered assets for $500,000 (for simplicity, we are assuming no taxes payable). Contact your accountant or tax advisor to understand the actual tax consequences of selling your assets.
2. You then pay off the mortgage of $500,000.
3. Using the equity in the home as security (or other financial assets depending on the scenario), you borrow $500,000 to invest in a diversified non-registered portfolio. As this is now a loan for investment purposes, the interest component may be tax deductible. Any principal payments are not tax deductible. You pay down the restructured debt(s) much as you did prior to implementing this strategy to replicate your cash flow. The details of the new loan would be arranged with the lending financial institution.

What are the potential tax savings?

Non-deductible debt	Deductible debt (Alberta)	Deductible debt (Ontario)
$500,000 mortgage	**$500,000 investment loan**	**$500,000 investment loan**
Non-deductible interest cost over 10 years:	Tax savings over 10 years at marginal tax rate of 39%:	Tax savings over 10 years at marginal tax rate of 46%:
Interest rate at 6% = $264,774	Interest rate at 6% = $103,261	Interest rate at 6% = $121,796
Interest rate at 7% = $312,310	Interest rate at 7% = $121,800	Interest rate at 7% = $143,662
Interest rate at 8% = $360,402	Interest rate at 8% = $140,556	Interest rate at 8% = $165,784

You have created a tax savings of $103,261 to $165,784 depending on interest rates and the province of residence – without changing your balance sheet of assets and liabilities or your cash flow.

Please contact your Investment Advisor and accountant for more information about the investment loan strategy. As with any tax strategy, make sure you also consult with a qualified tax professional before taking action.

Professional Wealth Management Since 1901

RBC Dominion Securities

STPTCL (11/07)