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The cash damming strategy

Reduce your taxes by restructuring debt

If you own an unincorporated business or a rental property, you may be able to take advantage of the cash damming strategy. The cash damming strategy may help you convert your personal (non-deductible) debt into tax-deductible debt, resulting in tax savings. This article describes the cash damming strategy and highlights some of the potential issues you should consider before implementing this strategy.

The strategy

If you have personal debt, such as a mortgage against your home, the interest on that debt is likely not tax-deductible. Interest will only be deductible if the money you borrow is used for the purpose of earning income from business or property. Business income includes income you earn from a profession or trade, or any activity you carry on for profit. Property income generally includes interest income, dividends, rents and royalties. As an unincorporated business owner, the cash damming strategy allows you to use your business income to pay down personal (non-deductible) debt and then reborrow to invest in your business, making the interest payments on your loan deductible for tax purposes.

To get started, you will need a line of credit or other loan facility. The borrowed funds received are used to pay your business expenses or to purchase investment assets. The funds received from business

operations are used to pay down your personal debt.

The cash damming strategy may also be used if you own a rental property. In this case, your personal expenses can be paid directly out of rental income while borrowed money can be used to finance expenses related to your rental property. Eligible expenses relating to your rental property may include but are not limited to: mortgage interest, property taxes, management fees, administration fees and maintenance and repair costs. Please consult with a qualified tax advisor to confirm which other expenses relating to your rental property are eligible.

Maintaining interest deductibility

This strategy generally involves using separate accounts to segregate funds received from borrowed money and funds received from other sources, such as your business operations. This strategy centres on ensuring interest on the borrowed money remains tax-deductible. Therefore, it's very

important to be able to directly link your borrowed funds to an income-earning purpose. Using a separate bank account to track borrowed funds and business expenses may help you keep track of which funds were used for each purpose.

Although cash damming using two separate bank accounts allows you to trace the use of your borrowed money more readily, it is not mandatory to have separate accounts. In situations where you deposit and comingle the borrowed money into one account with other funds, the Canada Revenue Agency (CRA) allows you to allocate, on a dollar-for-dollar basis, the borrowed money to a specific identifiable use. In other words, you're permitted to look at all of the uses of the money in the account, and link the borrowed funds to a specific use. However, you are required to place the borrowed funds into the account prior to, or on the same day, that the funds were used.

Illustration

Dr. Green is the owner of an unincorporated dental practice with two employees. She owns a house with a \$220,000 open mortgage, which gives her the freedom to pay down her mortgage without incurring penalties. In the current year, the gross annual income from her dental practice is \$300,000, and her business expenses total \$125,000. Dr. Green decides to use the cash damming strategy and uses a line of credit to pay for ongoing business expenses while using her practice's gross revenue to pay down her personal non-deductible mortgage.

	Before cash	After cash
	damming	damming
Business Revenue		
Gross Revenue	\$300,000	\$300,000
Less: Business expenses (paid from revenue)	(\$125,000)	\$0
Less: Mortgage payment (paid from revenue)	\$0	(\$125,000)1
Net business revenue before	\$175,000	\$175,000
income tax		
Mortgage Debt		
Mortgage balance	\$220,000	\$ 95,0001
Line of credit balance	\$0	\$125,000
Total debt	\$220,000	\$220,000
Business's Income Tax Liability		
Gross revenue	\$300,000	\$300,000
Less: Business expenses	(\$125,000)	(\$125,000)
Net business income	\$175,000	\$175,000
Less: Tax deductible interest	\$0	\$5,000 ²
expense		
Taxable income	\$175,000	\$170,000
Income tax liability (assumed rate of 35%)	\$ 61,250	\$ 59,500
Tax savings		\$ 1,750

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The key to this strategy is that interest paid on borrowed amounts used for business expenses is tax-deductible. Although Dr. Green's overall debt before and after using the cash damming strategy is the same (her mortgage decreased by as much as her line of credit increased), she effectively converted her non-deductible debt with tax-deductible debt. This conversion translated into tax savings of \$1,750 for the year. If Dr. Green continues to use her tax savings to make extra mortgage payments, she may be able to pay down her mortgage at a much faster pace than had she not used the cash damming strategy. In the end, she will have no mortgage and a large tax-deductible business loan.

Alternatively, she could use the tax savings to reinvest in her business, pay down 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?

Have you discussed financing options with your lender?

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

Do you have a long investment time horizon?

In the example illustration, the cash damming strategy is effectively converting Dr. Green's mortgage, which is a debt with a set time horizon, to an investment loan, which has an indefinite time horizon. If you're in a similar situation, since the investment loan does not have set repayment dates, you will need to have the discipline to repay the debt.

- Dr. Green uses \$125,000 from her line of credit to pay for her business expenses. She then uses \$125,000 of her practice's gross revenue to pay down her mortgage balance from \$220,000 to \$95,000.
- 2) Assuming an interest rate of 4% on the line of credit.

Do you have surplus cash flow?

It's important to understand the terms of the investment loan that you will use to pay for your business expenses. Some loans require a monthly repayment that's a combination of interest and principal while other loans require interest-only payments. Ensure you have adequate surplus cash flow (i.e. after-tax income less expenses) from sources other than your business to pay the applicable monthly payments.

Your source of cash flow should also be sufficient to absorb the effects of an economic downturn. An economic downturn might have a negative effect on your business's cash flow. It could also result in an increase in interest rates, which may potentially increase your borrowing costs. If your borrowing costs increase, it is prudent to have enough cash flow to cover any interest increases as well as any potential demands for repayment.

What's your risk tolerance?

Your risk tolerance is a measure of how comfortable you are with taking on risk. Borrowing to invest adds an additional level of risk to your overall financial situation.

If your borrowing costs increase, it is prudent to have enough cash flow to cover any interest increases as well as any potential demands for repayment.

Conclusion

The cash damming strategy may allow you to convert your non-deductible debt into tax-deductible debt in order to create tax savings and build long-term wealth. Your RBC advisor, along with a qualified tax advisor, can help you evaluate whether or not borrowing, and its associated benefits and risks, makes sense for you.

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