Wealth Management

# the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Karim F. Visram,
CFA, CGA, CFP, FMA
Portfolio Manager
karim.visram@rbc.com

Team line: 416-956-8888
Team email: TeamKarim@rbc.com
Team fax: 416-842-2222
Toll-free: 1-800-561-6431

RBC Dominion Securities
Royal Bank Plaza, South Tower
Suite 3900 - Toronto, ON M5J 2J2

www.karimvisram.com

## Debt swap and debt conversion strategies

Reduce your taxes by restructuring debt

**Do you own a home that's financed with a mortgage? If so, it's likely that the interest on that mortgage is not deductible for tax purposes. Interest is generally only deductible if the money you borrow is used for the purpose of earning income. So how can you turn your non-deductible mortgage into tax-deductible debt?**

**The debt swap and the debt conversion strategies effectively replace your mortgage (non-deductible debt) with tax-deductible debt in order to create tax savings. This article describes the two strategies and highlights some of the potential issues you should consider before incorporating these borrowing-to-invest strategies into your overall financial plan.**

### The debt swap strategy

If you own a home that's financed with a mortgage and you also own a portfolio of investments in a non-registered account, you may want to consider the debt swap strategy, especially if the value of your investment portfolio is equal to or greater than your outstanding mortgage. In a simple debt swap strategy, you dispose of your non-registered investments and use the proceeds from the sale to pay off your mortgage (the non-deductible debt). You subsequently re-borrow the same amount (secured by your home) and use the proceeds to purchase a non-registered portfolio of income-producing assets. At this point, since you are then directly using the borrowed money for the purpose of earning income, the interest you pay on the re-borrowing may be deductible for tax purposes.

#### How it works

To make your interest payments tax-deductible, you will need to identify your current non-registered assets and any debt where the associated interest payments are not deductible. You would need to sell the appropriate amount of your non-registered investments to pay off the non-deductible debt. If you are paying off a mortgage, you need to take into account any related fees or penalties. You should also consider the tax cost

of disposing of your investments in your non-registered account. Review your Notice of Assessment to determine if there are capital losses carried forward that you could use to offset any capital gains realized when disposing of your investments.

Once you have paid off your non-deductible debt, you would re-borrow the equivalent amount of the assets that were sold to pay off the debt, to replenish your non-registered investments. If you disposed of your original investments at a loss, consider waiting at least 30 days before reacquiring the identical securities, otherwise the superficial loss rules may prevent you from claiming the capital loss.

The result of this strategy is that your net assets and liabilities remain the same, but now that you've re-borrowed for investment purposes, the interest on the debt is tax-deductible.

### Debt swap illustration

Assume you have a mortgage valued at $200,000 with an interest rate of 5%, an interest term and amortization of 10 years, and you make monthly payments. The non-deductible interest cost on your $200,000 mortgage over 10 years is $53,956. You decide to pay off the mortgage using non-registered funds and then you borrow from a home equity line of credit (HELOC) at 5% to invest in an income-producing portfolio. The interest you pay on the HELOC is now tax-deductible.

Assume your marginal tax rate is 50%. While the amount of interest you pay remains the same over the 10-year period, your tax savings over 10 years would be $26,978 (50% x $53,956) due to the interest deduction.

### Using a holding company

The debt swap strategy works well when the tax cost of disposing of your investments in your non-registered account is minimal. If you have significant accrued capital gains and you have a holding company, you could consider an alternative — a debt swap using your holding company.

This strategy involves transferring your investments to your holding company on a tax-deferred basis in exchange for shares in your holding company and a promissory note. Care must be taken to ensure the value of the promissory note you take back does not exceed the tax cost of the investments you transferred to the holding company. You could then borrow money from the bank and use the cash to subscribe for more shares in your holding company. Since you'd then be borrowing to invest in shares (with a reasonable expectation of earning dividends from your holding company), the interest would be deductible on the borrowed money. Your company can use the funds it receives from your share subscription to pay off the promissory note owing to you. You can then use the proceeds from the promissory note to pay off your mortgage, your non-deductible debt.

If you disposed of your original investments at a loss, consider waiting at least 30 days before reacquiring the identical securities, otherwise the superficial loss rules may prevent you from claiming the capital loss.

## The debt conversion strategy

If you have a home that's financed with a mortgage but you don't have the cash flow for an investment portfolio in addition to your mortgage, you may want to consider the debt conversion strategy. The debt conversion strategy (also known as the "Smith Manoeuvre") involves making regular mortgage payments, re-borrowing the principal you just repaid and investing it in a portfolio of income-producing assets. The interest you pay on the re-borrowing may be deductible for tax purposes, since you are then directly using the money for the purpose of earning income. The deductible interest may create tax savings, which you can then use (as well as the income earned on your investments) to pay down your mortgage further. If you continue this process until the mortgage is completely paid off, you should end up with no mortgage, a portfolio of investments, and a tax-deductible investment loan.

### How it works

The debt conversion strategy involves setting up a re-advanceable mortgage that has two components: a regular mortgage and a HELOC. A re-advanceable mortgage lets you re-borrow the principal (not the interest) you pay off each month. As you make your mortgage payments, the lender increases the amount you can borrow from your HELOC by the amount of principal you pay off each month. You may then borrow from your HELOC and invest the funds in a portfolio of income-producing investments.

Provided you're investing the borrowed funds to earn income, you can deduct the associated interest expense on your tax return for the year. This interest deduction may result in tax savings. You can use the income earned on your newly acquired investments as well as the tax savings generated to pay down your mortgage further. You may repeat this process annually until your mortgage is completely paid off. The result of this strategy is that your home equity is converted into a HELOC, or investment loan, as you pay down your mortgage.

## Are these strategies right for you?

For these strategies to be most effective, you will need to be disciplined and not use any tax savings for daily cash flow. It's also important to be aware that these strategies will not reduce your debt level. Since you're only paying off the interest on your investment loan, your debt servicing level never decreases and it requires you, as an investor, to be extremely diligent about your cash flow to ensure you can service the debt. You'll need to be even more diligent if you use an investment loan with a variable interest rate, since the payments will fluctuate over time.

In the case of the debt swap strategy, you may consider using the income from the borrowed funds being invested to repay the principal of the loan to eliminate your borrowings.

In the case of the debt conversion strategy, once the equity in your mortgage is completely paid off, consider directing your annual tax savings to pay off your investment loan to increase your net worth and eliminate all borrowings.

### 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, 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?

A long investment time horizon increases the probability that your investments will appreciate in value such that your total investment assets will exceed your loan plus interest costs. It also allows for the potential of lower volatility on investment returns. Collapsing these strategies early increases the chance that a loss may result.

### Do you have surplus cash flow?

Ensure you have adequate surplus cash flow (i.e. after-tax income less expenses) from sources other than your investment portfolio to pay at least the interest on your debt.

Your source of cash flow should also be sufficient to absorb the effects of a market downturn. A market downturn may result in a potential increase in your borrowing costs as well as a decrease in the value of your investments. If borrowing costs increase, you should have enough cash flow to cover any loan interest payment increases.

In the case of the debt swap strategy, you may consider using the income from the borrowed funds being invested to repay the principal of the loan to eliminate your borrowings.

If the value of the investments you purchased with borrowed money decreases, this may result in significant losses. In this situation, it's prudent to have enough cash flow to cover any potential demands for repayment.

### What's your investment risk tolerance?

Your investment risk tolerance is a measure of how comfortable you are with taking risk in the hopes of earning greater returns on your investments. Most investments have some degree of risk associated with them, and borrowing to invest adds an additional level of risk to your investing. Borrowing to invest will magnify your returns when your investments are appreciating in value. This is due to the larger pool of investment capital that can benefit from investment growth. However, the downside is that if your investments start to decrease in value, your losses will be magnified as well, and it will be your responsibility to repay the loan as required by its terms. Diversification of the assets you purchase with your investment loan can help reduce the volatility of the investments.

### How can you keep your interest tax-deductible?

One major advantage of borrowing to invest is the ability to deduct your interest expense for tax purposes. This deductibility may allow you to increase your after-tax rate of return on your investment. There are a number of important points you should bear in mind in order to maintain interest deductibility. For information on this topic, ask your RBC advisor for an article on borrowing to invest.

## Conclusion

The debt swap and debt conversion strategies may allow you to replace your non-deductible debt with tax-deductible debt in order to create tax savings and build long-term wealth. However, they are aggressive strategies with associated risks. Your RBC advisor, along with a qualified tax advisor, can help you evaluate whether or not borrowing to invest makes sense for you.

*This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.*

Wealth Management

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI)*, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ®/™ Registered trademarks of Royal Bank of Canada. Used under licence. © 2022 Royal Bank of Canada. All rights reserved. NAV0176 (09/22)