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Seek advice before making mortgage manoeuvre

The pitch sounds very seductive. "Go ahead. Make your mortgage tax deductible. Yes. It can be done. Yes it's legal."

The pitch is used to promote an investment technique called the Smith Manoeuvre.

According to Smith Manoeuvre Financial Corporation (www.smithman.net), "the Smith Manoeuvre is a financial strategy that simultaneously converts mortgage interest to tax deductions, shortens the amortization of your mortgage and builds a free and clear pension portfolio for your retirement funded through your monthly mortgage payments and without requiring any additional monthly cash investment!"

The investment strategy is explained in a book called *The Smith Manoeuvre: Is Your Mortgage Tax Deductible?* by Canadian financial guru Fraser Smith (Outspan Publishing, $24.95).

But it may not be quite as rosy as it sounds.

Writing in the March issue of *REM* (*Real Estate Magazine*, remonline.com), a monthly publication for industry stakeholders, tax specialist Dan White sounds an alarm about using the strategy.

In providing a glimpse of the "dark side of the Smith Manoeuvre," he cautions anyone contemplating using the technique to "think again and think carefully."

Here's how the program works: The homeowner obtains what the Smith people call a re-advanceable mortgage which is basically a mortgage combined with a line of credit, where the balance can fluctuate from time to time.

As the homeowner pays down the principal with monthly payments, he or she then immediately has that amount re-advanced in order to invest in stocks, bonds or other real estate. In theory, that portion of the loan used for investments and that portion only is tax deductible.

In other words, the interest paid on the "re-advanced" portion of the loan can be used to reduce investment income.

According to White, the "significant flaw" in the scheme is when the primary purpose of using it is to make a home mortgage tax deductible, it leaves the homeowner vulnerable to attack by Canada Revenue Agency.

Under CRA rules, interest paid on money used from a mortgage to produce capital gains is not tax deductible.

As a result, if a Smith Manoeuvre loan is used to buy stocks mainly for the purpose of capital appreciation, the interest is not deductible.

Interest can only be deducted as a legitimate business expense if it is used to invest in an active business to generate business income. "Even so," warns White, "if you are going to do this kind of stuff, you need to think it through, get good advice and set yourself up strategically."

White reminds REM readers that the government is always looking for ways to generate more income. "There is a reason they call it the Canada Revenue Agency," he adds.

For occasional or passive investors, White warns that the Smith Manoeuvre could be a costly mistake.

"If you are doing this with your principal residence and you claim 100 per cent of your mortgage interest as a business expense, then there is a strong argument that your home is a business and as such, you are not exempt from capital gains on the sale of the residence," he writes.

White is not alone in criticizing the investment strategy.

Writing in the *Star* in January, 2007, Ellen Roseman quoted some critics of the Smith Manoeuvre. Among them was Gary Newby, a certified financial planner in Toronto.

In Roseman's column, he warned, "It's not good for the average person. Most of my clients wouldn't understand it because it's very complex."

David Trahair, a Toronto chartered accountant, is also quoted in Roseman's column.

``It's a high-risk strategy," he says, "because you're betting the farm that some investment adviser can do better than you can."

I agree with the critics of the Smith Manoeuvre. It's far too risky for the average homeowner.

Always obtain tax advice from a qualified person, such as an accountant or tax lawyer, who is not selling or promoting anything, and to whom the client's interests come first.

If the tax adviser stands to make a commission selling participation in a scheme like the Smith Manoeuvre, he or she is in an obvious conflict of interest and the advice can hardly be said to be impartial.

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