



Why a large tax refund is no reason to celebrate

The idea of a tax refund, particularly a large tax refund, is cause for celebration for most people, but it shouldn't be. The reality is that a tax refund means you have paid the Canada Revenue Agency (CRA) too much tax throughout the year.

In essence, you have provided the government with an interest-free loan. The larger the refund, the larger the loan amount. Who knew you could be so generous!

You shouldn't have to wait until the following spring to get your money back. Fortunately, there is a way you don't have to.

THE SOLUTION

If you have non-payroll RRSP contributions, childcare expenses, interest expenses on investment loans, alimony, maintenance or support payments, charitable

donations or rental losses, you can reduce the amount of tax deducted at source by your employer. Simply complete CRA Form T1213, "Request to Reduce Tax Deductions at Source", a straightforward one-page form, and send or take it to your local tax office. If approved, CRA will authorize your employer to deduct less tax from your pay.

Quebec residents must also complete and file form TP-1016, "Application for a Reduction in Source Deductions of Income Tax" with the Quebec Ministère du Revenu to ensure they receive both federal and provincial source deduction relief.

NOW WHAT?

Like most Canadians, extra monthly income could prove useful. Just think of the possibilities. But before you start envisioning that big screen TV, think about how that money could work for you. You could use these additional funds to pay down your mortgage,



fund a periodic investment plan or fund an investment loan. The rewards can be substantial, and without any added cost to you. Let's illustrate how this might work.

Assumptions

You earn \$80,000 a year, make non-payroll RRSP contributions of \$6,000 a year and incur childcare expenses of \$6,000 a year. By filing the T1213 form, your monthly after-tax income would increase from \$4,887 to \$5,307.¹ That's an additional cash flow of \$420 per month.

LET'S LOOK AT THE OPTIONS

PAY DOWN THE MORTGAGE

By using the additional cash flow to pay down your mortgage throughout the year, you can become mortgage-free much sooner without any additional cost to you.

This powerful strategy starts with a "flexible mortgage account" that enables you to reduce your mortgage principal with the savings that are sitting in your bank account. Essentially, a flexible mortgage account is a mortgage account, line of credit and savings/chequing account rolled into one. Each deposit you make

immediately lowers your mortgage principal and saves you interest. Paying interest on a lower principal for at least a portion of each month can cut years off your amortization.

In the context of taxes deducted at source, the additional money you keep in your hands during the year can be applied immediately to your mortgage within a flexible mortgage account and significantly increase the savings further. Remember, this is money that is already yours, but that you have been lending to the government. You don't need to put aside any extra savings to achieve results similar to the following example.

A \$150,000 mortgage with a 15-year amortization, a fixed five-year interest rate of 4.75% and monthly payments would incur \$60,014 in interest before being paid off.

This is compared to a \$150,000 mortgage with a flexible mortgage account at the current prime interest rate of 4.25% (as at March 1, 2005). It is assumed that the full after-tax salary of \$4,887 is deposited into a flexible mortgage account and is not touched – reducing the amount of your mortgage principal – for 10 days before you start to spend it. Gradually, over the next 20 days, you withdraw \$3,421 (70% of your take-





home pay) to cover your monthly expenses, including your RRSP contribution of \$500 a month and childcare expenses of \$500 a month. If you do this consistently until your mortgage is paid off, you could save \$25,075 in interest (a savings of more than 40%) and be mortgage-free four years and four months early.

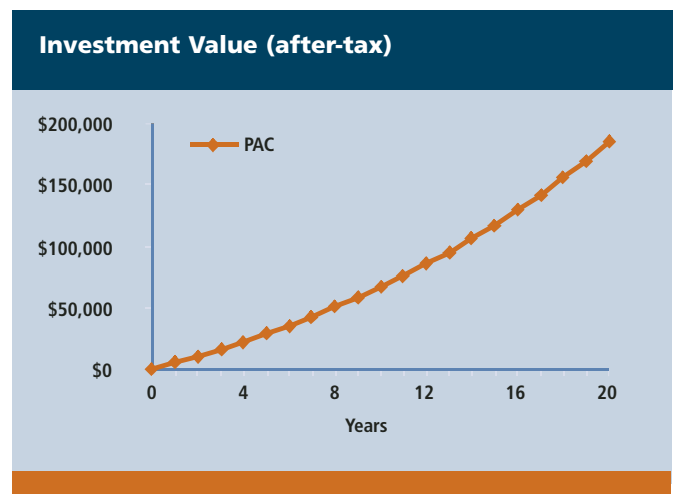
If you deposit the additional \$420 a month you receive as a consequence of the reduction in source deductions into your flexible mortgage account each and every month and leave it untouched, you could save \$34,898 in interest (a savings of nearly 60%) and pay off your mortgage seven years and two months early. In other words, by putting the money that already belongs to you back in your pocket – and without adding a single cent of extra cash – you can dramatically reduce your mortgage expenses and be mortgage-free in almost half the time.

FUND A PERIODIC INVESTMENT PLAN

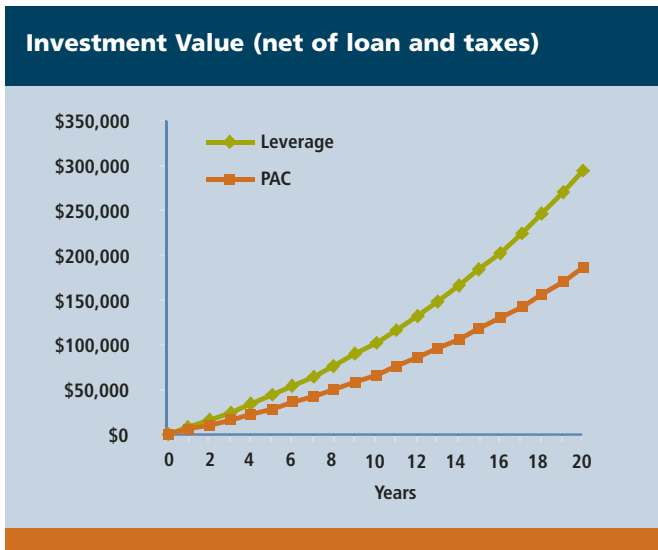
You could also use the additional cash flow generated by the reduction in source deductions to fund a periodic investment plan also known as a pre-authorized chequing plan (PAC). A PAC of \$420 a month could grow into a significant investment account over time. Think of the freedom and peace of mind additional savings would provide: early

retirement, that dream vacation or securing your child's education. Because you choose what you want to do with the money, the possibilities are endless.

Assuming a 7% annual rate of return, your investment would be worth \$66,932 after tax in 10 years, and \$185,144 after tax in 20 years – a very nice supplement to your savings plan and, again, this is all done without making any dent at all in your take-home pay.



Assumes a 7% rate of return, annual taxable portion of 25%, tax rate on income allocations of 30% and marginal tax rate of 40%.



Assumes a loan interest rate of 6%, a 7% rate of return, annual taxable portion of 25%, tax rate on income allocations of 30% and marginal tax rate of 40%.

LEVERAGE INVESTMENT²

Another option is to use the \$420 of additional monthly cash flow to pay the interest on a leverage loan. The interest payments on the loan are generally tax deductible, and this option can provide you with considerable non-registered savings. Not only are you benefiting from the compounding growth of your investment, but you are taking advantage of a large initial lump-sum investment.

The deductibility of the interest payments means that the additional \$420 a month could actually finance interest payments of \$700 a month. Put another way, \$700 in interest payments would only cost you \$420 out of pocket.³

In 10 years, and after repayment of the loan, your after-tax net worth will have increased by \$102,370, assuming an average annual compounded return of 7%.

In 20 years, after repayment of the loan, your after-tax net worth will have increased by \$294,081.

While the benefits of a PAC program are impressive, leverage (for the right individual) offers the potential for even greater gains, albeit with more risk.

As you can see, reducing your deductions at source can produce considerable benefits allowing you to pay your mortgage off years earlier or significantly increasing the value of your investments. And the beauty of this strategy is that you don't need any additional funds. Remember, this is money that was yours to begin with, money that you have been lending to the government interest-free. While you may have to give up celebrating that big tax refund, you can take comfort in the fact that your mortgage is being paid off years faster or that your net worth has increased substantially.





Footnotes & Disclaimer

1 This example is for illustration purposes only. The amount of the reduction in taxes deducted at source will depend on the particular facts involved.

2 The rate of returns and loan interest rates used are for illustration purposes only. Borrowing to invest is suitable only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans since losses as well as gains may be magnified. The value of your investment will vary and is not guaranteed, however, you must meet your loan and income tax obligations and repay your loan in full. Read the terms of your loan agreement and the investment details for important information, and discuss with your financial advisor before deciding whether to borrow to invest.

3 This amount is calculated by dividing the additional cash flow by 1 minus the marginal tax rate.

$$\frac{\text{Additional Cash Flow}}{1 - \text{Marginal Tax Rate}} = \frac{\$420}{1 - (.40)} = \$700 \text{ the amount of interest payments you can afford}$$

The amount of loan you can service is then determined by taking the amount of affordable interest payments for the year, in our case that would equal \$8,400 (\$700 x 12 months), and dividing that by the loan interest rate.

$$\frac{\text{Affordable Interest Payments}}{\text{Loan Interest Rate}} = \frac{\$8,400}{0.06} = \$140,000 \text{ the amount of an interest only loan you can carry}$$

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