



Borrowing smart – Are you paying too much interest?

STRATEGY 1: MAKE YOUR DEBT TAX-DEDUCTIBLE

In Canada, borrowing money has become so ingrained in our culture that most people don't think twice about borrowing to buy a car, pay for a child's education or take a vacation. Borrowing makes sense – it allows us to buy the things we need, when we need them. But not all loans are created equal. While the interest cost on most loans is fully paid by the borrower, the interest cost on an investment loan is generally tax-deductible – meaning that the government effectively subsidizes a loan that is used for investment purposes.

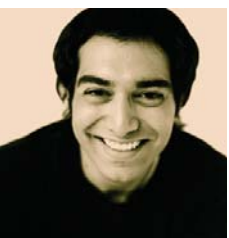
What does this mean for you? If you have an investment portfolio, a car loan and a mortgage, you're probably paying too much tax. Consider the following:

Matt, Rachel and Eric are siblings who decide they want to buy a \$150,000 family cottage, with each contributing \$50,000. All three have similar incomes, and each has a non-registered \$50,000 investment in

no-load units of a mutual fund, Fund XYZ. To pay for the cottage, each takes a different approach.

- Matt decides to sell his investment to pay for his share of the cottage. Over the subsequent 10 years, he repurchases \$5,000 of Fund XYZ at the end of each year, for a total new investment of \$50,000.
- Rachel maintains her investment and takes out a \$50,000 10-year loan from the local bank at an interest rate of 7%. During each of the next 10 years, Rachel repays \$5,000 of the loan, plus interest.
- Eric sells his investment to pay for his share of the cottage, but then immediately takes out a \$50,000 Manulife Bank Quick Loan to repurchase the investment. He chooses to pay off \$5,000 of the loan each year for 10 years, plus interest, at an average interest rate of 7%.

Over the following decade, the siblings and their families spend many happy days enjoying the cottage. All are pleased that Fund XYZ averages a 9.00% annual return during that time.



Strategy	Matt	Rachel	Eric
	Sell investments	Traditional loan	Investment loan
Gross investment value after 10 years	\$75,965	\$118,368	\$118,368
Less fund contributions	\$50,000	–	–
Less loan repayment	–	\$50,000	\$50,000
Less taxes paid on investment income	\$2,999	\$7,897	\$7,897
Less net interest payments	–	\$19,250	\$11,550
Net change in financial position	\$22,966	\$41,221	\$48,921

Taxable portion of return is 33%; tax rate on investment income is 35%; marginal tax rate is 40%; loan interest for Eric is 100% tax-deductible; loan interest for Rachel is not tax-deductible.

One night, while discussing cottage business, they decide to compare their different strategies for paying for the cottage. The chart shows that by structuring his finances so that his loan interest is tax-deductible, Eric has come out ahead of both his siblings.

STRATEGY 2: REDUCE YOUR INTEREST RATE

Converting non-deductible debt to deductible debt in this way can be a highly effective borrowing strategy. But what if Rachel and Eric didn't have an investment portfolio to convert into deductible debt? Are there any other strategies to reduce the cost of borrowing?

Let's assume that Rachel and Eric are homeowners, each with a \$250,000 home, and each with \$100,000 outstanding on their respective mortgages. Rachel has a traditional fixed-rate mortgage, and Eric has a flexible, variable-rate mortgage, such as Manulife One.

Rachel decides to take out a second mortgage on her home to fund the cottage purchase. Because it's a second mortgage, Rachel ends up paying a rate of 7% on her loan – which is higher than the standard fixed rate for a first mortgage.

Eric doesn't need to take out a second mortgage because Manulife One allows him to withdraw up to 75% of the value of his home at any time. Whenever he borrows through Manulife One, he pays the prime interest rate, which is 5% in this example. Eric sets up a sub-account within Manulife One to allow him to track his repayment of the \$50,000 he used to purchase the cottage. Both Eric and Rachel repay their \$50,000 loans over 10 years.

By accessing the equity in his primary residence at a lower interest rate, Eric comes out ahead by more than \$5,000 over 10 years, compared to Rachel. And that's based just on the interest rate difference. Since





Manulife One also uses a client's income to lower the principal throughout the month (until the client needs to take it back out for other monthly expenses), the interest savings over 10 years could be appreciably more.

Borrowing money can be a very effective way to achieve your financial and lifestyle goals. By making use of effective borrowing strategies, such as those used by Eric, you can reduce the cost of borrowing and focus more of your financial resources on creating wealth.

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. Please read the terms of your loan agreement and the investment details for important information, and discuss with your financial advisor before deciding to borrow to invest.

Strategy	Rachel	Eric
	Second mortgage	Manulife One
Time to repay \$50,000	10 years	10 years
Monthly principal payments	\$416.67	\$416.67
Interest rate	7%	5%
Total interest cost	\$17,645.69	\$12,604.07

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