

## Tax Deductible Interest

### a) *Prescribed Rate Loans*

The prescribed interest rate, set quarterly by CRA, on loans between non-arms length parties is very low. Once set, it is fixed for the duration of the loan.

Income splitting and utilization of lower income taxed family members can be facilitated through low interest loans from high income individuals to low income individuals at prescribed interest rates.

The lower income individuals can subsequently invest the loan proceeds at higher rates in the investment markets or by making loans to trusts or family controlled corporations. A spread of 5% is often available on loans thereby transferring \$5,000 of annual taxable income on every \$100,000 of loan amount.

### b) *Leveraged Investing*

Interest incurred on loans for investment purposes is tax-deductible.

Loans with non-deductible interest payments should be repaid where possible with available investment funds. The investments can be replaced by funds from the loans that will have tax-deductible interest.

The advantages of using borrowed funds to purchase capital gains oriented investments can be substantial but there is also increased risk due to the possibility of losses being magnified as well as gains.

### *Strategy Summary*

The strategy is to invest in tax deferred growth mutual funds with pre-packaged loan proceeds secured by the invested funds. Loan interest will be tax deductible. Loan payments are made monthly and may be interest only or may include principle. The following illustration assumes all loan payments represent interest payments only.

#### ➤ **Enhanced Returns:**

Are achieved through the used of the bank's money with a historical loan cost that is lower than long-term mutual fund yields.

#### ➤ **Reduced Risk:**

Is obtained by taking a strictly *long-term view* with a minimum investment period of 5 years or longer to smooth out market fluctuations in returns. Directing tax savings from the loan interest expense used to increase the investment or pay down the loan will further reduce risk. However, a prolonged period of low investment returns will still reduce the overall strategy yield.

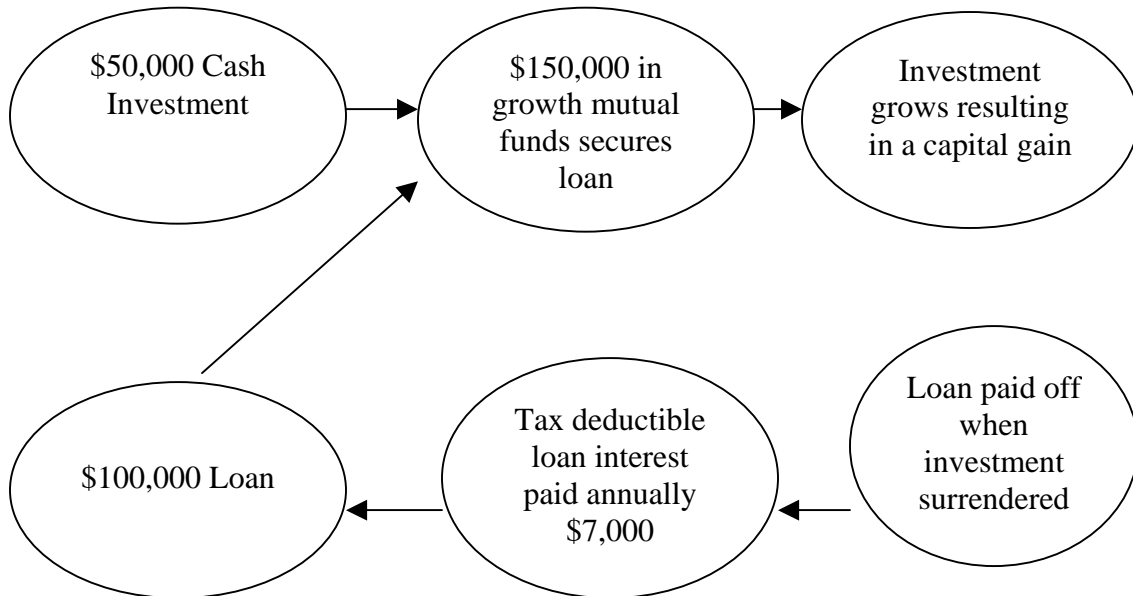




**Tax Advantages**

- **Conversion:**  
Is achieved by the loan interest being 100% tax deductible as an investment expense while capital gains are only 50% taxable. Thus, tax-deductible loan interest payments are converted in part to capital gains, 50% of which are tax-free.
- **Deferral:**  
Is achieved through deferring profits in the mutual fund investments until withdrawn as capital gains, and through the tax deductibility of the interest payments. This deferral can go past 69 and can be passed on to a spouse.
- **Elimination:**  
Is achieved through the 50% tax-free component of the capital gain.

**Strategy Overview**





*Income Tax Analysis*

➤ Tax Savings Applied to Increase Investment

| End of Year            | Loan Amount Invested | Loan Interest Rate | Loan Interest Expense | Tax Savings at 46.00% | Cumulative Tax Savings |
|------------------------|----------------------|--------------------|-----------------------|-----------------------|------------------------|
| <b>1</b>               | <b>100,000</b>       | <b>7.00%</b>       | <b>7,000</b>          | <b>3,220</b>          | <b>3,220</b>           |
| <b>2</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>6,440</b>           |
| <b>3</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>9,660</b>           |
| <b>4</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>12,880</b>          |
| <b>5</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>16,100</b>          |
| <b>6</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>19,320</b>          |
| <b>7</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>22,540</b>          |
| <b>8</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>25,760</b>          |
| <b>9</b>               | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>28,980</b>          |
| <b>10</b>              | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>32,200</b>          |
| <b>15</b>              | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>48,300</b>          |
| <b>20</b>              | <b>100,000</b>       | 7.00%              | 7,000                 | 3,220                 | <b>64,400</b>          |
| <b>Total Tax Saved</b> |                      |                    |                       |                       | <b>\$64,400</b>        |



## ➤ Tax Advantaged Strategy

|                        |           |                               |        |
|------------------------|-----------|-------------------------------|--------|
| Cash Investment Amount | \$50,000  | Client Marginal Tax Rate      | 46.00% |
| Loan Amount            | \$100,000 | Front End Fees                | 0.00%  |
| Loan Rate              | 7.00%     | Monthly Loan Interest Payment | \$583  |

## Tax Savings Applied to Increase Investment

|             |                           |  | Net Account Values and Rates of Return |                 |                 |                   |                 |                 |
|-------------|---------------------------|--|--|-----------------|-----------------|-------------------|-----------------|-----------------|
|             |                           |  | 6.00% Gross Yield                      |                 |                 | 8.00% Gross Yield |                 |                 |
| End Of Year | Net Cumulative Investment | Net Cumulative Investment at After Tax Loan Rate | Before Tax Value                       | After Tax Value | After Tax Yield | Before Tax Value  | After Tax Value | After Tax Yield |
| 1           | 57,000                    | 57,000   | 62,220                                 | 60,150          | 6%              | 65,220            | 62,460          | 10%             |
| 2           | 64,000                    | 64,265   | 75,173                                 | 70,865          | 6%              | 81,658            | 75,858          | 10%             |
| 3           | 71,000                    | 71,804   | 88,904                                 | 82,178          | 6%              | 99,410            | 90,268          | 10%             |
| 4           | 78,000                    | 79,628   | 103,458                                | 94,125          | 6%              | 118,583           | 105,771         | 10%             |
| 5           | 85,000                    | 87,748   | 118,885                                | 106,745         | 6%              | 139,920           | 122,456         | 9%              |
| 6           | 92,000                    | 96,175   | 135,238                                | 120,077         | 6%              | 161,653           | 140,416         | 9%              |
| 7           | 99,000                    | 104,920  | 152,573                                | 134,165         | 6%              | 185,805           | 159,754         | 9%              |
| 8           | 106,000                   | 113,977  | 170,947                                | 149,054         | 6%              | 211,889           | 180,580         | 9%              |
| 9           | 113,000                   | 123,415  | 190,424                                | 164,792         | 6%              | 240,061           | 203,012         | 9%              |
| 10          | 120,000                   | 133,190  | 211,069                                | 181,429         | 6%              | 270,485           | 277,180         | 9%              |
| 15          | 155,000                   | 187,896  | 334,432                                | 280,122         | 6%              | 463,255           | 379,315         | 9%              |
| 20          | 190,000                   | 253,752  | 499,520                                | 410,942         | 6%              | 746,497           | 601,115         | 9%              |

**Net Cumulative Investment equals Cash Investment Amount plus After Tax Loan Interest**

**This report illustrates the effect of different compound interest rates, which are not guaranteed.**





***LEVERAGING DISCLOSURE***

**Borrowing Money to Buy Investment Funds**

Mutual fund units and other securities may be purchased using available cash, or a combination of cash and borrowed money. If cash is used to pay for the purchase in full, the percentage gain or loss will equal the percentage increase or decrease in the value of the securities. The purchase of securities using borrowed money magnifies the gain or loss on the cash invested. This effect is called leveraging.

For example, if \$100,000 of mutual fund units are purchased and paid for with \$25,000 from available cash and \$75,000 from borrowings, and the value of the fund units declines by 10% to \$90,000, your equity interest (the difference between the value of the securities and the amount borrowed) has declined by 40%, i.e. from \$25,000 to \$15,000

It is important that an investor proposing to borrow for the purchase of securities be aware that a purchase with borrowed monies involves greater risk than a purchase using cash resources only.

To what extent a purchase using borrowed monies involves undue risk is a determination to be made by each purchaser and will vary depending on the circumstances of the purchaser and the securities purchased.

It is also important that the investor be aware of the terms of a loan secured by securities. The lender may require that the amount outstanding on the loan not rise above an agreed percentage of the market value of the securities. Should this occur, the borrower must pay down the loan or sell the securities so as to return the loan to the agreed percentage relationship. In our example above, the lender may require that the loan not exceed 75% of the market value of the mutual fund units. On a decline of value of the units to \$90,000, the borrower must reduce the loan to \$67,500 (75% of \$90,000). If the borrower does not have cash available, the borrower must sell units at a loss to provide money to reduce the loan.

Money is, of course, also required to pay interest on the loan. Under these circumstances, investors who use borrowed funds to purchase their investment advice are advised to have adequate financial resources available both to pay interest and also to reduce the loan if the borrowing arrangements require such a payment.

**I acknowledge that I have read and understood this “Leveraging Disclosure.”**

\_\_\_\_\_  
Date

\_\_\_\_\_  
Client

