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RRSP mortgages

Most people know you can use RRSPs – now to a higher withdrawal limit – for a down payment on your first home. What savvy investors have come to realize is that you can also use these funds to finance investment properties. Here's how

By Monte Dobson

One of the few tax benefits still available to Canadian taxpayers is the Registered Retirement Savings Plan, or RRSP. Unfortunately, many are ill-informed with respect to maximizing the full benefits of this savings instrument. Many investors believe that by simply contributing into a registered account such as an RRSP, that they are 'investing' towards their retirement.

Every year near tax time, Canadians are bombarded with massive marketing campaigns encouraging them to run down to their local financial institution to contribute to their RRSP and "save tax." The fact of the matter is that when this occurs, many people have no idea what they are contributing towards, and end up placing their hard earned dollars into mutual funds or GICs by default, because they feel these are the only options available to them. Sadly, many investors don't realize that many mutual funds underperform in the stock market due to the heavy management fees associated to them, which can erode their investment returns over the long term.

MERs and mutual funds

When a person buys a mutual fund within their RRSP, there are always associated fees such as MERs or management expense ratio. This is the fee that the financial institution charges you to manage your mutual fund. These fees are charged regardless of how your investment performs, whether it gains or loses. The average MER for mutual funds in Canada is 2.87%, more than any other developed country.

Let's take a look at an example of an investor who bought \$10,000 of mutual funds with an MER of 2.5%. The MER is simply the fee that the fund manager takes on an annual basis to manage your funds. This doesn't sound like much, but let's dig deeper and do the math.

Let's assume that this mutual fund yields an average annual return of 8% for 20 years. After 20 years, the total gross amount in the investors account would be \$46,610 (the original \$10,000 investment, plus returns of \$36,610). Sounds good, right? It is good, but this is before the MER has been deducted.

Total fees deducted from the investor's account over the 20 years add

up to \$8,970, and because these fees are charged on an annual basis, the MER also impacts the investment through a concept called 'lost return potential.' Simply put, the money you paid in fees is not earning you a return and is therefore the opportunity cost of the MER. So the total impact of the 2.5% MER is \$17,980 leaving a net return of only \$18,629, a far cry from the expected return of \$36,610.

Original investment	\$10,000
Return before fees	\$36,610
Less total fee impact (MER + lost return potential)	\$17,980
Account total (after fees)	\$18,629
Average annual return (after fees)	5.4%

So, instead of the investor earning an expected return of 8% as predicted by many mutual fund companies, the

investor has earned a 5.4% annual return on their investment. And how for many years have we seen mutual funds earn 8%? Lately, not many.

For this reason, we sought out a better way to earn a greater return on our investment. One option we have utilized with our RRSPs and helped others invest in is called RRSP mortgages. This method of investing is an advanced strategy, and just like any investment, there are risks and rewards. However, with a little education and due diligence, RRSP mortgages can deliver steady long-term growth and solid net returns.

RRSP mortgage

An RRSP is not legally allowed to own a piece of real estate directly. However, an RRSP is able to lend money secured on title by a mortgage on a property. This is really no different than the banks lending money as a mortgage on a property and, in fact, they compete

very aggressively to do so because of the security of this investment. There is a reason the banks typically provide very low interest rates on mortgages, because they know mortgage lending can be a very safe and secure long-term investment when it's done correctly.

Let's introduce a topic many Canadians likely have never heard of – arms-length mortgages. This is a type of mortgage that can be held within your RRSP account, to lend money on a specific property that you are considered 'arms length' to, or have no direct ownership in the property through blood, marriage or adoption. The income tax act has very specific rules around the definition of 'arms length' and the mortgage must be structured according to these rules to ensure that there are no tax implications. Once you find a property (for example, if you are a lender) or if you have a property that you want to find an RRSP mortgage for (as a real





estate investor), then it is a relatively easy process to set it up.

First, an investor must open a self-directed RRSP account and transfer the funds from their existing RRSP into this account. This does not trigger any tax and is simply a transfer of funds, similar to opening up a new savings account at another bank and moving your money over to this new account. Not all banks that offer self-directed accounts allow investors to hold a mortgage-based investment, so you will have to find a trustee that allows this type of plan. Two examples that do are Olympia Trust and TD Waterhouse.

Now, the investor becomes a de facto bank, and holds a mortgage on a specific property for another investor. The investor has complete control on the investment selection, direction, terms and return on investment of the funds they have available within their self-directed RRSP account.

The RRSP mortgage is basically a 'private mortgage' that is agreed upon between two parties, so it is up to the lender or RRSP holder to do their own due diligence on both the borrower and property that they plan to lend on. Some key factors are the track record of the property owner, whether it is a rental property or personal residence, the rental income, and most importantly, the Loan-to-Value or LTV, which is the property value less the total mortgage balance.

LTV level

RRSP mortgages can be placed on the property in a first, second or even third



position, which is simply the order that the mortgages are paid off when the property is sold or went into foreclosure. Many RRSP mortgages are loaned in the second position,¹ which means it is secured after the first mortgage financing on the title of the property. This is why the total LTV of all mortgage balances must be adhered to as this is your largest factor of risk. A high LTV can indicate high risk, while a low LTV can indicate a low risk investment.

Typically, the higher the LTV, the higher the potential returns for the RRSP lender and therefore the higher the interest rate for the borrower. It is not uncommon to see interest rates or the rate of return in the range of 10% to 15%. Again, this is completely negotiated by the RRSP lender and borrower.

A good rule of thumb is to never exceed 85% LTV (total of all mortgages on the property).

One might ask why anyone would pay 10% to 15% interest rates when

prime is currently at 2.5%. The simple answer is that some investors are willing to pay such high interest rates due to the fact that this equity is sometimes untouchable under current bank lending rules and criteria, and the fact that sophisticated investors know they can utilize this equity to reap even higher returns by using it to buy more real estate. Many banks also have caps or limits in place and will not let real estate investors exceed these lending limits. Because of this, it is sometimes necessary for investors to seek private funding from sources such as RRSP holders in order to further expand their real estate portfolio or make improvements to existing properties.

The borrower

Importantly, the RRSP trustee or planholder in no way reviews the merits of your investment. They simply hold your RRSP funds and it is up to you as the investor to ensure it is a good investment.

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So, it's critical you take the time to properly review the property and the borrower.

When it comes to assessing a property, for the first few deals it may be preferable that a person work with an experienced party that is knowledgeable about all aspects of the process. Some mortgage brokers can assist with this process, but it is buyer beware as mortgage brokers get paid their commissions on arranging the financing whether the deal is profitable or not. It is likely best to work with someone who can review the first few proposals. An experienced lawyer that specializes in real estate, and preferably RRSP mortgages is a key part of the team as well.

Another factor to consider is the track record of the borrower, including credit rating, income, stability, job status and credit history. With regards to the property, it is a good idea to verify the first mortgage details (term, payments, interest rate), as well as all other income expenses related to the property (property taxes, utilities, lease agreements, insurance). Based on the numbers, ask yourself whether the property still cash flows after all debt service payments and expenses. If not, how capable is the borrower in covering the payments?

In the event that the borrower defaults, the lender should consult a lawyer right away. If the payments remained in default, the property would eventually enter into foreclosure and then it goes to the courts to work out who gets paid what. This is where the LTV is very important, as the RRSP holder needs enough equity in the property to cover off not only the repayment of the loan, but any legal fees associated with the foreclosure process.

This whole process can take some time, about three months or more, before you can get your money back.

Getting started

Once you find a 'deal' or property that fits all of your investment criteria, then you proceed to get a lawyer to draft up the RRSP mortgage documentation and have it signed by the borrower. The mortgage is then registered on the title of the property to protect your investment, just like the mortgage you get at a bank.

Once the mortgage is registered on title, the funds are transferred from your RRSP account to the lawyer, who distributes them to the borrower. Once the mortgage is set up, the mortgage payments are sent to your RRSP account via direct deposit.

Another factor to consider is payment structure. RRSP mortgages can be set up so that payments are made on a monthly, quarterly or annual basis. There is also the option of a balloon payment due at the end of the term of the mortgage. Typically, the more frequent the payments, the lower the returns due to the level of risk. However, balloon payments are beneficial to real estate investors as this allows them to utilize the capital for the length of the mortgage, without affecting their cash flow today.

Interest rates for balloon payment mortgages are typically higher due to the higher degree of risk for the RRSP holder.

Here is an example:

Property:	3-bedroom house in Grande Prairie, Alta.
Appraised value:	\$250,000

First mortgage balance:	\$162,500 (65% LTV)
RRSP second mortgage loan:	\$37,500 (15% LTV, 5-year term at 12% interest rate)
Total value of all mortgages:	\$200,000 (80% LTV)
RRSP second mortgage interest rate or ROI:	12% per year
Second mortgage payments:	\$375 per month (direct deposited into self directed RRSP account)

After five years, the RRSP holder would have earned a total return of \$375 per month times 60 months, for a total of \$22,500. Their total RRSP account balance after this period would then be \$60,000 (the original investment of \$37,500, plus a return of \$22,500). This is the net return that the RRSP investor would receive inside their RRSP account, and there are no additional fees or expenses to deduct from this return. Also, with a LTV of only 80%, this property would have to drop in value by more than \$50,000 over the next five years before any of the investors initial investment of \$37,500 would be at risk. ■

Monte Dobson is president of C2 Ventures Inc., White City, Sask. No magazine article can consider your personal needs in relation to

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