



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment
Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

The cash damming strategy

Reduce your taxes by restructuring debt

You may realize potential tax savings by converting personal debt (non-deductible) into tax-deductible debt through the cash damming strategy. If you own an unincorporated business or a rental property, this approach may help you reduce your overall tax liability and support your wealth-building goals. This article describes the cash damming strategy and highlights some of the potential issues you should consider before implementing this strategy.

The strategy

If you have personal debt, such as a mortgage against your home, the interest on that debt is likely not tax-deductible. Interest will only be deductible if the money you borrow is used for the purpose of earning income from business or property. Business income includes income you earn from a profession or trade, or any activity you carry on for profit. Property income generally includes interest income, dividends, rents and royalties. As an unincorporated business owner, the cash damming strategy allows you to use your business income to pay down personal (non-deductible) debt and then re-borrow to invest in your business, making the interest payments on your loan deductible for tax purposes.

To get started, you will need a line of credit or other loan facility. You'll borrow the funds from the line of credit

and use them to pay your business expenses or to purchase investment assets. You'll pay down your personal debt using the funds received from your business operations.

If you own rental property, you may also employ the cash damming strategy. In this case, you pay your personal expenses directly out of rental income while you borrow money to finance expenses related to your rental property. Eligible expenses relating to your rental property may include, but are not limited to, mortgage interest, property taxes, management fees, administration fees, and maintenance and repair costs. Please consult with a qualified tax advisor to confirm which other expenses relating to your rental property are eligible.

Maintaining interest deductibility

The cash damming strategy generally involves using separate accounts



to segregate funds received from borrowed money and funds received from other sources, such as your business operations. This strategy centres on ensuring interest on the borrowed money remains tax-deductible. Therefore, it's very important to be able to directly link your borrowed funds to an income-earning purpose. Using a separate bank account to track borrowed funds and business expenses may help you keep track of which funds were used for each purpose.

Although cash damming using two separate bank accounts allows you to trace the use of your borrowed money more readily, it's not mandatory to have separate accounts. In situations where you deposit and commingle the borrowed money into one account with other funds, the Canada Revenue Agency (CRA) allows you to allocate, on a dollar-for-dollar basis, the borrowed money to a

specific identifiable use. In other words, you're permitted to look at all of the uses of the money in the account and link the borrowed funds to a specific use. However, you are required to place the borrowed funds into the account prior to or on the same day the funds were used.

Illustration

Let's say you're the owner of an unincorporated dental practice with two employees. You own a house with a \$220,000 open mortgage, which gives you the freedom to pay down your mortgage without incurring penalties. In the current year, the gross annual income from your dental practice is \$300,000, and your business expenses total \$125,000. You decide to implement the cash damming strategy and use a line of credit to pay for ongoing business *expenses* while using your practice's gross revenue to pay down your personal non-deductible mortgage.

	Before cash damming	After cash damming
Business revenue		
Gross revenue	\$300,000	\$300,000
Less: Business expenses (paid from revenue)	(\$125,000)	\$0
Less: Mortgage payment (paid from revenue)	\$0	(\$125,000) ¹
Net business revenue before income tax	\$175,000	\$175,000
Mortgage debt		
Mortgage balance	\$220,000	\$95,000 ¹
Line of credit balance	\$0	\$125,000
Total debt	\$220,000	\$220,000
Business's income tax liability		
Gross revenue	\$300,000	\$300,000
Less: Business expenses	(\$125,000)	(\$125,000)
Net business income	\$175,000	\$175,000
Less: Tax-deductible interest expense	\$0	\$5,000 ²
Taxable income	\$175,000	\$170,000
Income tax liability (assumed rate of 35%)	\$61,250	\$59,500
Tax savings		\$1,750

¹ You use \$125,000 from your line of credit to pay for your business expenses. You then use \$125,000 of your practice's gross revenue to pay down your mortgage balance from \$220,000 to \$95,000.

² Assuming an interest rate of 4% on the line of credit.

The key to this strategy is that interest paid on borrowed amounts used for business expenses is tax-deductible. Although your overall debt before and after using the cash damming strategy is the same (your mortgage decreased by as much as your line of credit increased), you effectively converted the non-deductible debt with tax-deductible debt. This conversion translated into tax savings of \$1,750 for the year. If you continue to use your tax savings to make extra mortgage payments, you may be able to pay down your mortgage at a much faster pace than if you hadn't used the cash damming strategy. In the end, you will have no mortgage and a large tax-deductible business loan.

Alternatively, you could consider using the tax savings to reinvest in your business, pay down some of the business line of credit, save for retirement, or treat yourself to a vacation — the savings are yours to do as you see fit.

Is this strategy right for you?

Have you discussed financing options with your lender?

Paying off your mortgage or other debt ahead of schedule may trigger a prepayment penalty. Make sure you discuss your prepayment options with your lender well in advance. In addition, you may have difficulty securing a large business line of credit if you don't have sufficient collateral. Also, if the interest rate on your line of credit is higher than your mortgage rate, you'll need to determine if the income tax savings outweigh the incremental borrowing cost.

Do you have a long investment time horizon?

In the example illustration, the cash damming strategy is effectively converting your mortgage, which is a debt with a set time horizon, to an investment loan, which has an indefinite time horizon. Since the investment loan doesn't have set repayment dates, you'll need to have the discipline to repay the debt.

Do you have surplus cash flow?

It's important to understand the terms of the investment loan that you'll use to pay for your business expenses. Some loans require a monthly repayment that's a combination of interest and principal while other loans require interest-only payments. Ensure you have adequate surplus cash flow (i.e. after-tax income less expenses) from sources in addition to your business to pay the applicable monthly payments.

Your source of cash flow should also be sufficient to respond to the effects of changing economic conditions. An economic downturn might have a negative effect on your business's cash flow. An increase in interest rates may potentially increase your borrowing costs. If your borrowing costs increase, it's prudent to have enough cash flow to cover any interest increases as well as any potential demands for repayment.

AMT is a parallel tax calculation that applies to certain high-income taxpayers who may otherwise pay little or no tax because of the deductions, exemptions and credits they claim under the regular tax system.

What's your risk tolerance?

Your risk tolerance is a measure of how comfortable you are with taking on risk. Borrowing to invest, in your case in your business, may add an additional level of risk to your overall financial situation.

Will the tax-deductible interest cause alternative minimum tax (AMT)?

AMT is a parallel tax calculation that applies to certain high-income taxpayers who may otherwise pay little or no tax because of the deductions, exemptions and credits they claim under the regular tax system. AMT is designed to ensure these taxpayers pay at least a minimum amount of tax. Consequently, you're required to compute your tax liability by calculating your regular tax and AMT for federal tax purposes. You pay either the regular tax or the AMT, whichever is the highest. If you're required to pay AMT, it may be recoverable over the next seven years. As such, it's often seen as a prepayment of taxes.

The AMT rules limit the deduction of interest and carrying charges. For AMT purposes, you can only deduct 50% of the interest and carrying charges you would typically claim as a 100% deduction for regular tax purposes. If you're subject to AMT due to the interest expense claimed, you may need to re-evaluate the tax effectiveness of the cash damming strategy. For a detailed discussion on how the interest deduction would impact your AMT, please ask your RBC advisor for an article on AMT and the impact on individuals.

Conclusion

The cash damming strategy may allow you to convert your non-deductible debt into tax-deductible debt to create tax savings and build long-term wealth. Your RBC advisor, along with a qualified tax advisor, can help you evaluate whether this strategy and its associated benefits and risks make sense for you.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



**Wealth
Management**

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Wealth Management Financial Services Inc. (RBC WMFS), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI)* and Royal Mutual Funds Inc. (RMFI). *Member – Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies, RBC DI or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. In certain branch locations, one or more of the Companies may carry on business from premises shared with other Royal Bank of Canada affiliates. Notwithstanding this fact, each of the Companies is a separate business and personal information and confidential information relating to client accounts can only be disclosed to other RBC affiliates if required to service your needs, by law or with your consent. Under the RBC Code of Conduct, RBC Privacy Principles and RBC Conflict of Interest Policy confidential information may not be shared between RBC affiliates without a valid reason. ®/™ Trademark(s) of Royal Bank of Canada. Used under licence. © Royal Bank of Canada 2026. All rights reserved.