The True Cost of Debt

To truly understand it, one needs to factor in taxes

"Becoming debt-free is a goal that most Canadians share, but few put concrete plans in place to make sure they'll get there," said Doug Conick, president and CEO on the results of a survey Manulife Bank of Canada has sponsored.

Increase income, minimize expenses and increase the capacity to save is what people must do. To achieve this they need to overcome debts. So they must understand and assess how tax efficiency impacts their financial allocation decisions. This requires them venturing out of their conditioned parameters, away from the usual comfort zone, and practise a disciplined approach for the long term.

Changing perceptions

People refer to income, both employment and investment in pre-tax terms. They say, "I make $75,000" not "I make $57,978 (after tax in Ontario)."

That appears to make sense. Few actually calculate after-tax income, and $75,000 sounds better because it's higher, and. we all like knowing we make more - even if we keep less.

On the other hand, we look at expenses based on nominal value, as in, "I paid $50 for that."

If the expenses happen to be deductible or qualify for a tax credit, the average person usually knows it will actually cost them less than $50.

But what would people have to earn to pay that $50? In Ontario, residents earning $75,000 have an average tax rate of 22.70% and would have to earn $64.68. That's kind of a depressing discovery. Considering before- and after-tax amounts can help people allocate money differently.

The true cost of debt

Interest rates have been at all-time lows, great news for anyone with debt. But what is debt really costing People?

The "Pre-tax Carrying Cost" chart below shows the pre-tax carrying cost of various interest rates across various average tax rates. We can see that:

• People with lower average tax rates have pre-tax carrying costs similar to the after-tax rate (as to be expected)

• The inverse is true for higher-income earners. The pre-tax carrying cost of an 18% credit card is actually 25.71%. That is, to pay $18 of interest on a $100 Balance, this person would have to earn $25.71 (18/ (1-0.3)), 43% more than the pre-tax carry cost. Even a 3% rate or $3.00 turns into $4.29 (3/ (1-0.3)).

To higher-income earners, this revelation can be rather shocking. The reaction is typically, "Oh well, what can I do? I have to pay tax." While this is true, it provides us with a new frame of mind for allocating funds.

To make those decisions, we need to consider marginal tax rates as illustrated in the other chart below "Cost of Debt with Marginal Rates". It looks a lot uglier, doesn't it?

The folly of emergency funds

Most people feel the need to have a cash cushion – few thousand dollars, or up to six months' income - and have this fund in regular or high-interest savings accounts earning up to 2%.

Meanwhile, carrying mortgages are paying at least 3% interest. On the surface, this looks like a 1% loss per year. But comparing them before- and after-tax interest rates as we've seen, it's like comparing apples to oranges.

Let's say a person in a 40% marginal tax bracket has $10,000 sitting in an emergency fund and a mortgage at the same time. Based on the respective 2% & 3% rates, take a look at the after-tax implications:

- After-tax rate of return from deposit: 1.2% (2% x 0.6)
- Interest paid on the mortgage: 3%
- Total loss 1.8%

Most would say the 1.8% (3-1.2%) is a small price to pay for peace of mind. But take a look at it on a pre-tax basis for:

- Pre-tax interest earned: 2%
- Pre-tax interest cost: 5%
- Total pre-tax loss: 3%

Now the person must consider, "If there were a new high- interest savings account paying me 5% instead of 2%, would I move my money?" Who wouldn't? So the choice is clear: this person should pay down debt instead of holding a pile of cash for an emergency that may never come.

But what if an emergency should occur? This is where proper planning comes in.

I encourage everyone who uses their emergency fund to pay down the mortgage; take out a home equity line of credit to use in case of emergency, and be disciplined enough to limit the use of the LOC for emergency only. Sure, that means paying Interest when emergency happens. But in the meantime, you save interest. For more disciplined clients, more advanced mortgage solutions, like all-in-one line of credit mortgages, can make this even easier to implement.

True mortgage is a cost, not a return. But return increases your disposable income, and so does not paying interest. Compound these savings over time and you'll see how fast you can reduce your debts. That simple $10,000 deposit could save as much as $10,699.07 in interest over the course of 25 years. That's equivalent to 3% a year, or the same thing as earning 5% a year pre-tax in a 40% tax bracket.

PRE-TAX CARRYING COST				*COST OF DEBT WITH Marginal Rates*			
Rate	*10%*	*20%*	*30%*	*Rate*	*30%*	*40%*	*50%*
3%	*3.33%*	*3.75%*	*4.29%*	*3%*	*4.29%*	*5.00%*	*6.00%*
5%	*5.56%*	*6.25%*	*7.14%*	*5%*	*7.14%*	*8.33%*	*10.00%*
7%	*7.78%*	*8.75%*	*10.00%*	*7%*	*10.00%*	*11.67%*	*14.00%*
18%	*20.00%*	*22.50%*	*25.71%*	*18%*	*25.71%*	*30.00%*	*26.00%*

Adapted from an article of the same name by JASON PEREIRA, MBA, PCSI, and FMA. Ontario tax rates could change over time.