Your Money Matters
TIMELY ADVICE FOR CLIENTS OF GOLD KEY FINANCIAL

Knowing good debt from bad

American industrialist Jean Paul Getty once said, "If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem." An integral part of sound financial planning is the ability to manage your borrowing and credit so that it never becomes anyone's problem – yours or the banks.

Certain types of borrowing are necessary and considered good debt. Most Canadians wouldn't be able to purchase a home without first arranging mortgage financing. They don't have $150,000 of unspoken for cash. Likewise, borrowing money to make an RRSP contribution, invest in a promising business venture or to purchase rental property are other examples of good and prudent borrowing.

Good debt usually exhibits the following characteristics.

First, you anticipate the asset you've purchased using borrowed funds will appreciate in value. No one buys a house or invests in rental property with the hope to sell for less in the future. The anticipation is for a profit. Even if the property is owned for a long time, as the mortgage is paid down and the property value rises, your net worth will be increasing.

Secondly, the interest on the loan is tax deductible. Borrowing money to invest into something where you have a reasonable expectation of profit from the investment makes the interest on the loan tax deductible. Loans for real estate or a business venture can usually be structured to make the interest deductible, reducing the net cost of carrying the loan. Your home mortgage and interest on an RRSP loan are exceptions to this rule.

Keep in mind that in October 2003, the federal Department of Finance released amendments to the Income Tax Act that, if implemented, could affect interest deductibility in certain situations. Consult with your tax advisor on this point if you're deducting interest on an investment loan.

Third, the interest rate on good debt should be within a few percentage points of the bank's prime lending rate. With bank prime currently at 4.25%, expect to pay between 5% and 7.25% for mortgages and investment loans. Financing for a business loan may be at a slightly higher rate depending upon your credit profile and the lender's comfort with your business idea.

Lastly, good debt isn't delivered to your mail box each week, boldly proclaiming that you've been pre-approved, in advance, to receive this very special platinum card offer, "…subject to credit approval," revealed only in the fine print.

Of all the modern financial tools, credit cards are unmatched in their ability to get you deep and quickly into debt. They make it too easy to overextend yourself financially through impulse buying and the perception you have more money than you actually do.

As essential as certain types of borrowing are to your lifestyle, other types of debt can too quickly become unmanageable liabilities. Know the difference between borrowing that will increase your financial well being, and that which is just making it easy to spend money you may not have.

January 22, 2005

GOLD KEY FINANCIAL Brandon, Manitoba Phone 204.728.5909 Email advice@goldkeyfinancial.com