Manulife

TAX, RETIREMENT
& ESTATE PLANNING
SERVICES

TAX MANAGED STRATEGY 11

Put your retained earnings to work

Many business owners have built up significant retained earnings in their corporation and are looking for ways to pull those earnings out. There's a simple strategy available that moves earnings out of the company and puts them to work generating investment returns – in a tax efficient way.

Retained earnings are a mixed blessing for business owners. On one hand, they represent the company's success and profitability. On the other hand, it can be a challenge to take those earnings out of the business without incurring a large tax bill.

If you are a business owner looking to pull money out of your company, there is a strategy available to you.

The strategy involves taking out an investment loan and using withdrawals from your corporation to pay the interest on the loan. The interest payments are generally tax deductible[1] and allow you to withdraw an equivalent amount from your company without any net tax consequence.[2]

At the same time, you now have the potential to significantly increase the value of your non-registered investment portfolio over the long term as you have a large lump sum amount invested that takes advantage of the benefits of compounding.

Furthermore, this strategy provides business owners with the potential to safeguard their portfolio from creditors, help protect their capital, potentially avoid estate fees and diversify their investments, by investing in a segregated fund contract.

CONSIDER THE TAX CONSEQUENCES OF HAVING THE CORPORATION FUND A $250,000 PERSONAL INVESTMENT

Traditional method of taking money from a business

Pre-tax withdrawal required from company	$462,963
Tax payable @ 46%	$212,963
Net assets available for investment	$250,000
Tax Paid	**$212,963**

For illustration purposes only.

Looking at a leverage strategy

Net assets available for investment	$250,000
Interest on Loan	6%
Annual withdrawal from company to service interest only loan	$15,000
Interest deduction	$15,000
Tax Paid	**$0**

[1] Actual tax deductibility of loan interest depends on a number of factors with the *Income Tax Act* (Canada) providing the framework for determining deductibility. Individual tax situations and tax deductibility will vary. Results for Quebec residents may differ due to different deductibility rules. Tax laws are subject to change. Clients should consult their own tax and legal advisors with respect to their particular circumstance. [2] The funds withdrawn must be paid to the business owner as salary or bonus and not directly to the lending institution. The corporation should not guarantee the loan or provide security for the loan as this may have adverse tax consequences. Retained earnings can be paid out as dividends which have different tax implications that will affect the tax consequences and results of this strategy. Withholding tax on a withdrawal from the company can be reduced by filing form T1213 "Request to Reduce Tax Deductions at Source".

HERE'S HOW IT WORKS, STEP-BY-STEP

STEP 1

Take out an investment loan.

STEP 2

The amount of the loan is applied in a lump sum to purchase non-registered assets.

STEP 3

The corporation pays you an amount as salary or bonus equal to the interest on the leveraged loan. This amount is included in income.

STEP 4

You may be able to deduct the interest payments at your marginal tax rate.

The end result, is that you use an investment loan to invest in a non-registered investment. Meanwhile, you use the payments from your company to fund the interest payments. The interest payments may be tax deductible and offset the amount brought into income allowing you to take money out of the corporation without paying any additional tax.

As you can see, it's a simple strategy – and it can help make a big difference to your bottom line.

HOW FAR AHEAD COULD YOU BE? – A CASE STUDY

Jeremy, age 45, is a business owner. He takes out a $250,000 investment loan and invests the loan proceeds in a segregated fund contract.

Assumptions

Total loan amount	$250,000	Annual investment fund rate of return	7%
Loan interest rate	6%	Annual taxable portion of fund return	25%
Marginal tax rate	46%	Tax rate on income allocations	25%

WHAT IT LOOKS LIKE AT YEAR 10

After 10 years, assuming an average annual compound return of seven per cent, the leveraged account has almost doubled, growing in value to $491,788. After repayment of the loan, Jeremy's net worth after-tax has increased by $200,079.

By using this leverage strategy Jeremy has enhanced his personal net worth without paying tax on the withdrawal from his company.

Sample case for illustration purposes only. This illustration assumes that a specific percentage of loan interest is tax deductible. Individual tax situations and tax deductibility will vary.

The $200,079 represents a gain of $241,788 less $41,709 taxes paid on the leveraged investment. Assumptions used are for illustration purposes only and are not indicative of future performance.

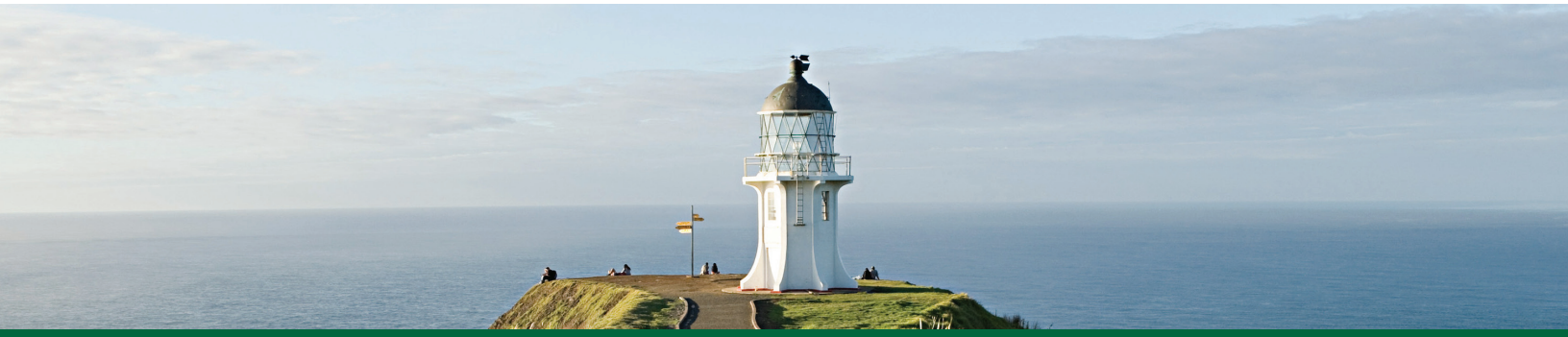
IDEAL CANDIDATES

- Business owners who have built up significant retained earnings within their corporation that they would like to withdraw in a tax efficient manner and use to increase the value of their personal assets

TAKE ACTION

Consider:

- The amount of retained earnings you would like to pull out of the corporation
- Use payments from the company to fund tax-deductible interest expenses on an investment loan



INVESTMENT OPTIONS AVAILABLE FROM MANULIFE

Manulife Segregated Fund Contracts combine the growth potential offered by a broad range of investment funds, with the unique wealth protection features of an insurance contract. Through Manulife Segregated Fund Contracts, investors can minimize their exposure to risk through income, death and maturity guarantees, potential creditor protection features, and the estate planning benefits – all from a single product or insurance contract.

For conservative investors looking to help grow their wealth but who are also concerned about minimizing risk, Manulife Segregated Fund Contracts can provide an ideal solution.

Mutual Funds from Manulife Investments can help meet your specific financial needs, throughout your life. Whether you are just starting out, accumulating wealth or are nearing/in retirement, mutual funds offered by Manulife Investments, can provide you with solutions to help build a portfolio that meets your needs. Manulife utilizes four principal asset management firms to oversee its extensive fund family. Each firm is recognized for its strength and depth of experience in various asset classes and investment styles. Manulife is committed to providing superior investment products and services so you can enjoy life and worry less.

Manulife Bank Investment Loans allow your clients to make a large initial investment contribution and benefit from the potential for compound growth and interest deductibility. These loans are available for a variety of mutual fund accounts and segregated fund contracts offered by Manulife, and offer attractive options such as 100 per cent financing, no margin-calls on market fluctuations, interest-only payments and a one-step application process.

Borrowing to invest may be appropriate only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans since losses as well as gains may be magnified. Preferred candidates are those willing to invest for the long term and not averse to increased risk. The value of your investment will vary and is not guaranteed however you must meet your loan and income tax obligations and repay the loan in full. Please ensure you read the terms of your loan agreement and the investment details for important information. The dealer and advisor are responsible for determining the appropriateness of investments for their clients and informing them of the risks associated with borrowing to invest.

FOR MORE INFORMATION, PLEASE CONTACT YOUR ADVISOR OR VISIT MANULIFE.CA/INVESTMENTS

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