

Wealth Transfer Strategy *for the Business Owner*



// My business is doing well. How can I tax-effectively transfer the assets from the business to my personal account?"

For many years, that business owner has invested time and effort into carefully building a successful business. Like many small-business owners, he has paid little attention to his retirement plan. As retirement approaches, he starts considering how to transfer his business assets to personal assets.

The Strategy

The business owner wealth-transfer strategy offers a way to move assets from your business to diversify your investments. The objective is to move money from your business in a tax-effective manner.

With this strategy, the owner secures a personal investment loan and purchases nonregistered investments to diversify and grow wealth outside the company.

The corporation then pays the owner a salary, dividends, bonus, and so on. Those payments will be taxable to the owner and they can be deducted by the corporation.

The owner uses the payments to pay the interest on the investment loan. It is important that the business does not pay the loan interest directly.

The investment loan-interest deduction offsets the tax arising from the income that the business owner received from the company.

Advantages of the Strategy

- The owner pays the interest on the investment loan using income received from the business. The tax on the income from the business may be offset by deducting the loan interest paid. Obtaining professional tax advice is crucial before implementing this strategy.
- Borrowing money helps diversify business owners' investments so all their money isn't tied up in one investment—their business.
- Business owners can potentially magnify returns and build wealth outside their business asset.
- A properly diversified investment plan helps reduce and manage risk.

How Does This Strategy Work?

1. **Owner takes out personal investment loan and invests in a portfolio of Investment Funds.**
 - Take out \$250,000 Personal Investment Loan (6% interest rate).
 - Invest the \$250,000 in Investment Funds, assuming 6% annual rate of return.
2. **Owner withdraws money from the business (personal income—**

withdrawal of bonus, salary, dividends, and so on) to pay the interest on the personal loan.

- Withdraw \$1250 from the business for the monthly interest obligation (\$15,000 annual interest payment).
3. **On tax return, the owner uses the interest deduction on the personal loan to offset the income from the business.**
 - Offset \$15,000 Taxable Income with the \$15,000 Interest Deduction.

With the net 6 percent annual rate of return for 10 years, the \$250,000 Investment Funds will grow to \$447,712.

After 10 years, the \$250,000 loan is repaid to the borrowing institution by selling part of the investment.

Once the loan is paid, using the assumptions in this example, the remaining balance of the business owner's investment is worth **\$197,712** (this assumes all income and gains are deferred). Part of this amount can be used to pay tax on any capital gain that arose from selling \$250,000 of the investment.

Over 10 years, the corporation paid the business owner \$150,000—the business asset decreased by \$150,000—and recovered \$30,000 in tax deductions for a net of **\$120,000** (assuming 20 percent corporate tax rate).

Factors to Consider

Different types of loans are available from various borrowing institutions. To minimize the risk of borrowing, the loan should set up this way.

- No Margin Calls Loan
- Monthly repayment obligation: Interest Only
- Early principal repayment option
- Variable rates ranging from Prime rate to Prime + 1%
- Collateral: Investment Funds purchased with loan proceeds

To reduce the investment risk, the business owner may want the advantages of implementing this strategy with **Guaranteed Investment Funds (Segregated Fund policies)**.

- Guaranteed Investment Funds provide potential creditor protection for a business owner's personal investments.
- 75% to 100% investment principal is guaranteed at maturity.
- Estate planning solution has the advantage of naming a beneficiary and bypassing the probate process.
- Diversified Investment options include Canadian and International equities, with over 3000 Guaranteed Investment Funds available in Canada.

Understand the Risks

- Reliable monthly cash flow: Investors may need to be prepared to pay loan interest from sources other than income from the leveraged investment, such as payment to the owner from the business.
- Investors must be able to accept market volatility and stay in the markets to allow the strategy to work in the long term (minimum recommended is 8 years' investment timeline).
- Rising interest rates can mean greater interest payments for the borrowers.
- Borrowing arrangements magnify potential losses, as well as potential gains. Investing in Guaranteed Investment Fund

options tailored to an investor's risk tolerance helps ensure the investment variability is at acceptable levels.

- For the loan interest to be tax deductible, investors must meet all the requirements of the *Income Tax Act*, including future changes to tax laws.
- Repaying part of the loan may eliminate any interest deduction for that portion of the loan. If the investor uses the funds from the loan for other purposes, the loan interest will no longer be deductible.

Properly structured, this wealth-transfer strategy is an effective way to move the value of your corporation's assets and participate in the growth of your company, while offsetting the tax effect of doing so.

Talk to a trusted financial advisor to see if this strategy is right for you. Your investment can be considered eligible for the deduction of interest, so please discuss with your tax professional the conditions necessary to deduct personal loan interest.

Remarks

The example is for illustrative purposes only. Situations may vary according to specific circumstances.

The information provided is based on current tax legislation and interpretations for Canadian residents. Future changes to tax legislation and interpretations may affect this information. The above should not be taken as providing legal, accounting, or tax advice. Clients should obtain independent professional advice from their lawyer and/or accountant to address their particular circumstances. ▲

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