



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 that money out. Well, there's a simple strategy available that moves retained earnings out of the company and puts them to work generating investment returns – in a tax efficient way.

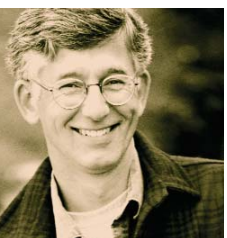
Retained earnings are a mixed blessing for business owners. On one hand, they represent your company's success and profitability. On the other hand, it can be a challenge to take retained earnings out of your business without incurring a large tax bill.

If you are a business owner looking to pull money out of your retained earnings and have significant equity built up in your house there is a strategy available to you.

The strategy involves borrowing against your home equity to invest and using your retained earnings to pay the interest on the loan. The interest payments are tax deductible and allow you to withdraw an equivalent amount from your retained earnings without any net tax consequence. ¹

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 portfolios from creditors, protect their capital, avoid estate fees, and diversify their investments, by investing in segregated fund contracts.



HERE'S HOW IT WORKS STEP-BY-STEP

Step #1

Take out a loan against your home equity.

Step #2

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

Step #3

Leverage that investment at a ratio of 2:1, 3:1 or 4:1.

Step #4

The corporation pays you an amount equal to the interest on the line of credit and leveraged loans from retained earnings². This amount is included in income.

Step #5

You deduct the interest payments at your marginal tax rate.

The end result is that you leverage an existing asset – your house – to invest in a segregated fund contract. Meanwhile, you use the payments from your retained earnings to fund the interest payments. The interest payments are tax deductible and offset the retained earnings brought into income allowing you to take money out of the corporation without paying any additional tax.

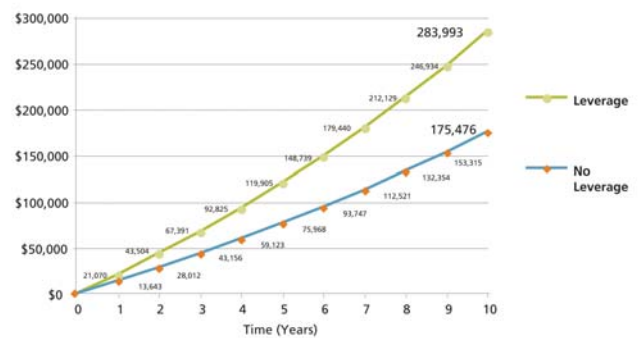
Notice that in step 3, you can choose the leverage ratio you are comfortable with based on such factors as risk tolerance and financial resources available.

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

HOW FAR AHEAD COULD YOU BE? – A CASE STUDY

Jeremy, age 45, is a business owner with \$100,000 outstanding on the mortgage for his house, which has a current market value of \$400,000. He withdraws \$100,000 of equity from his home, uses these funds to secure a 3:1 investment loan and invests the \$400,000 in a segregated fund contract.

INVESTMENT FUND LEVERAGE EXAMPLE INCREASE IN NET WORTH AFTER-TAX





Assumptions			
First year client deposit	\$100,000	Annual investment fund return	7%*
First year loan amount	\$300,000	Annual taxable portion of fund return	25%
Loan ratio (1:1,2:1.3:1,4:1)	3:1	Tax rate on income allocations	30%
Total loan amount	\$400,000		
Loan interest rate	6%**		
Marginal tax rate	46%		

* Investment return is for illustration purposes only and is not indicative of future performance

** The illustration uses 6%. However, a personal line of credit is available through Manulife One at prime (at the time of print, prime is 3.75%).

DETERMINING THE AMOUNT OF RETAINED EARNINGS TO WITHDRAW

Jeremy's required annual payment from retained earnings to fund the interest payments is calculated as follows:

$$\text{Total Loan Amount} \times \text{Loan Interest Rate} = \\ \$400,000 \times 6\% = \$24,000$$

HOW THE SITUATION STACKS UP

Jeremy is able to withdraw \$24,000 a year from his retained earnings without paying any additional tax. He uses these funds to cover all borrowing expenses and enjoys the benefits of having a lump sum invested (\$400,000).

WHAT IT LOOKS LIKE AT YEAR 10³

After 10 years, assuming an average annual compounded return of 7%, the leveraged account has nearly doubled, appreciating in value by \$386,861. After repayment of the loans, Jeremy's net worth after-tax has increased by \$283,993 versus \$175,476 if he had simply invested his after-tax retained earnings payments directly into the same investment.

By using this leverage strategy Jeremy has enhanced his net worth by \$108,517 and saved \$81,385 in taxes.

At 6%, the loan interest amounts to \$24,000 a year, for a total of \$240,000, paid out of retained earnings, tax-free, which is his objective. If Jeremy wanted to receive \$283,993 in after-tax dollars from a lump sum bonus payment out of retained earnings it would require a payment of \$525,913 much more than the \$240,000 required under this scenario (assuming a 46% marginal tax rate).



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.
- Business owners who have significant equity in their home to use as collateral for an investment loan

TAKE ACTION

Consider:

- The amount of retained earnings you would like to pull out of the corporation.
- Adding a leverage loan to increase wealth accumulation and using payments from retained earnings to fund the tax-deductible interest expenses.

1 It is assumed that the retained earnings are paid as a salary or bonus. Retained earnings can be paid out as dividends which have different tax implications that will affect the tax consequences and results of this strategy.

2 The retained earnings must be paid to the business owner and not directly to the lending institution and the corporation should not guarantee the loan or provide security for the loan as this may have adverse tax consequences.

3 This illustration assumes that a specific percentage of loan interest is tax deductible. However, actual tax deductibility of loan interest depends upon a number of factors, with the Income Tax Act providing the framework for determining deductibility. Tax laws are subject to change and, therefore, tax treatment of illustrated figures cannot be guaranteed. Results for Quebec residents may differ due to the new interest deductibility rules introduced in the 2004 – 2005 Budget. Readers should consult their own tax and legal advisors with respect to their particular circumstances.

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