Business owner hedging strategy

It's common for business owners to have the majority of their assets tied up in their businesses. Many investment experts warn against the risk of concentrated (or under-diversified) investment portfolios. As a business owner, if you're concerned about a majority of your assets being tied up in your company, yet you find it challenging to move assets from your business in a tax-effective manner, one solution may be a business owner hedging strategy.

How the strategy works:
Hedging is defined as the practice of undertaking one investment activity to protect against loss in another. The business owner hedging strategy has four steps:

1. As a business owner, you take out an interest-only personal investment loan from a lending institution and invest the loan proceeds in a non-registered diversified portfolio.
2. You withdraw funds[1] from the company to pay the interest on the loan. This is a personal withdrawal, taxable to you personally.
3. You may offset the taxable income from the personal withdrawal from the business (used to pay loan interest) with the potential tax-deductible interest expense from the personal loan.[2]
4. Continue with steps two and three each year for the life of the loan.

[1]Note: Income could be in the form of a bonus, salary, dividends etc.
[2]At this time, the Canada Revenue Agency (CRA) indicates that investments such as mutual fund trust, corporations and segregated fund policies are eligible investments for interest deductibility purposes. CRA can change its position at any time, so interest deductibility cannot be guaranteed.

You have now withdrawn funds from your company and potentially offset the taxable income with a tax deduction.

Business owner hedging strategy advantages

- If you withdraw funds from your business to pay the loan interest, the interest deduction can offset the taxable income (subject to interest deductibility rules).
- Adding a diversified portfolio of non-registered investments increases your overall liquidity and provides a savings plan separate from your business.
- You can have the opportunity to generate returns and build wealth outside your business assets.
- While your business is successful, it's prudent to protect against unforeseen events, to help manage your risk. This strategy creates assets for you outside your business.

Business owner hedging strategy risks

- Business becomes unable to support the amount required to service the interest on the leveraged loan.
- All risks associated with a leveraging strategy apply, including any changes to tax laws, potential for rising interest rates and market volatility.
- Repaying part of the loan may eliminate the interest deduction for that portion of the loan. If the investor uses the funds from the loan for another purpose, the loan interest may no longer be deductible.

Properly structured, a business owner hedging strategy is an effective way to participate in the growth of your company, while building a diversified portfolio outside of it at the same time.

Talk to your financial planner to see if this strategy fits into your financial plan.

Leveraging magnifies gains or losses. It is important that a client proposing a leveraged purchase of an investment product be aware that a leveraged purchase involves a greater risk than a purchase using cash resources only. To what extent a leveraged purchase involves undue risk is a determination to be made on an individual basis by each investor. Please ask your financial security advisor to explain these risks.

While borrowing to invest can be a powerful means to build wealth, the risks involved make it a strategy that is not suitable for everyone. Your financial security advisor can help you determine if borrowing to invest is a strategy that is right for you.

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