Dr. Brown Uses $400,000 From Corporate Cash to Pay Off Mortgage

Now that dentists in Ontario have been able to incorporate for a few years, many are beginning to see the benefits. One of the positive results of incorporation is that dentists are building-up cash within their companies. In most cases this is good news, unless it comes at the expense of prolonging the repayment of a mortgage or other non-deductible debt.

The Problem

We recently met with Dr Arthur Brown and his wife Judy (names have been changed). The Brown's (ages 48 and 47 respectively) have one adult child (19) attending university and one minor child (16). Judy works actively in the practice as the office manager. Dr Brown had incorporated in 2003 but did not have a hygiene company.

As a result of the ability to leave money in the corporation (unlike a sole proprietor), Dr Brown had built-up a large amount of cash within his company ($600,000).

The Brown's had recently upgraded their home and taken on a $400,000 mortgage. They had enough cash in the company to pay off the new mortgage but were reluctant to do so, fearful of the anticipated tax on the withdrawal.

Our objective was to find a way to pay off the mortgage immediately with minimal tax impact. The Brown's also owned a rental property that had been purchased just a couple of years ago. The property had increased in value, but they found that they were not too keen on being landlords after all, so they were considering selling the property.

The Brown's other top priorities were paying for the children's post-secondary education and saving for retirement.

The Opportunity

Using the new shareholder rules, we suggested adding their eldest child (age 19) as a non-voting shareholder. This would allow for the payment of dividends on a tax-free basis up to $35,000 per year, since he had no other source of income

Income to the son could be used initially for mortgage repayment, then in subsequent years towards his education costs. We also suggested creating a hygiene company with Judy as the sole shareholder. This would allow additional flexibility for income splitting.

To address their retirement plans, we suggested creating an Individual Pension Plan (IPP) to include both Arthur and Judy as beneficiaries. There are a number of benefits to IPPs, such as they allow for greater contributions than RRSPs, contributions are paid by the company instead of the individual, the funds are creditor protected, and there can be additional deposits permitted upon retirement. With incorporation dating back to 2003, additional top-up payments could also be made to catch-up on past service. The Brown's could now resume saving within the Professional Corp. and Hygiene Corp. for their retirement.

The Solution

With the new corporate structure in place, a number of steps could be taken to pay off the mortgage immediately. Given the large amount of retained earnings in the company, we decided to spread dividend payments over two years.

1) Allocate $150,000 of dividends to Dr Brown, resulting in $105,000 net of tax.
2) Allocate $70,000 of dividends to his son, resulting in $70,000 net of tax.
3) Advance $135,000 from the Prof. Corp. to the Hygiene Company as loans. Each year, Judy could take a $67,500 shareholder loan (based on the projected profitability each year); this loan would need to be repaid within 12 months, then paid out again as dividends, resulting in $100,000 net after tax.
4) Withdraw $25,000 from the Prof. Corp. tax-free against the shareholder account.
5) Sell the condo for proceeds of $50,000 net after tax.
6) Sell the non-registered investment portfolio for proceeds of $50,000 net of tax (this amount to be re-borrowed so the resulting debt becomes tax-deductible).

By following the steps above, the mortgage can be paid off immediately. The solution will result in $95,000 of tax. By contrast, the interest that would have been paid on the mortgage over a 15-year term is two-and-one-half times the immediate tax impact, so this is a substantial savings.

To finalize their plan, the IPP would be funded with $75,000 cash in the Professional Corp, and the remaining $145,000 would be used towards their retirement goal.

The Result

With the mortgage paid off and the IPP started, the Brown's could focus their free cash flow on additional retirement savings. Based on a 10-year time horizon, the Brown's would need to have $4 million in savings to achieve their retirement goal of $120,000 net after tax, indexed to inflation.

With the ability to save within the Prof. Corp and Hygiene Corp, they can take advantage of the tax deferral that is available. In addition, they could invest in a new type of investment vehicle, called Corporate Class funds. These new funds do not distribute investment income each year but defer them until the investments are sold, thus reducing the annual tax burden. This is a powerful feature that will help them reach their goals faster.

And under the new structure with Dr Brown's son as a shareholder, he can continue to pay dividends to his son essentially tax-free while he remains a student. The other child could also be allocated non-voting shares once becoming an adult in a couple of years.

Dr. Brown and his wife are now mortgage-free, are able to save for their retirement and fund their children's education in the most tax efficient manner possible. The above case not only demonstrates the flexibility a proper corporate structure can add to your affairs, but that solutions have to be tailored to each individual client given their unique circumstances and preferences.

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