The TaxLetter®

Vol. 34, No. 1 — Your Guide to Tax-Saving Strategies — Single Copy: $10.00 January 2016

*FINANCIAL*PLANNING

Create a safe haven for investment income in your corporation

Safe Haven

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The new year is traditionally a time for welcoming a fresh start, making lofty resolutions (often broken) and setting new goals.

For some Canadians, the beginning of 2016 evokes fond memories of lower personal tax rates, and less onerous corporate investment tax rates in the past. But those individuals earning more than $200,000 a year will see their personal income tax rates rise by four per cent to 33 per cent. Residents in some parts of the country will now give up half of their incomes to combined federal and provincial taxes. In addition, when dividends are paid to individual taxpayers, these dividends will now be taxed at higher rates—part of the ripple effect from the implementation of the new 33 per cent federal personal income tax rate.

What may be of equal concern to business owners are accompanying increasing rates of tax on investment income in a Canadian-controlled private corporation (CCPC). The new, higher rates make it less attractive than ever to earn investment income in a CCPC than earning it personally.

Exempt vs. non-exempt life insurance policies

But there is a way to mitigate these tax changes—through the cash value found in an exempt life insurance policy. Non-exempt life insurance policies are subject to annual accrual taxation on investment earnings; e.g., the growth or increase in the cash value. But the growth of the cash value in an exempt life insurance policy is, literally, exempt from that accrual taxation—and at death, is paid tax-free, as part of the insurance policy's death benefit, to the corporation.

Not only is there no tax deferral with a non-exempt policy, there is now a greater tax cost and prepayment of tax to the federal government from earning investment income in a CCPC.

The corporate investment income tax rates that have increased as a result of the increase in personal tax rates include refundable tax rates.

New tax rates for CCPCs

For example, the additional (and refundable) tax on investment income for CCPCs has increased to 10 2/3 per cent from 6 2/3 per cent beginning in this 2016 tax year. At the same time, the refundable dividend tax rate for private corporations also rises from 33 1/3 per cent to 38 1/3 per cent.

'Refundable dividend tax on hand' accounts

The corporate investment income tax rates (and the various components) are part of the refundable tax mechanism that operates through the "refundable dividend tax on hand," or RDTOH account for short. The RDTOH account ensures that the overall tax payable on investment income is basically the same whether it is first earned in your corporation and then paid to shareholders as a dividend or if you earn it personally in the first place. The high corporate investment income tax rates (and the RDTOH) also ensure there is no deferral of tax on investment income by having it first earned in a corporation before being distributed to shareholders as a dividend.

Refunds always sound good, but when it comes to taxes and

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refunds, “refunds” is a deceiving term. You shouldn’t think of tax refunds as a windfall. It’s true you will get more refundable tax back when you finally pay dividends to individual shareholders. But in the meantime, you are paying higher rates of tax to Ottawa and getting no return or interest on the money your company had prepaid in taxes. Instead of allowing the government to have use of that money, you could be putting it to work for your own purposes in your business.

Minimize the new corporate investment income tax rates

To minimize the higher corporate investment income tax rates, consider taking advantage of the tax deferral opportunity available from the cash value growth inside an exempt permanent life insurance policy.

There is another time-sensitive point to keep in mind. The exempt status testing of permanent life insurance policies is about to change on January 1, 2017. Current policies, issued before 2017, are to be grandfathered so the benefits, generally speaking, will remain as they are.

The rules change in 2017

But starting next year, new federal legislation comes into effect that will change the “exempt test” of life insurance policies to reflect the fact that people are now living longer (i.e., mortality experience is improving) and so their insurance policies will pay out later in life. One of the major differences in the new policies will allow for more tax sheltering in the first eight years of a new policy, but less over the long term. There are additional consequences to corporate-owned insurance as a result of the exempt test changes. For example, life insurance policies issued after 2016 will likely have a larger adjusted cost basis for a longer period of time meaning a smaller credit to the capital dividend account of private companies and therefore a smaller amount of tax-free capital dividends to shareholders.

Few safe havens left

There aren’t many places to safely preserve and grow your money on a tax-exempt basis. The shrinking list includes your principal residence, your Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF)—but only until you take the money out of these—and your Tax-Free Savings Account (TFSA). One of the last remaining safe havens is the exempt life insurance policy.

Choose your beneficiaries

You have three possible beneficiaries of your final estate: the government, loved ones, and favourite charities. Given the opportunity to pick only two of the three as beneficiaries, most individuals inevitably and understandably choose family and charity, leaving nothing for the tax department.

If your wealth is not properly directed, the federal government will automatically collect a tidy sum from your estate upon the death of the second spouse.

The new top tax bracket and the ripple effect

For individuals in the new top tax bracket it is also possible that a tax rate of more than 50 per cent will apply to your hard-earned RRSP and RRIF savings, a 32 per cent tax rate will apply to dividends (e.g., on the value of assets in your holding/operating company when distributed as a dividend) and a tax rate of at least 25 per cent will apply to accrued capital gains on investments, real estate and business equity. Most people are unaware of the potential exposure to these significant tax liabilities.

Tax rules will inevitably continue to grow more complicated, and we know from experience that when rules change it’s rarely for the benefit of the taxpayer. This is the time to take advantage of the current tax deferral opportunities to grow cash value inside an exempt permanent life insurance policy. I know that you, like most readers, will easily identify many better and smarter ways to use your money than giving it to the government in the form of higher taxes.

Seek professional advice

It makes sense to invest 60 minutes of your time with a professional planner to keep your money in the family.

Contact us to determine how this strategy can help you, or to get a second opinion on your current planning.

Don’t do it yourself. Seek professional help. The best way to get financial peace of mind is getting advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner. ❐

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