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New tax rules hit entrepreneurs hardest

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Let me begin by wishing you and your family a happy, healthy and prosperous new year. Business owners and incorporated professionals may not be aware of Ottawa's latest tactic to collect more taxes by changing the rules regarding tax on passive income.

Examples of passive income include rental income and any business activities in which the earner does not materially participate during the year. Passive income differs from active income, which is any earned income including all the taxable income and wages the earner gets from working. Passive income can include things such as rental income, interest income, royalties, dividends or pensions.

New rules: The tax rules that became effective on Jan. 1, 2019 target Canadian-controlled private corporations (CCPCs). The hardest-hit are business owners, entrepreneurs and incorporated professionals such as doctors, lawyers and accountants.

Corporations with more than $50,000 of annual passive income will now lose all or part of their Small Business Deduction and then get highly taxed for every dollar of excess passive income. This could amount to an additional tax grab of $55,000 to $70,000 unless you plan now.

In brief, the federal government set an annual maximum of $50,000 of annual passive income for CCPCs. Failure to stay below that amount could be costly. Now, for every $1 of passive income over $50,000, the small business deduction level of $500,000 will be reduced by $5. This equates to a full reduction of the small business deduction when passive income is greater than or equal to $150,000.

The good news is that the amount resets the following year with no carryover. Even better, there are a few tax-efficient strategies that can help you keep more income for yourself and your family instead of the tax department. Here are some of them:

Individual Pension Plans (IPPs) let you deposit significant corporate funds for the shareholders' benefit. These deposits are tax-deductible for the CCPC, a non-taxable benefit to the shareholder and provide tax-effective access to money from a corporation when you retire.

You can save significantly more with an IPP than under current RRSP rules – up to 65 per cent more – depending on your T4 income and years of prior service.

One of the unique characteristics of an IPP is that it can act either as a defined benefit pension plan or a defined contribution plan, and you can switch every year depending on your company's cash flow.

Take the example of Brenda, a 55-year-old business owner, incorporated for 10 years. She has saved $285,715 in RRSPs and plans to make the maximum contributions every year until she turns 65. Staying in RRSPs, she will accumulate a total of $1,570,905 by the time she turns 65. But if she invests in an IPP instead and makes the higher annual contributions, she will have more than $2,272,000 at age 65. That's 45 per cent more than had she used only RRSPs to save for retirement, a big difference that can't be ignored.

Unlike her RRSP, IPP assets enjoy greater creditor protection from provincial legislation. On top of that, she will have access to a wider selection of investment vehicles, and options not allowable in an RRSP, including shares of private businesses and real estate.

Many unmarried Canadians, whether they're single, divorced, or widowed, don't realize their RRSP savings will be fully taxed when they die. So, a $1,000,000 RRSP would only be worth $460,000 to heirs other than a spouse. An RRSP can only be rolled over on a tax-deferred basis to a spouse or disabled child. For married taxpayers, the same thing occurs on the death of the second spouse.

With an IPP, if your spouse or children are employed in your business and earning T4 income, they are eligible to become members of your IPP, and those IPP assets can pass to the next generation without incurring tax or probate fees.

Shared Ownership Critical Illness (CI) Insurance can provide important protection for the business owner, their families and their business, and deliver a substantial guaranteed return on investment.

Often confused with Disability Insurance, CI covers more than two dozen conditions like heart attack, cancer, stroke and bypass surgery, and pays up to $2 million in a tax-free, lump sum 30 days after the diagnosis of a covered condition. There are no strings attached on how you use that money.

If you buy the Return of Premium (ROP) rider and don't make a claim, you can get back all the money you paid for those premiums after 15 years. It's a forced savings bundled with vital protection.

You can designate your company (rather than the insured owner) and its shareholders, key people and executives, as the beneficiary of the CI policy. Using this strategy, your corporation pays the insurance premiums for the CI benefit only, using tax-effective corporate dollars. The insured individual pays only the premium for the ROP rider with their after-tax personal income.

Let's take the example of Richard, a 45-year-old dentist with a professional corporation who wants to buy $500,000 of CI insurance. Ninety per cent of the total premiums can be paid by his company, and he pays the balance personally for the remaining 10 per cent that covers the ROP rider. After 15 years, just for remaining healthy, the insurance company will return to Richard all the money he paid for that ROP rider, plus all the premiums that his corporation paid for the insurance.

Using this CI shared ownership strategy, shareholders can receive significant funds from their corporation in a tax-effective manner. The rates of return are high, currently in the range of 15 per cent to 30 per cent, with no interest rate risk or exposure to the volatile stock market.

In Richard's case, if he gets diagnosed with a covered condition along the way, the $500,000 will be paid into his corporation and would have to come out as a taxable dividend or salary. If he has any shareholder loans, then it comes out tax-free.

You may prefer to use a different ownership structure — perhaps owning the policy individually or corporately in its entirety, or in a shared ownership arrangement. Those options should be considered only after consulting with a professional.

Tax-Exempt Corporate-Owned Life Insurance is a no-limit TFSA for your company.

Investor's Digest readers use TFSAs because investments grow without being taxed, and funds can be accessed tax-free, but you can deposit no more than $6,000 a year.

Corporate-Owned Life Insurance enjoys the tax-exempt attributes of a TFSA, with no upper limit.

Life Insurance continues to enjoy unique treatment under Canada's Income Tax Act, in contrast to every other financial investment (stocks, bonds, GICs, real estate, cryptocurrencies, other portfolio investments, etc.).

Why would a business owner want it?

Business owners use corporate-owned life insurance as a tax-effective way to accumulate passive wealth inside a company, to access that wealth tax-free and to transfer it tax-free to surviving beneficiaries. It can also be used to fund buy-sell agreements when other shareholders are involved.

Businesses usually invest retained profits or surplus cash in taxable investments. This usually occurs when the business owner doesn't need the extra income and has a higher marginal tax rate than their business. They take advantage of the low corporate tax rates on active business income by saving money in their corporations, if they don't require it for personal purposes.

This accomplishes a tax deferral only. Eventually, these assets will come out of the corporation and be taxed at high dividend tax rates.

Invest some of the retained profits in tax-exempt permanent life insurance. There are two main benefits to making such an investment.

The savings component of the life insurance policy can grow on a tax-free basis and a significant portion, if not all, of the policy proceeds payable at death can be paid to the shareholder's estate as a tax-free capital dividend.

Other income tax advantages: Premiums are paid with corporate after-tax dollars, which are taxed at a much lower rate than the individual shareholder's personal rate. The corporate tax rate applicable to active business income in Ontario is approximately 15 per cent and to investment income is 50 per cent. The top individual marginal tax rate in Ontario is approximately 53.5 per cent.

Upon death, an individual is deemed to dispose of his or her property at its fair market value. As it pertains to shares of a corporation that owns a life insurance policy, the Income Tax Act dictates to value the life insurance policy at its cash surrender value immediately before death. This value will typically be significantly less than the policy's payout following death, and far less than the value of the property that would have otherwise been accumulated by the corporation had it not purchased the life insurance policy.

As a result, purchasing life insurance can reduce the tax payable at death in respect of shares of a private corporation, as it usually leads to a lower valuation for the corporate shares than had no life insurance been purchased. (Please see my September 2018 article, "Business Owner? Get Life Insurance")

An **Immediate Financing Arrangement (IFA)** is a strategy to get Life Insurance without tying up your money paying premiums, securing your tax and estate planning liquidity needs.

It is most commonly used by business owners, real estate investors and developers, high-income professionals, and people with substantial investment portfolios.

A 65-year-old business owner needed Permanent Life Insurance but wasn't prepared to pay the premiums. He was earning over 20 per cent annually on his business investments and reluctant to reduce his returns to buy Life Insurance.

We structured an IFA to cover 100 per cent of his insurance premiums. He continues to invest his money in his business. The effective net cost of his Life Insurance is the tax-deductible interest cost only, amounting to two per cent annually of the true premium.

The insurance policy serves as collateral to secure a loan with a Canadian chartered bank. The loan is used to pay the premiums and the insured pays only the interest on the loan, which is tax-deductible. The loan will be paid off at death with the Life Insurance proceeds. The balance will go to his family and charity, virtually tax-free.

Other benefits to consider

- Convert fully taxable dividends into tax free dividends through the Capital Dividend Account (CDA) less the adjusted cost base.
- Make charitable gifts without affecting cash flow or the capacity to make investments.
- Increase an estate and transfer wealth tax-free.

Don't do this alone.

Get advice from an experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner. Our advisors across Canada are available to help you. Contact us for a free, no-obligation consultation.

Mark Halpern is one of Canada's top life insurance advisors, a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) and CEO of WEALTHinsurance.com®. He guides successful business owners, who are already challenged for time, through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other successful business owner clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Incompletions rob us of energy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His approach is simple. He makes sure what is important to you gets done. He gets you organized, provides a big picture view of your financial affairs, determines your strategy and helps you act. He will simplify the complicated, so you and your family can rest easy. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 o Mark@WEALTHinsurance.com. Visit WEALTHinsurance.com. Get your FREE Estate Planning Toolkit at WEALTHinsurance.com/toolkits.html. Visit MarkHalpernBlog.com.

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