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BATTEN DOWN THE HATCHES ON SMALL-BUSINESS TAX SHELTERS

Three tax strategies face the chopping block

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Self-employed Canadians work long and hard to make a good living in this beautiful country of ours, but two recent events are causing great consternation among taxpayers and estate planners from coast to coast.

One involves the potential abrupt end of generally accepted tax strategies for private corporations, and the other, a sudden jump in the cost of universal life insurance.

The first event occurred on July 18. Finance Minister Bill Morneau announced that Ottawa wants to stop three essential income-tax strategies used for decades by businesses and professionals with private corporations.

This really shouldn't come as much of a surprise. After all, the proposals are consistent with the Liberal government's oft-repeated campaign promises to collect more taxes from high-income earners and grow the middle class.

The Canada Revenue Agency (CRA) will surely collect much more tax money, and the Liberal party, with a majority in place, will trumpet expanding support of a growing middle class. They probably won't explain that the middle-class growth will result from high-income earners earning a lot less.

Of course, many small businesses and professionals who have private corporations consider themselves part of the middle class. In any case, the three tax strategies the government wants to eliminate are:

• Income sprinkling (or income splitting), used by private corporations to shift income from a person with a higher personal tax rate to a lower-income family member. (There are already rules in place to prevent salaries being paid to family members who are not earning the money they get. Also, let's not forget the "kiddie tax" rules that prevent dividends being paid to minor children from being taxed at their personal tax rate.)

• Holding a passive investment portfolio, which is often financially advantageous for owners of private corporations. That "extra" money is used to invest in the company, including hiring people.

• Claiming regular business income as lower-taxed capital gains to reduce their marginal tax rate.

The irony of Mr. Morneau's announcement is that all three strategies were originally put in place to support the growth of independent business.

The entities most affected by these measures - successful small businesses - are THE employers of the country. Small businesses employ more than 8.2 million people, or almost 71 per cent of the total, private labour force, according to Innovation, Science and Economic Development Canada. Medium-sized businesses account for almost 20 per cent of employment, while large businesses lag at just under 10 per cent.

Anyone who employs the methods mentioned above could be negatively affected by the Liberals' proposal.

Many overburdened taxpayers are rightfully offended by the government's backhanded attempt to promote class warfare. The government has cynically portrayed self-employed professionals and small business owners as "wealthy tax cheats" who use "loopholes" to avoid paying their "fair share". The truth is that provincial governments actively encouraged them to incorporate in the first place.

Professionals and small business owners usually work more than 40 hours a week and don't get a regular paycheque deposited in the bank for them. They don't receive any vacation time, sick time or retirement benefits.

Doctors, dentists, lawyers, accountants and others with private corporations spend many years at university learning their professions, often graduating with considerable debt that takes many more years to pay off. Now that they are finally out of the hole, the government wants to ding them again.

The tax strategies in peril have been used by business owners to help create jobs and reinvest in their businesses under previous Liberal and Conservative governments.

A recently formed new voice for business groups, called the Coalition for Small Business Tax Fairness, released a letter to Mr. Morneau asking him to forgo the July proposals.

Some taxpayers have adopted a wait-and-see approach, choosing to delay their insurance, tax and estate planning until the final resolution of the tax change proposals.

On the matter of timing, many have criticized the government's decision to announce the proposed changes in the middle of summer (when so many people are away or in holiday mode), and then gave the various constituents involved a short 75-day window of consultation, which ends Oct. 2.

Of course, many are asking for a longer period of consultation. Looking back, it took a few years to bring in the tax-exempt test on some life insurance policies that went into effect at the beginning of this year.

In the meantime, if you have a private corporation and use it to save on taxes, I encourage you to contact your member of Parliament or write directly to the federal government at fin.consultation.fin@canada.ca to share your views on how these proposed tax changes will affect you and your business.

You can also sign an action alert at www.cfib-fcei.ca/cfib-documents/DIN1031.pdf and forward it to your Canadian Federation of Independent Business representative.

On a brighter note, life insurance continues to enjoy unique treatment under Canada's Income Tax Act. Benefits received from a life insurance policy are non-taxable.

However, while the federal government did not mention life insurance on July 18, an unrelated announcement from within the insurance industry deserves your attention as it too can directly affect your tax liabilities.

A highly respected life insurance company announced extraordinary premium increases on its level-cost, universal life insurance policies. The rates will rise from 15 per cent to 50 per cent, depending on age.

The new rates were due to take effect Sept. 23 and will result in other insurers following suit.

Until now, relatively inexpensive universal life insurance (at a permanent level premium up to age 100) has been the least costly way to settle future tax liabilities, pennies today for dollars when needed to pay taxes. By every measure, universal life is a proven and reliable strategy to preserve estate values.

There is now a great limited-time opportunity for those with "never spend" money – that is, those who have all the money they will ever need and more than they will ever spend. "Never spend" money usually gets invested in risky places like bonds, equities and mutual funds, where gains are highly taxed, or low-yield instruments like mortgages, money markets, etc., where they meet the same highly-taxed fate.

Given the premium increases ahead, the return on investment for a joint last-to-die universal life policy will never be better. Canada and Japan are currently the only two countries with guaranteed level rates, and it's only a matter of time before this type of insurance coverage will be cost-prohibitive or no longer available in Canada.

Universal Life for $1,000,000

Joint Last-to-Die Policy - Level Cost to Age 100
Assumes Life Expectancy to Age 90

	Annual Premium	After-Tax Return	Pre-Tax Equivalent
Age		**NET**	**GROSS**
55	$ 9,419	5.77%	12.28%
60	$12,584	6.03%	12.83%
65	$18,607	5.85%	12.45%
70	$22,388	7.78%	16.55%
75	$29,306	10.90%	23.18%

Assumes 53% Personal Tax Rate

Aside from universal life rates changing, insurance companies will have new reporting requirements for reserves, beginning in January 2018, to more closely reflect the risk within each company's actual, in-force portfolio.

The new regulatory standard will probably result in additional rate increases.

For those who qualify, universal life insurance should be considered as an investment both for individuals and corporations. Remember that corporate holdings get a tax-free, capital-dividend account; when capital dividends are paid out to shareholders, they are not taxable. Compare the returns, even with a 53 per cent personal tax rate *(see table)*.

This is a great option for people with no appetite for market risk, who want to pay less tax, don't like paying management fees (there are none), and who want to stop worrying about currency and interest rate fluctuations.

The rates stay at a guaranteed level basically forever, and the policy's death benefit will not be affected by markets or interest rates.

Permanent life insurance will become even more important as the most cost-effective way to minimize or eliminate taxes or provide the funding to pay them.

Term insurance begins at a reasonable premium, but the premiums go up at each renewal and make policies prohibitively expensive. In contrast to term insurance, permanent life insurance is an asset, not an expense.

Instead of paying for permanent insurance from cash flow, which many perceive as a "grudge" purchase, consider transferring taxable assets you already own (such as stocks, bonds, and fixed-income investments) to a tax-exempt insurance asset.

Many real estate investors and business-owner clients use a leveraging strategy to acquire life insurance , without directing all their cash toward premiums.

Writing in *Investor's Digest* last August, I explained how to use immediate financing arrangements (IFAs) to acquire life insurance at a fraction of the true premium cost, without reducing cash available for business use or investment. There's a lot going on these days for those with private corporations and those without. You owe it to yourself to preserve your hard-earned money for the people and causes you care about.

To get the financial peace of mind you deserve, begin with advice from an impartial and experienced certified financial planner.

Contact us for help. Our advisors and other qualified professionals are available to help you across the country.

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