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FINANCIALPLANNING

The coming tax whammy for high-income Canadians

New rules

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Prime Minister Trudeau will likely deliver on a key election promise: higher-income Canadians will pay more taxes.

The Liberal party swept to power on an economic platform of higher deficits, lower taxes for the shrinking middle class and a new, higher tax bracket for those with taxable incomes greater than $200,000 a year.

The first bill from the new government, the Liberals promised, will reduce the current tax rate to 20.5 per cent from 22 per cent for those with taxable annual income between $44,701 and $89,401.

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Increased taxes on high-income Canadians

The current top bracket of 29 per cent will continue to apply on earnings between $138,586 and $200,000. Prime Minister Trudeau also pledged to impose a new tax bracket of 33 per cent on taxable incomes above $200,000 a year.

Changes to insurance and annuity products

The country's highest income earners face that rate jump plus a change in the taxable portions and the exempt portions on certain life insurance policies and annuity products, which comes into effect on January 1, 2017.

Insurance companies will continue to develop innovative products and strategies, but we are unlikely to again see anything that will match the benefits currently available.

Insured annuities are now widely considered one of the most tax-efficient, consumer-friendly products available for both individuals and those with corporations.

The benefits of insured annuities

An insured annuity can be set up personally or by your corporation. An insured annuity provides higher cash flow during your lifetime than most fixed-income guaranteed instruments, with lower tax rates that allow you to leave a legacy to your beneficiaries through tax-exempt life insurance. You often hear this concept referred to as a "back-to-back" annuity when it involves buying an annuity and insurance together.

The combination of this annuity plus life insurance is ideal for those who are major shareholders of a private corporation with surplus capital that is not required to operate the business.

How insured annuities work

With this personal strategy, you first buy a term-to-100 universal life insurance policy. You are listed as the life that is insured and your estate is the beneficiary. The amount of the death benefit is equal to the prescribed annuity amount. The life insurance can be purchased in the corporation, but the annuity must be owned personally to obtain prescribed status.

The next step is to liquidate some of your interest-earning investments to buy the prescribed life annuity. Before 2008, many annuities provided cash flows equivalent to a guaranteed income certificate (or "GIC"), often resulting in near double-digit pre-tax returns.

After years of waiting in vain for interest rates to return to "normal," people now realize that interest rates may remain low for a long time to come. With a shortage of good fixed-income options, annuities are fast becoming a very appealing choice for retired investors.

The cash flow from the prescribed annuity, which is paid either monthly or annually, pays the life insurance premiums as well as the tax payable on the annuity income. What's left is used to help supplement your income on a guaranteed, after-tax basis instead of the usual higher tax paid on traditional fixed-income investments.

The opposite of a mortgage

In many ways, annuities pay out in a fashion that is opposite to how you pay off a mortgage. With a mortgage, you make monthly payments, most of which are dedicated to paying interest and a small amount of principal. But with an annuity, your non-registered funds are given to an insurance company, which then pays you a regular income that is made up mostly of principal. Each payment contains the same taxable portion of interest and capital, evening out the amount subject to tax while providing some tax deferral.

This is particularly attractive for those in high tax brackets. Like everyone else, annuity holders want to retain as much as they can of their original investment while paying lower taxes.

With an annuity, your original capital is paid back to you in your lifetime. Payments continue for as long as you live and stop when you pass away. The purchase of the accompanying life insurance policy—to create a "back to back" annuity—ensures that money will be left to your children, other beneficiaries and favourite charities.

An attractive investment

Right now, insured annuities are a truly attractive investment option that benefit from their original design. This was based on 1971 mortality tables, which had shorter life expectancies. As a result, more of the cash flow from the prescribed annuity is designated as capital and less as income.

To see how this works, take as an example an investment of $500,000 in an optimal insured annuity structure. Assume the policy holder has a combined marginal tax rate of taxable amount of $2,059 and tax payable of $927—a modest amount.

Compare this with putting $500,000 in a taxable investment, such as a GIC, that provides four per cent interest. The annual income from the GIC is $20,000, of which all is taxable, to the tune of $9,000—almost 10 times more tax than the annuity.

With the annuity, the cash flow before paying for the life insurance premium is $37,103 compared with a cash flow of only $11,000 from the GIC.

Advantages of covering premiums via a corporation

Many people pay the insurance premiums through their corporation. Upon death, the excess of the death benefit over the adjusted cost base of the policy gets credited to the corporation's capital dividend account.

Your corporation then uses the proceeds to pay a dividend to your estate. This dividend can be a tax-free capital dividend up to the amount available in the corporation's capital dividend account. Your estate can then gift the funds as directed in your will to your heirs or charities.

At death, a corporately-held annuity has a "nil" value on the balance sheet and is not subject to any taxes. The life insurance is similarly considered to have a "nil" value as the proceeds come out of the company tax-free through the capital dividend account. Using a corporate insured annuity, the tax rate in Ontario would be zero.

This window is still open—for now

But the tax benefit that Canadians now receive from annuities is set to drop on January 1, 2017, when the tax-exempt status of annuities will change—some of them drastically. A prescribed annuity can only be purchased by an individual taxpayer, not a corporation. Take, for example, a 65-year-old male who currently has a $100,000 prescribed annuity guaranteed for three years. His current annual income from the annuity is $6,273 with taxable income of $492. That taxable income jumps to $1,170 in January 2017 because of the changes in the tax exempt status.

For a 70-year-old female, earning $6,653 of annual income from the prescribed annuity, her current taxable income of $441 will rise to $1,127 in 2017.

Are annuities for you?

Annuities are not for everyone. They are locked-in for life, so it's important not to rely solely on annuities for income. Get advice from an experienced insurance and estate planning professional to help you decide how much of your money should or can go into an annuity and how much should be allocated to other assets, like equities, bonds, mutual or segregated funds or other financial products.

Insured annuities today exemplify a near-perfect investment and insurance concept. That will change in 2017 with the coming changes to the tax exempt status.

Five more defensive steps to consider now

1) Set up an Individual Pension Plan

Business owners and incorporated professionals should consider the many advantages of using an Individual Pension Plan (or "IPP") instead of relying on a traditional Registered Retirement Savings Plan (or "RRSP").

IPPs are fully approved by the Canada Revenue Agency and can be setup for one employee or a group of employees.

All contributions made by the employer are fully tax deductible and a non-taxable benefit to the employee.

IPPs can only be set up by active business corporations, not holding companies and the plan member (employee) must be a Canadian resident and pay Canadian taxes.

Just for starters: You will enjoy higher contribution limits, better returns, improved creditor protection and the ability to transfer wealth to family members on a tax-free basis.

2) Set up an HSA

A Health Spending Account (or "HSA") allows you to pay medical, dental and other eligible health-related expenses with pre-tax dollars.

Use your HSA to pay for health insurance premiums, dental expenses, prescriptions, medical prostheses, hair transplants, cosmetic surgery, and any other eligible medical expenses that may not be fully covered under your base benefit plan.

3) Consider Participating Life Insurance as an Alternative Investment

As noted above, the tax-sheltered growth of participating whole life insurance policies will change dramatically on January 1, 2017.

Participating whole life insurance is a unique asset accumulation, estate and retirement planning tool. The funds inside the plan grow tax free.

Wealthy clients who don't need more insurance are buying it now as a risk-free portfolio investment that grows in value every year.

4) Review Your Insurance and Protection Portfolio Now

Get a second opinion on your current arrangements from an experienced insurance and estate planning professional to help preserve what you have worked for.

5) Compete the Estate Planning Toolkit

Finally, complete the Estate Planning Toolkit, available free at our website – see details below. ❐

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