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TAXSTRATEGY

Know more and pay less

The Tax Grind

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Are you among the many people fortunate enough to find your work satisfying and enjoyable? I hope so. Despite the long hours, missed school concerts and hockey games with the kids, you really don't mind putting in the time and effort because your efforts will provide long-term benefits for you, your family and even your favourite charity.

And every year, like clockwork, tax time rolls around and your not-so-silent partner (the Canada Revenue Agency) takes a huge chunk of that hard-earned money. Depending on where you live, more than half of your earnings are lost to income taxes - whether earned personally or by your corporation.

Adding Insult to Injury

The after-tax income you do get to keep is further eroded by many additional taxes and fees (harmonized sales tax, business tax, consumption taxes, realty tax, etc). You find yourself in The Tax Grind. The current situation is that Canadians who earn more than $220,000 a year are losing up to 53.53 per cent in taxes in Ontario (it varies by province) and are subject to taxes again in investments like GICs, bonds and real estate income. The last federal budget also made several changes aimed at making it even more difficult for high net worth Canadians to keep the money they have earned. (See my TaxLetter April 2016). That's just on the personal side.

On the corporate side, once you take money out of the company, you have to pay a taxable dividend: if it's an "eligible" tax dividend, you will be taxed at 39.34 per cent and if it's an "ineligible" tax dividend, you will pay the government 45.3 per cent. Over the years, the cumulative tax loss to an estate that occurs with fixed-income investments, like GIC's or a personal savings account, can mean a major loss to your estate.

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Tax Grind in action

Here's an example. A 65-year-old couple with money in a holding company ('holdco') decides to invest in a safe GIC at the bank earning interest at 4 per cent. If they deposit $100,000 per year into the GIC for exactly ten years, and then allow their funds to grow on their own for the next 15 years (no further deposits from them), the total after-tax amount available to their family and heirs is approximately $990,000. After 25 years and a million dollars invested, they emerge with less than the base amount they deposited.

The interest earned over 25 years (all passive income) was taxed annually at the rate of 50.17 per cent, with an additional tax of 45.3 per cent levied when the money leaves the holding company and gets distributed among the family. Our couple could buy a tax-exempt life insurance policy instead, and the holdco could instead deposit exactly the same $100,000 annually, for 10 years only, in a joint and last-to-die tax-exempt life insurance policy. With timelines and deposit amounts exactly as above, after 25 years, their beneficiaries receive net after-tax proceeds of about $3.12 million, compared to the $990,000 with the bank GIC. Their equivalent rate of return is approximately 13 per cent. The only difference was the choice of financial instrument used.

An alternative

Instead of obediently sending more than half of your income to Ottawa every year, you could use some of that

income to pay the premiums for a new life insurance policy that will ultimately meet all of your financial aspirations for family and charities – and all tax-free. You can also take advantage of current tax-exempt rules on life insurance policies issued before January 1, 2017, when new rules come into effect that will sharply reduce the maximum cash value accumulations you are allowed to build up tax-free.

As it now stands, when an insurance policy is considered tax-exempt, any value over the basic amount can grow without tax (within limits set out by the government). Tax-exempt life insurance policies issued before 2017 will be grandfathered. Many additional remedies are available to pay less tax.

On the personal side, maximize your RRSPs and TFSAs as soon as possible. Consider giving a gift to an adult child, tax-free, or using prescribed rate loans for income splitting with family members.

Critical Illness (CI) insurance has been around for many years, and is still one of the industry's best-kept secrets. The vast majority of insurance advisors have never sold a policy. Not only does it provide a tax-free lump sum of up to $2 million in the event of an illness (many policies cover more than two dozen conditions like cancer, stroke and bypass surgery), but you can also get back all your premiums if you don't make a claim within a specified time, usually 15 years, with the optional Return of Premium (ROP) rider.

CI protection can also be used tax-effectively in your business to ensure continuity of the business and protect it against the financial consequences of a critical illness. Using the CI Shared Ownership Strategy, the company pays the premiums for the insured individual, such as the owner, a shareholder or a key person, and the insured person pays the nominal ROP premium. At the end of 15 years, if no claim is made, all of the premiums paid (including what the company paid) is returned to the insured individual, making it an attractive investment opportunity that allows shareholders to withdraw funds from their corporation in a tax-effective manner.

With the help of an experienced advisor, the rates of return on the ROP can be very high, often exceeding thirty percent or more, pre-tax. A Private Health Services Plans (PHSP) can help you convert medical and dental expenses into a business expense whether you are a business owner or self-employed. There is a huge list of allowable medical expenses (www.cra.gc.ca) like dental services, cosmetic surgery, dentures, chiropractic, glasses and U.S. healthcare premiums that can go toward the medical expense tax credit.

The CRA will credit 15 per cent of a taxpayer's expenses back beyond the lesser of $1,925 and three per cent of the taxpayer's net income for the previous year. There are a host of other savings self-employed individuals can claim through a PHSP compared to the same expenses being claimed on their income taxes.

Other thoughts

Additional ways to reduce your taxes: Make sure you have the right types of insurance to meet your specific needs. This includes income replacement, estate preservation, estate equalization and legacy building. If you are charitably inclined, consider making tax-efficient donations when you die by establishing charitable remainder trusts, private donations and donor-advised funds – or include charitable gifts of securities in your estate plan. For your business, ensure that key person insurance is in place to implement a contingency plan. Give some thought to an estate freeze to minimize your tax liability. With this strategy, the amount of corporate capital gain subject to a tax in a business owner's estate is frozen. Future growth of the company's value will not accrue to the principal shareholder but to the successors or to a discretionary fund. Ensure that children and grandchildren, especially those with disabilities, are properly looked after. At the same time, consider providing financial security for any other dependents, including aging and financially dependent parents, through your tax-free life insurance.

Probate fees add up quickly and are just another way the government takes more taxes. Ask your financial advisor, accountant or lawyer whether there are ways to save probate and other estate costs on assets that don't require probate – private company shares, for example. You can have two wills in Ontario to counter some of the costly probate fees. The first $50,000 of estate assets is taxed in this province at 0.5 per cent and anything above that is subject to 1.5 per cent.

Some assets must go through probate, but others, like private company shares, don't and should be contained in a secondary will. And while this may sound simplistic, ensure that you have made the appropriate beneficiary designations for registered plans and insurance policies. The last thing you want is to have the wrong people become beneficiaries of your hard earned money. ❒

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