Options available to mitigate tax changes

MERRICK WEALTH

By Peter Merrick

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

Peter Merrick, MerrickWealth.com

When I heard David Bowie had passed, his song *Changes* began running through my mind. When it comes to tax planning, adapting to change is the true mark of a trusted financial adviser.

At the beginning of this year, the federal government made a major change for Canadians earning more than $200,000 annually by raising the federal personal income tax rate to 33 per cent. Taxpayers in some parts of the country will now bear witness to giving up half of their incomes in combined federal and provincial taxes. Now when dividends are paid to individual taxpayers, these dividends will be taxed at higher rates.

What may be of equal concern to business owners are the accompanying increased tax rates 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.

Fortunately, there are still ways to mitigate these tax changes. While this was happening I was lucky to have an insightful conversation with Mark Halpern, a life insurance adviser and CEO of WEALTHinsurance.com.

Our conversation turned to how cash value growth in exempt life insurance policies is tax exempt — and at death, gets paid tax-free, as part of the insurance policy's death benefit. "Even better if the insurance is corporately owned so the proceeds can flow out the capital dividend account tax-free," Halpern said.

We then began to discuss the implications of how the rising personal tax rates impact the refundable tax rates. He explained "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 rose from 33 1/3 per cent to 38 1/3 per cent. 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."

He continued: "Refunds always sound good, but when it comes to taxes and 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 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."

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

We chatted about another time-sensitive point: the exempt status testing of permanent life insurance policies that's about to change on Jan. 1, 2017. Current policies, issued before 2017, are to be grandfathered so they will remain as is. Future policies will be good but not as good as life insurance purchased now.

Starting next year, new federal legislation will change the "exempt test" of life insurance policies to reflect the fact that people are now living longer 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. Halpern pointed out 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.

There aren't many places left to safely preserve and grow your money on a tax-exempt basis. The shrinking list includes your principal residence, your RRSP or RRIF (but only until you take the money out) and your Tax-Free Savings Account. One of the last remaining safe havens is the exempt life insurance policy that gives you tax-free growth and a tax-free distribution.

"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 taxman," Halpern said.

If your wealth is not properly cared for, the federal government will automatically collect a tidy sum from your estate upon the death of the second spouse. For individuals in the new top tax bracket it is possible that a tax rate of more than 50 per cent will apply to you and your clients' hard-earned RRSP and RRIF savings, with a close to 40 per cent dividends tax rate (e.g., on the value of assets in your holding/operating company when distributed) 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. It is important to remember that clients compensate their trusted advisers to legally mitigate these potential tax burdens with our sound advice as we assist them to implement well-crafted solutions.

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 — it is the best tax deferral and tax elimination strategy left in Canada.

You can use it for a variety of tax planning solutions. But don't do it yourself. Seek professional help from the experts. The best way to obtain 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 and estate practitioner.

Peter J. Merrick, BA, FMA, CFP, TEP, FCSI is a trust and estate practitioner and president of MerrickWealth.com, an exit planning firm in Toronto. He is the author of *ASK - Advisors Seeking Knowledge, The TASK – The Trusted Advisor's Survival Kit and The Essential Individual Pension Plan Handbook*. He can be reached at *Peter@MerrickWealth.com* or 416-854-1776.

Pressure mounting to disclose status

By DONALEE MOULTON

Canadian companies with U.S. shareholders should take active steps to confirm if they are and if they need to be classified as a passive foreign investment company (PFIC) under American tax rules. In some cases, companies can have their PFIC status changed.

The call to action is done on behalf of American investors. "The Canadian company doesn't suffer adverse tax consequences. The only effect is on U.S. shareholders. They're taxed under a very onerous U.S. tax regime," said David Mattingly, a law partner with Torys LLP in New York.

The tax rules that apply to a passive foreign investment company are intended to prevent American shareholders from deferring U.S. tax by earning investment income through a non-U.S. corporation. These rules are aimed at corporations that hold primarily passive assets or that earn primarily passive income, which includes dividends, interest, gains from the sale or exchange of investment property, and certain rents and royalties. Holding companies, mutual funds, and mining enterprises, for example, are often classified as a PFIC.

It is a designation that can potentially deter investors from buying shares. "While U.S. tax rules are seldom straightforward, the PFIC rules are particularly long and complicated," noted Russell Crawford, a partner with KPMG LLP in Vancouver, adding that, "It is safe to say that most U.S. shareholders would prefer to avoid holding shares in a PFIC."

LUNDENBERG

A U.S. investor with shares in a PFIC becomes subject to one of three special tax regimes, and the rules impose additional reporting, complexity, and tax liability. For American shareholders, noted Dan Lundenberg, a consulting partner with Grant Thornton LLP in Toronto, "being a PFIC carries a compliance burden and a potential adverse tax consequence."

If a U.S. shareholder in a PFIC does nothing to mitigate the tax implications and a distribution is made, the taxpayer will be taxed at the highest possible rate. In addition, an interest charge will be levied because the tax is considered to have been deferred. Investors who sell their shares in a PFIC will be taxed at the highest capital gains rate. "It's a very complicated excess distribution regime — the most draconian form of taxation," said Mattingly,

Canadian and other non-U.S. corporations are classified as a PFIC if they satisfy one of two tests. If at least 75 per cent of a company's gross income for the taxable year is passive income, it may be deemed a passive foreign investment company. A corporation can also be classified as a PFIC if the average percentage of its assets held during the taxable year that produce passive income or are held for the production of passive income is at least 50 per cent.

Foreign companies with U.S. shareholders must be tested annually for PFIC status. However, if a non-U.S. corporation is treated as a PFIC in one tax year,

See Frequent on page 27