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Build a no-limit tax-free savings account

Mark Halpern

"Tax-free" is a term you don't hear often, especially when it comes to investments, retirement and estate planning. After almost 30 years in this profession, I can tell you that when it comes to clients' financial futures, taxes are the one thing most people don't like to think about at all and rarely take into consideration.

The Tax Grind: Take the case of this 72-year-old widower we met recently. He has done well for himself with assets of close to $11 million, a well-diversified portfolio with holdings in real estate, marketable securities and other investments. We analyzed his portfolio and had to give him the heartbreaking news that when he dies, his estate will only be worth only $6.5 million.

With no spousal rollover available, his registered money exceeding $220,000 will be taxed at 54 per cent, and the capital gains on investments, real estate and marketable securities will be taxed at 27 per cent. If he had a holding company, taxes could exceed 50 per cent. It's what we call the Tax Grind, the subject of my December 2017 Investor's Digest column.

Like other Canadians, he faces the harsh reality of taxes and their negative impact on investments at death. It's not what you make, but what you're left with, that's the key to planning your financial future.

Most people don't mind paying some taxes and in fact, half of our taxes come back to us in the form of important social services. Federally, it's things like the Canada Child Benefit and Old Age Security benefits. At the provincial level, health care and post-secondary education top the list.

Depending on where you live, more than half of your earnings are consumed by income taxes – either personal or corporate. In Ontario, people who earn more than $220,000 a year lose 53.53 per cent in taxes. On top of that, we pay taxes on investment returns from GICs, stocks, bonds, real estate, and more taxes when we spend what's left on simple things (like gas for the car, cell phone services, etc.)

The final four: There are now only four ways for Canadians to escape this tax bite: through your principal residence, lottery winnings, tax-exempt life insurance and a tax-free savings account, or TFSA. Everyone in Canada should have a TFSA because your money grows tax-free and remains tax-free, even when you withdraw it (unlike heavily-taxed RRSPs and RIFs). The only downside to a TFSA is the deposit limit of only $6,000 a year.

If you are like most people, wouldn't you prefer to have a TFSA with no upper limit, where your money grows tax-exempt, can be accessed during your lifetime tax-free and passed along virtually tax-exempt to your family? The good news is that such a strategy does exist. It's called tax-exempt Permanent Cash Value Life Insurance.

A no-limit TFSA for business owners and individuals

Most people know what insurance is. They just don't know what it can do.

We recommend that investors consider moving some of the taxable investments in their portfolio into tax-exempt life insurance.

This way, the savings component of the life insurance policy (known as the cash surrender value or CSV) grows tax-exempt, accumulates funds that can be accessed during your lifetime if needed for emergencies, investment opportunities or to help supplement your retirement. And the death benefit proceeds payable at death are also paid out tax-free if a policy is owned personally or with little tax if owned corporately.

Immediate Financing Arrangements: If you qualify, you can acquire permanent life insurance using an Immediate Financing Arrangement (IFA).

With an IFA, your insurance policy CSV can serve as collateral to secure a line of credit with a Canadian chartered bank and use those borrowed funds for other investments. The interest cost is tax-deductible because you are borrowing to invest. With current interest rates of about four per cent, the real net interest cost is two per cent.

In most cases, clients will use the life insurance policy to pay off the loan balance at death with the remainder going to family and charity, virtually tax-free.

Corporate-owned life insurance: Business owners or incorporated professionals can enjoy a no-limit TFSA via corporate-owned life insurance.

They can invest some of the retained profits in their businesses into the insurance policy as an effective way to accumulate passive wealth inside a company and not be subject to passive income tax of 50.17 per cent on gains in Ontario.

When buying corporate-owned life insurance, the premiums are paid with corporate after-tax dollars, which are taxed at a much lower rate than the individual shareholder's personal tax rate. The savings component of the policy grows tax-exempt and the CSV can also be accessed tax effectively. A major portion, if not all, of the proceeds of the policy can be paid to the shareholder's estate as a tax-free capital dividend.

The difference between putting money into an investment or corporate-owned life insurance is stunning. Take the example of a married couple, Mr. and Mrs. Smith, age 65, who own a holding company with $100,000 of after-tax income available to invest each year.

The Smiths use their holding company to deposit $100,000 a year for 10 years in a solid invest-

ment, which earns a four per cent rate of return. After 25 years, their beneficiaries receive net after-tax proceeds of about $990,000.

You probably noticed that's less than their original investment. Here's why: the interest earned over those 25 years was all passive income and was taxed every year at the rate of 50.17 per cent. An additional tax of 45.3 per cent is levied when the money leaves the holding company and gets distributed among the family.

If the Smiths were readers of Investor's Digest, their holding company would deposit the same $100,000 for 10 years in a joint last-to-die tax-exempt life insurance policy. After 25 years, their beneficiaries receive net after-tax proceeds of about $2.8 million, an equivalent rate of return of about 12 per cent.

That's $2.8 million compared to $990,000.

In the meantime

Maximize your regular TFSA as soon as possible and the same thing goes for RRSPs. If you believe you have enough money to cover all eventualities, think about giving a gift to an adult child, tax-free, or using prescribed-rate loans for income splitting with family members.

As well, make sure you have the right kinds of insurance to ensure peace of mind. This includes income replacement, estate preservation, estate equalization and legacy building. Consider making tax-efficient donations when you die by establishing charitable remainder trusts, private donations and donor-advised funds. You can also include charitable gifts of securities in your estate plan.

Plan for unforeseen events ahead of time – think COVID-19.

A properly developed financial plan involves more than just investing. It considers your goals, objectives and risk tolerance. It's easy to put off decision-making but the need to plan is crucial to ensure you have tax-efficient strategies and investments in place. This is especially true if you want to leave funds to adult children or a worthy charitable cause.

If you don't prepare properly, the money or property that you had earmarked for your children or a charity can end up in the hands of the Canada Revenue Agency.

Structure your estate planning and investments appropriately It's worth your time and money to consult an estate lawyer and other planning professionals.

If you did this years ago, this is the time to get an updated, second opinion. I often compare this to having old financial furniture that doesn't fit a client's current architecture.

Depending on your situation, you may want to have a family meeting to discuss issues, especially if adult children are involved in a family business.

The same level of careful thought is required if you want to leave money to a charity. There are several ways this can be accomplished, including through an endowment.

An endowment entails providing an irrevocable gift to either a private foundation or a donor-advisor fund (DAF) within a public foundation. It's a good idea when you want to create a legacy gift over a long period of time, rather than a one-time gift.

There are certain tax rules that come into play, including that the endowment must disburse a minimum of 3.5 per cent of its asset value every year. Again, structuring this kind of charitable benefit properly is essential to its viability.

RRSP or IPP?: If you are a business owner or incorporated professional, you should consider using an Individual Pension Plan (IPP) instead of an RRSP. It allows you to save more than allowed under RRSP rules - as much as 65 per cent more - depending on your T4 income and years of service.

You can also save on taxes while enjoying an expanded level of creditor protection. With an IPP, you can know exactly how much you will receive every year under its defined benefit component. Or, if you prefer, you can take the defined contribution path and know how much you will put into the plan every year.

Don't do it alone

Comprehensive estate planning and tax-friendly structuring of your investments requires professional help. Don't do it alone, especially if you are the custodian of family wealth for the next generation. The Canada Revenue Agency is your uninvited silent partner waiting patiently for "a piece of the action".

Proper planning will ensure you have organized your affairs in the most tax-efficient manner, and you won't be paying a dollar more than legally required.

Our advisors are available to help you across the country. Please do not hesitate to contact us to arrange your personal no-obligation consultation. It will be time well-invested.

Stay safe and healthy.

Mark Halpern is one of Canada's top life insurance advisors, a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP), Master Financial Advisor – Philanthropy (MFA-P™), and CEO of WEALTHinsurance.com®. He provides special expertise and tax-friendly insurance strategies in the areas of Estate Planning, Life Insurance and Philanthropy for business owners, entrepreneurs, professionals and high net worth families.
Mark can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com. Visit WEALTHinsurance.com. Get your FREE Estate Planning Toolkit at WEALTHinsurance.com/toolkits.html. The 2020 Toolkit now includes: Estate Directory, Estate Planning Checklist, Executor Duties Checklist, and Business Owners Planning Guide.
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