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Investor's Digest of Canada

June 7, 2019 Vol. 51, No. 11

Paying attention to your RRSPs and TFSAs all year-round pays off

Higher returns, lower taxes

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The seasons change quickly. It's hard to believe that summer is already around the corner. Many Canadians will be heading away on holidays in the coming months, especially as the school year winds down. Even while we take some well-deserved time to relax, though, it pays to be mindful of our investments.

RRSPs and tax-free savings accounts (TFSAs) are often mistakenly considered seasonal investments, when in fact they are available year-round. But the fact is that many (most?) people delay buying into these government-sanctioned savings plans until the last possible minute.

Every Canadian above the age of 18, including business owners and incorporated professionals, can take advantage of both plans.

RRSP contributions are limited to 18 per cent of your previous year's earned income and for 2019, the maximum was $26,500, up from $26,230 in 2018.

A TFSA, while providing great benefits tax-wise, has a deposit limit of only $6,000, up from $5,500 last year.

Only the TFSA is tax-exempt when you remove the money. RRSPs are tax-deferral vehicles only. They do transfer tax-free to a surviving spouse, but upon the second death, taxes are payable. In Ontario, the government gets the lion's share of up to 54 per cent.

A bigger bang: Many of our clients buy life insurance products to realize other tax strategies that give high-earning professionals, investors and business owners a much bigger bang for their buck: Corporate-owned life insurance (COLI), and tax-exempt permanent life insurance.

Most affluent Canadians are sufficiently self-insured by virtue of their assets and don't necessarily need to leave insurance to their families when they pass away, but can still profit from such strategies.

Corporate-owned life insurance, for example, is a tax-effective way to accumulate passive wealth inside a company, access that wealth tax-effectively and then transfer it virtually tax-free to surviving beneficiaries.

Many businesses invest retained profits or surplus cash in taxable investments, like stocks, bonds, real estate, precious metals and recently, cryptocurrencies.

This situation usually occurs when the business owner doesn't need the extra income and has a higher marginal tax rate than their business. In such cases, they can take advantage of low corporate tax rates on active business income by saving money in their corporations if they don't need it for personal reasons.

However, this only defers the tax, and they can't withdraw funds tax-free like a TFSA. At some point, the funds will come out of the corporation and will be taxed at the high, then-prevailing dividend tax rate. If you invest some of the retained profits in corporate-owned, tax-exempt life insurance, you can reap several benefits.

The biggest advantage is that the savings component of the policy, also known as the cash surrender value (CSV), grows tax-free and can be accessed tax-effectively.

Corporate-owned life insurance became even more attractive this year, when tax rule changes concerning Passive Income came into effect. It restricts access to the Small Business Deduction limit, which is the amount of annual income eligible for the small-business tax rate.

The restriction applies to Canadian-controlled private corporations (CCPCs) that earned more than $50,000 of passive investment income in the previous year. The federal small business limit of $500,000 is to be phased out at $5 for every $1 of investment income above the $50,000 threshold. The limit will be eliminated when investment income in the prior year reaches $150,000.

Untouched by Ottawa, however, is income earned from investment in an exempt life insurance policy, which in most cases will allow CCPCs to still claim the small business deduction. Most life insurance policies are tax-exempt, but it's a good idea to speak with a professional before buying a policy.

Under this scenario, CCPCs can invest some of the retained profits from their business into permanent life insurance. This allows the business owner of the policy to accumulate the savings part of the life insurance policy tax-free.

On top of that, a large portion, if not all the of policy proceeds payable at death, can be paid to the shareholder's estate as a tax-free capital dividend.

There is another major advantage of owning life insurance in a corporation. Because the premiums are paid with corporate after-tax dollars, they are taxed at a much lower rate than the individual shareholder's personal tax rate. Currently in Ontario, the corporate tax rate that applies to active business income is about 13.5 per cent while the rate on investment income is 50 per cent. The top individual marginal tax rate in Ontario is about 53.5 per cent.

When it comes to tax-exempt permanent life insurance, those with substantial investment portfolios and unrealized capital gains, including high-income professionals and real estate investors, see it as an alternative investment that can grow at an equivalent taxable rate of return of approximately nine per cent annually.

Those funds can be accessed tax-free and given to family and favourite charities, also tax-free. Donors can also receive a tax-effective charitable donation receipt.

As noted above, the problem for affluent Canadians is that they are subject to income taxes of almost 54 per cent (in Ontario) on annual income of more than $220,000, including investment income.

Immediate Financing Arrangements

If you qualify, several leveraging strategies are available to make buying permanent life insurance more compelling.

In summary, under an Immediate Financing Arrangement (IFA), the insurance is arranged, and you pay the premiums using your own money. You then use the policy's CSV, and often some additional collateral, to secure a loan from a Canadian chartered bank and use the loan proceeds to invest in your business, investment portfolio, real estate or private equity.

You pay only the interest on the loan, which is tax-deductible, and continue to use your own money for your business or other investments to produce income.

The loan is typically paid off at death using the life insurance proceeds. The balance goes to family and charity.

A recent case

A 50-something couple owned a company for many years and sold it a few years ago. They now own a holding company containing the proceeds of the business sale.

The husband continued working as an executive and was about to retire. His current portfolio of non-registered assets and real estate was worth about $14 million. With other personal assets added in, his net worth totalled about $17 million.

When we first met, he was aware of the $5-million potential tax liability at his death but had no formal plan to deal with it.

We structured a life insurance policy of $5 million to cover that tax liability.

We showed him how the $5-million death benefit would continue to grow, and how to structure it in a manner that would be cash flow-efficient for his business.

It is important to note that you should use an experienced professional to help you navigate this process. Rates of return cannot be guaranteed.

Used properly, this strategy can sharply increase your estate value.

Instead of, or in addition to your RRSP, consider an Individual Pension Plan (IPP) to save much more than you can under the RRSP – up to 65 per cent more, depending on your T4 income and years of service.

With an IPP, you have the choice of either receiving a specified amount every year under its defined benefit component or putting in a specified amount under the defined contribution plan route. You also have the choice of switching every year between the two kinds of components depending on your cash flow needs in your business.

So, there you have it – several ways to reduce your taxes and accumulate much more for your retirement.

Don't do it yourself. Seek professional help. The best way to get financial peace of mind starts with advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner.

Our team of experienced advisors is available to help you across the country. Contact us for your no-obligation consultation.

Mark Halpern is one of Canada's top life insurance advisors, a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) and CEO of WEALTHinsurance.com®. He guides successful business owners, who are already challenged for time, through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other successful business owner clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Incompletions rob us of energy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His approach is simple. He makes sure what is important to you gets done. He gets you organized, provides a big picture view of your financial affairs, determines your strategy and helps you take action. He will simplify the complicated, so you and your family can rest easy. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com. Visit WEALTHinsurance.com and get your FREE Estate Planning Toolkit at WEALTHinsurance.com/toolkits.html. The 2019 Toolkit now includes: Estate Directory,
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