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*TAX*MATTERS

An Uncharitable Budget

A bigger bite

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The new federal budget tabled last month continued to make good on the government's election promise to collect more taxes.

TaxLetter readers will recall that 'wealthy' was re-defined not long ago to include people earning more than $200,000 annually. Already hit by a 4% tax rate increase in 2016, those 'wealthy' Canadians will pay even more as a result of the changes in the budget.

With provincial taxes taken into account, the highest earners now lose more than half of their earnings to income tax. Many Canadians are now paying income taxes of up to 53.53 per cent. The picture grows bleaker after deducting consumption taxes like the Harmonized Sales Tax, realty taxes, business taxes, etc.

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A shrinking list of tax-free investments

The federal government eliminated or reduced a number of benefits available to high net worth Canadians. Other than lottery winnings, your primary residence and Tax-Free Savings accounts (TFSA's), life insurance is one of the few tax-free vehicles still available to everyone.

Interest-earning investments like GICs or high-interest savings accounts are taxed the heaviest, while stock dividends receive more favourable tax treatment. On the other hand, life insurance goes directly to a beneficiary, bypasses probate and is 100 per cent tax free, regardless of beneficiary. Additional tax advantages are available for those leaving a legacy to a charity.

In its budget, the federal government ensured some legal "loopholes" don't accidentally pay out too much in tax benefits.

Policy transfers

The budget slammed the door shut on Life Insurance Policy Transfers, exactly as predicted in my very first *TaxLetter* article published in 2011.

Your life insurance policy can still be transferred to a private corporation or partnership, but you can no longer take anything more than the fair market value of a policy over its cash surrender value as a tax-free benefit.

A similar measure will apply to cut the amount added to a capital dividend account, paid-up capital and/or adjusted cost base when a policy is transferred to a corporation of a partnership.

Income splitting

The budget eliminated a version of income splitting, previously known as the "Family Tax Cut Credit," introduced by the previous government in 2014.

It would have allowed an individual to notionally transfer up to $50,000 of his or her income to the lower-income spouse or common-law partner, if they had a child under age 18. It would have meant a savings of up to $2,000 a year in taxes.

Some income splitting strategies remain untouched and available to help high-income

couples with disparate incomes. Those strategies include pension income splitting, spousal or common-law partners' RRSPs for post-retirement income splitting, and lending funds to lower-income family members at a rate prescribed by the Canada Revenue Agency.

Taxation of stock options

Reacting to opposition over possible changes to the taxation of stock options, the existing regime was untouched. In the weeks leading up to the budget, Finance Minister Bill Morneau said there would be a $100,000 cap on the favourable tax treatment afforded stock options. He later announced they would be grandfathered. Ultimately, the government decided to leave things as is after small-to medium-business owners made clear that compensating employees with stock options in lieu of pay was a legitimate way to attract talent.

Child disability benefit

Recognizing the additional costs of caring for a child with a severe disability, the government increased the maximum Child Disability Credit from $2,695 to $2,730.

It's important to note that both the Canada Child Benefit and the Child Disability Benefit are income based. The Canada Child Benefit will replace several current benefits, some of which (such as the Universal Child Care Benefit) were not income based. Unfortunately, as a result of the new Budget, previous guidelines to qualify for the Child Disability Benefit will probably be changed, and any family with income over $150,000 will have benefit reductions. No benefits will be available to families with income above $180,000.

Charitable donations

Charities and taxpayers were dealt a nasty blow. The government announced it will not proceed with the implementation of a charity-friendly plan (introduced by the previous government) to eliminate the capital gains tax on the sale of appreciated real estate and private company shares if the proceeds were donated to charity with 30 days.

The good news is that the donation of publicly traded shares was unaffected.

Small business tax rate frozen

A Canadian business that qualifies as a Canadian-controlled private corporation (CCPC) qualifies for a number of tax benefits, including access to the small business tax rate on the first $500,000 of active business income. The government announced it would freeze the small business tax rate at 10.5% for an indeterminate period. The previous government had committed to reducing the small business tax rate to 9% by 2019.

New Tax Rule Changes

Upcoming tax rule changes concerning life insurance will have an even bigger impact on wealthy Canadians than this new budget. Before you make any financial decisions this year, be sure that you know exactly how the new tax rules and new budget will affect you.

New rules coming into effect January 1, 2017 will change the exempt test of life insurance policies, sharply reducing the maximum cash value accumulations that are allowed to build up tax-free. Currently, if the policy is deemed exempt from tax, anything over the basic amount can grow without tax within government limits. Starting next year, the tax-free amount will be reduced. Insurance policies issued before 2017 will be grandfathered. As a practical matter, this opportunity is really available until October because it usually takes about 90 days to get a new policy through the process of application, medical underwriting and issuance.

Insured annuity strategy

Shareholders of private corporations should consider an insured annuity because it provides higher cash flow during your lifetime than most fixed-income, guaranteed instruments with lower tax rates that allow you to leave funds to your beneficiaries through a life insurance policy. The combination of an annuity plus life insurance is ideal for shareholders of private corporations with surplus capital that is not required to operate the business.

Personal Pension Plan (PPP)

Business owners and incorporated professionals may want to look at the idea of a PPP, approved by Canada Revenue Agency and available for one or more employees. All contributions made by the employer are fully tax deductible and a non-taxable benefit to the employee. PPPs can be used by an operating company ("opco") or holding company ("holdco"). The PPP test is met if the corporation pays T4 income to the employee for

services rendered. A holdco can act as plan sponsor, with an opco as participaing employer, and both can contribute to the PPP. Under these plans, you can enjoy higher contribution limits, better returns, improved creditor protection and the ability to transfer wealth to family members on a tax-free basis. An additional benefit of setting up a PPP is that it is considered a "comparable plan" under the Ontario Retirement Pension Plan ("ORPP") that is slated to impact every business in Ontario starting in 2018. Consider a two-for-one strategy: use the additional tax deductions obtained from the PPP to fund the purchase of a tax-exempt life insurance policy before the tax rules change as discussed earlier. Budget 2016 reaffirmed Ottawa's desire to implement a Canada-wide agreement on an expanded CPP.

What lies ahead

Expect more changes and higher taxes. The government promised to undertake a comprehensive examination of the entire tax system with a view to eliminating "the ability of high net worth individuals to use private corporations to inappropriately reduce or defer tax."

Proper estate planning and tax minimization is not a do-it-yourself project. People need professional help. Seek advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Professional.

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