TAX

BY MIKE GEORGE

Spread the wealth

Income planning isn't just for retirees


GEORGE

When people think of income planning, they usually think of retirement. Prior to retirement, Canadians are mainly concerned with paying debt and accumulating retirement assets, so they ignore income-planning opportunities.

Many options before retirement

There are, however, a number of situations before retirement where income planning can play a role within a broader wealth plan. In these situations, it may be appropriate, and even tax-efficient, for clients to take income from their portfolios before they retire.

These often-overlooked opportunities range from utilizing low tax rates for family members to maximizing the benefits of professional corporations.

As part of managing a full and balanced portfolio, pre-retirement income planning involves looking at all the different "buckets" available — RRSPs, TFSAs, insurance products, non-registered portfolios, and other products — and making use of them in ways that are creative and hopefully more tax-efficient.

Scenario #1: Generating income for the professional practitioner

Low tax rates are currently in effect for professionals and small business owners who earn active business income inside a corporation. Allowing business income to accumulate within a corporation is an excellent way to reduce overall taxes. The downside, of course, is that this money must remain within the corporation.

This is the first scenario where it is appropriate to create and draw income from a personal investment portfolio before retirement. This personal portfolio must generate sufficient income to fund the owner and his or her family's lifestyle until it is time to pull money out of the company. This may be at retirement, or, in certain situations, upon an owner's death.

By creating an income stream from existing funds, the low tax on corporate earnings can be deferred until the funds are eventually pulled out. This tax deferral is as high as 35% in certain provinces. With such a large discrepancy, corporate portfolios can accumulate substantially and create a much larger retirement portfolio.

Scenario #2: Taking RRSP income before age 71

At age 71, Canadians must convert their RRSP to a RRIF and begin drawing income. What was once a vehicle used to accumulate assets has now become a vehicle from which to take income. Some retirees are advised to keep their RRSP intact until age 71 and live off their non-RRSP investments, because income earned within an RRSP is not taxable until it is pulled out. This tax deferral allows investments to grow faster. While general financial planning recommends this strategy, in some cases it makes sense to take income from your RRSP prior to age 71 and forgo this tax deferral. This is often referred to as an RRSP meltdown strategy.

One strategy involves taking money from your RRSP if you have little or no other taxable income. If structured properly, you may also receive up to $2,000 with few or no tax consequences by gaining access to the $2,000 pension credit. These benefits may outweigh the lost tax deferral opportunity.

A second strategy consists of melting down your RRSP to avoid the Old Age Security clawback. This involves taking income out of an RRSP in low-income years to reduce the value of the RRIF created at age 71. This lowers minimum payments — which are based on the value of the RRIF — and minimizes the Old Age Security clawback. In 2011, the Old Age Security clawback begins when net income exceeds $67,688. For each additional dollar of net income, $0.15 is clawed back to repay the Old Age Security benefits received.

Scenario #3: Creating income for children

Splitting income with children can be tricky. There are various attribution rules within the Income Tax Act that mean a parent still has to pay tax on dividends and income generated by assets given to their underage children. That said, if the money is invested inside a properly set-up trust, capital gains can be taxed in the child's hands at lower tax rates.

In most instances, the capital gains can be sheltered using the child's basic personal exemption and other personal tax credits. Since a capital gain is usually the only type of continued on page 16

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income a minor can earn without it being attributed back to the parent, properly structuring a portfolio to create primarily capital gains income (as opposed to interest, foreign income and Canadian dividends) is important.

Luckily, there are a number of investment products structured primarily for this purpose. Creating a portfolio that generates annual capital gains income can be more efficient than investing purely in growth-oriented (tax-deferred) investments.

Second-generation income, or income earned on income, is taxed in the child's hands. To make things easier, families often create an additional investment account to track second-generation income. Once the child turns 18, attribution ceases and all income is taxed in the child's hands. In these cases, creating income to make use of lower tax rates and personal credits such as tuition and education credits can go a long way to enhancing the family's overall wealth.

When using a trust, you must ensure it is set up properly, or the parents could find themselves on the hook to pay the capital gains taxes as well.

Creating income for a disabled child is also an important consideration for some families. In this case, you could create an investment portfolio that generates income sufficient to meet the disabled child's needs. Alternatively, you may want to consider purchasing an annuity from an insurance company to ensure there is a guaranteed income stream for life.

Scenario #4:
Spousal loans

Shifting income from one spouse to another is a particularly appealing strategy, especially in the current low interest rate environment. Although the Canada Revenue Agency prescribed rate could increase in the future, it is currently set at 1%, the lowest rate in over 25 years.

By implementing a spousal loan, a low-income-earning spouse can borrow from the higher-income spouse to invest in an income-generating portfolio and make use of that spouse's basic personal credits and lower tax bracket.

It's generally a good idea to ensure that the income generated by the investment will also cover the 1% interest rate payable to the lender. This amount must be paid by January 30 of each year for the loan to be valid.

Scenario #5:
Using TFSAs

Currently, there isn't much contribution room in Tax-Free Savings Accounts, but when the ceiling rises, TFSAs will become a more important part of income and portfolio planning. Today, many use the TFSA to shelter capital gains made from active trading or on shares that have drastically increased in value.

There are various attribution rules within the Income Tax Act that mean a parent still has to pay tax on dividends and income generated by assets given to their underage children.

As interest rates rise and as TFSA contribution room grows, however, the accounts will become equally valuable to conservative investors. Unlike dividends and capital gains, interest income is fully taxable, which means almost 50% of income goes to tax. Keeping interest-bearing investments inside a TFSA can eliminate this.

Final thoughts

Cash flow planning can make a big difference in the tax paid on income-generating assets. It's a simple concept: the higher-income-earning spouse pays the family's daily living expenses while the lower-income earner accumulates capital for investing can result in significant tax savings. It is also possible to pay taxes on behalf of other family members since the payments are not subject to attribution rules. AER

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BY DOUG CARROLL

Avoid the cash grab

RCAs are more palatable with the return of the 50% bracket


CARROLL

The 50% tax bracket is back. In case you missed it, Nova Scotia residents will be subject to a 50% tax rate on income over $150,000 when they file their returns for 2010. And if recent tax platform reversals in British Columbia and New Brunswick indicate the broader political mood, there could be company coming to that 50-plus party.

There's something magical — and not in a good way — about the 50% threshold. The notion that the government gets more of your earnings than you do can be a powerful incentive to explore tax-planning options. Unfortunately for those of us who are straight-up employees, there are relatively few avenues to relief.

By contrast, business corporation owners and incorporated professionals have much greater latitude with which to organize their affairs strategically. One vehicle that may return to the planning radar due to its close association with the 50% bracket is the retirement compensation arrangement (RCA).

RCA tax fundamentals

Though RCAs may lead to tax benefits, they are not inherently tax beneficial. In fact, the rules were created in 1986 to forestall what were perceived as abusive 'top hat' pensions, which aggressively supplemented beyond RPP limits. The RCA rules have not outlawed these supplemental executive retirement plans (SERPs), but are sufficiently onerous to make planners weigh the issues before heading down that road (see sidebar, "Retirement Compensation Arrangement Rules").

At first blush, it appears the employee's personal marginal tax rate would have to be greater than 50% to consider an RCA. While that might be preferred, the RCA can be better viewed as a coordinated component of a broader plan comprising current compensation, creditor protection, business succession, retirement income and estate planning.

Still, the ultimate value of the RCA depends on good tax management, and that in turn relies upon tax-informed investment management.

RCA investment practices

The refundable tax account (RTA) is like an interest-free loan to the government. While this may be unavoidable with respect to the initial deposit, carefully managing the RCA can limit further additions to the RTA that would otherwise arise out of realized earnings.

Sophisticated strategies go so far as including housing-exempt life insurance policies, or even shared interests in such vehicles, within the RCA. While such arrangements may have benefits, they may not be appropriate where the RCA is intended to operate principally — if not exclusively — as a pension supplement.

On a general operational level, then, what considerations should inform the investment management of an RCA?

The RCA and other investments

The RCA should not be viewed in isolation from other investment and income sources. For the RCA, one may be inclined to choose assets designed or expected to generate unrealized gains; the drawback, however, is those gains will eventually be treated as regular income, despite the accompanying market risk.

It may be preferable to skew the owner or employee's non-registered asset allocation toward such investments, to be eventually rewarded through preferred capital gains and dividend treatment in that tax environment.

As a corollary, that would mean that the RCA assets would lean toward fixed income. The drawback here is that annual realized income forces payments over to the RTA. While this causes a drag in accumulation years, it may not matter as much once the drawdown phase has begun, as RCA payments to the employee will recover RTA deposits.

During the accumulation period, it may be useful to defer annual recognition while maintaining a conservative risk profile. This might be achieved by holding a structure like mutual fund corporation shares that carry underlying fixed income instruments.

Ultimately, whether prompted by tax developments or personal circumstances, the RCA discussion is worth having with appropriate entrepreneurs and professionals, and is probably best framed in that broad planning context. AER

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RETIREMENT COMPENSATION ARRANGEMENT RULES

Public corporations were the primary providers of RCAs until 1998, when the CRA formally revised guidelines for Canadian Controlled Private Corporations so private corporations could establish RCAs. Corporations use RCAs to increase employee loyalty by allowing them to accumulate more tax-sheltered retirement savings. The RCA rules are:

- An employer may deduct contributions to a funded SERP, termed an RCA.
- Out of the amount contributed to the RCA, 50% must go to a refundable tax account (RTA) with the CRA.
- Earnings within the RCA are not entitled to the capital gains inclusion tax rate, or to preferred dividend gross-up and tax credit treatment.
- As with contributions, 50% of realized RCA earnings must be paid to the RTA.
- For each $2 paid out to the employee from the RCA, $1 is refunded by CRA from the RTA to the RCA; on wind-up, the whole RTA is refunded to the employee.
- Payments from the RCA to the employee are regular income.