April 2018

There may be a business person or professional in Canada who doesn't know that the Federal Government substantially changed the tax rules this year, but we haven't met any. For months, LinkedIn had daily comments about this.

Columnists at The National Post and the Globe and Mail were given free rein by their editors to write about it at length. Mainly it was about the problems that would be created, not about solutions. But there were some thoughtful exceptions. The national law firm, Millar Thompson, wrote this in their Federal Budget Review:

> "Business owners should also consider repositioning investments to items which will not affect the SBD [Small Business Deduction] limit, such as exempt life insurance policies, and declaring dividends by December 31, 2018, to avoid a loss of SBD in future years."

And from a major accounting firm, Collins Barrow, in their Budget Watch Analysis, came this:

> "We expect some affected individuals and private companies will want to quickly consider alternative investment planning. Options might include the purchase of assets that increase in value over time (capital appreciation) but don't offer dividend payments in the present. Or, tax exempt life insurance policies and contracts."

Our experience over the last months has been that our clients are doing just that. We will briefly explore why.

The New Problem

What did the government do? Of course, they substantially squashed income splitting for many people, and this got a lot of the press. But the issue we want to talk about is the change to how the government taxes passive investment income in a company.

In BC a company generally gets taxed at about 13% (and falling in coming years) on the first $500,000 of its income from an active business. If it invests the after

tax amount, it is taxed at about 50% on the resulting income from those passive investments. That is high, but it is about the same as the personal tax rate, so where is the problem? The government's position was that business owners had an advantage. They could get more money invested up front than working-for-wages employees. The cynics among us think this line of thinking may have been started by working-for-wages employees at the Ministry of Finance.

After the tax changes the final outcome is this. If you hold passive investments in a company the income is taxed at 50% as always. However, if those assets create more than $50,000 of income then you will also start to lose the Small Business Deduction. You lose it entirely at $150,000 of passive income.

Let's make it simpler than that. Not only does having passive assets result in a 50% tax rate on the income from those assets, it also means that if you have a significant amount of them, your general tax rate on your regular business income doubles from 13% to 26%! That is a 100% tax increase, in case you didn't notice.

The Solution

The comments from the legal and accounting communities above point out that an exempt life insurance policy may offer a solution. What is an exempt life insurance policy? Section 148 of the Income Tax Act exempts from tax certain life insurance policies. The growth is not subject to tax, and the eventual pay out (if it comes out at death) is not subject to tax. This has always been the case, and we have built planning strategies for clients based on this. What is new is that this also avoids the application of the new rules. There is no passive income with an exempt policy, so there is no 100% increase in the general small business corporate tax. The same old 13% tax rate continues to apply.

What Does An Exempt Policy Look Like?

An exempt policy can take a few forms. For us, the usual structure is to use a participating policy. Such policies are offered by a few companies in Canada (Sun Life, Canada Life, Equitable Life and, later this year, Manulife are the main choices). They are not well understood, which is surprising as they are pretty simple.

A participating policy is essentially participation in a pooled fund. The fund is owned by the participants, essentially. It is shared between them on an actuarially derived basis. There are four key things to know about such an instrument:

1. It goes up in value each year, not down (secure);
2. It requires no management by the participants (time is valuable);
3. It has a very long track record (over 100 years in most cases, without a negative year once);
4. It has better rates than you are going to get elsewhere for something conservative (north of 7% for an average for the last 25 years, currently over 6% for 2018).

And let's recall some other things. The growth is not subject to annual tax. The payout at death, including all growth, is not subject to tax. The Income Tax Act contains a mechanism where most or all of that final payout can be distributed to shareholders (ie family) largely or entirely free of tax.
Should someone go all in on this instrument? Not at all! Should it form one part of the portfolio for most successful people? Unquestionably.