The Last Great CORPORATE Tax Structure

By Simon Marples

With all the new tax changes being introduced, it's at least comforting to see that the strategies our clients have been appreciating for many years, continue to be as effective as ever. Read on to understand why this highly effective structure is rising to the top and becoming even more prevalent than ever in the minds of accounting professionals.

Michael has been in business for 20 years now. For 15 of those years he has owned his own company, and for the past 8 years, the business has been generating a sizeable profit.

Michael is now 49 and beginning to focus on his plans for retirement. He enjoys his work and believes he will be active in the business until age 60 or 65 before he's ready to sell his business and retire. This sounds like the beginning of a nice story, and for the most part it is. However, there is one consideration which preoccupies his mind: How can he manage his company's profits in the most efficient manner and pay the least amount of tax possible?

You see, Michael's business is showing net revenues of $400,000 for the year; that is, gross revenues generated by the business, less all expenses, rents, advertising, and all the other costs associated with running a business.

So, let's say Michael pays himself an annual income or dividend of $220,000. That still leaves a net business income of $180,000. In B.C., the new small business tax rate is 12%, or $21,600, leaving his business with an after-tax surplus of $158,400 for the fiscal year.

It is this after-tax surplus with which Michael should be concerned. As his business continues to generate a profit for the next several years and beyond, the books could start showing a sizeable amount of retained earnings. If this cash is simply invested, in B.C. it can result in tax rates as high as 49%. His tax rate is higher in this case because the investment income is not deemed to be income actively generated through business operations. With tax rates this high, Michael is now very motivated to consider alternatives. He's looking for the most tax efficient use of his retained earnings in his business.

Michael's immediate consideration should be a life insurance policy. His company (or Holding Company) has an insurable interest in acquiring a life insurance policy on Michael's life, and the premiums can be paid from retained earnings. As there will be no tax relief for the premiums, using after-tax surplus to pay for the insurance has the advantage of using money taxed at 12% rather than Michael's personal tax rate now topping out at over 40%. Some life insurance products have now become very sophisticated but enjoy a variety of highly attractive tax benefits. In addition to the tax-free death benefit, the growth on investments inside the insurance contract, within limits, is also non-taxable. This is where universal life insurance comes in. Michael's company can acquire a universal life (UL) policy for, say $2,000,000 of coverage on his life.

Canadian tax law also allows Michael's company to invest up to $82,000 per year into the plan and select from a wide variety of investment options, from GICs to Segregated Fund Accounts, and pay no tax on the growth earned on those investments. Upon Michael's death, the capital and growth on those investments are paid tax free to the company, resulting in no tax ever being paid on investment income inside the UL policy. Because Michael's company is the purchaser of the insurance policy, the company must also be the beneficiary. However, Michael's spouse can still personally receive the insurance proceeds tax free through the company's Capital Dividend Account (CDA).

The CDA of the company is a special account which can be used to make tax-free dividend payments to shareholders of the company. Proceeds of life insurance policies paid to companies result in a CDA credit equal to the death benefit of the policy, less its cost base (in later years, the cost base can be $0). Upon Michael's death, his shares in the business will rollover tax free directly to his spouse, making Michael's spouse a shareholder in the business and allowing her to receive payments of the insurance proceeds through the CDA. (A qualified financial advisor or tax accountant should be consulted for all the details pertaining to this approach).

If arranged correctly, Michael will end up with a paid-up life insurance policy, funded by corporate after-tax dollars. This will save him an enormous amount of tax on his taxable income, which he can spend while he's alive. Ideally, upon his death his family will have enough insurance to pay the tax disposition, enabling him to leave a legacy for his children and grandchildren.

So, let's flow through how this works:
Michael personally purchases a low-cost term UL policy. His company makes monthly or annual deposits to the UL contract. These deposits are sufficient to not only pay the insurance premiums, but also to create a substantial investment value inside the contract. This investment value belongs to Michael even though it was paid by his company, since the company's deposits are deemed to be purchasing insurance.

Let's explain this further by going back to the $2 million example. Michael buys a $2 million policy on himself and then sells the rights to the insurance to his company. The company pays the ongoing annual cost for this insurance every year. Alternatively, his company could also pay up the insurance over a 10-year period at $82,000 per year, which represents the fair equivalent value for his insurance if paid over a 10-year period. This annual $82,000 of premium paid by the company will generate significant investment values inside the contract which will actually be owned by Michael, but he will not receive a taxable benefit from these company-paid premiums. This is because they are deemed to be the fair equivalent value of the price of the insurance which the company is acquiring in Michael's name.

Shared Ownership is your best solution. Avoid the tax trap. Take advantage of this method of getting corporate income into your hands to invest and spend tax free while you're still alive.

The personal ownership of the investment funds has several major advantages for Michael:

1) He can name a personal beneficiary for those values in the event of premature death, meaning that the investment values can be paid directly to his spouse tax free on his death, without having to go through the company and this will avoid significant probate fees.

2) Michael can leverage his funds to use in an investment or serve as retirement income. The remaining funds can be used to repay any outstanding loans at death. Of course, loans used as income are not taxable during Michael's lifetime. Utilizing this strategy, along with a reasonably conservative investment return assumption of 5%, we can project a tax-free retirement benefit for Michael of about $100,000 per year from age 65 for many, many years.

3) A third valuable aspect of this contract is that all the funds held inside this contract would be deemed to be creditor proof. This means that if Michael finds himself in a lawsuit or pursued by a creditor, including CRA, nobody but Michael has access to his funds, unless of course Michael was involved in criminal activities.

The implementation of the above strategy is actually quite straightforward; however, there are several important considerations which must be reviewed by a professional who clearly understands this concept.

Working with hundreds of business owners over the years has provided me with some very valuable lessons. One very important lesson is to get your insurance in place as soon as possible, before any health issues arise which would preclude you from qualifying for the insurance. This is often the biggest challenge. It should never be taken for granted that obtaining insurance can be done when you get around to it. If this strategy is of interest to you, **don't procrastinate**.

Regardless of the actions you ultimately take, you will not be alone. A qualified financial advisor who specializes in this strategy can help you make the proper decisions to manage both your personal and corporate finances in a more tax-efficient manner and save you thousands in taxes. If you qualify for this concept it is your best solution. Avoid the tax trap and take advantage of this legal method of transferring corporate income into your hands to spend while you are alive. It would be like building your own corporately funded tax-free retirement pension, largely funded with money which would otherwise be paid to the taxman.

Regardless of the size of your business, you can take advantage of this exceptional strategy. You'll know it's time to look deeper into this concept if you're feeling discomfort thinking about the amount of personal tax you're paying.

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