FINANCIAL PLANNING: PART 1

Think beyond traditional tax solutions

By PETER MERRICK

Today, we're seeing banks, trust companies, insurance companies and brokerage firms brought together as never before. With these services increasingly under the same roof, many small business owners are finding that a single financial problem can quickly become a multi-dimensional one. Solutions may reach beyond the skill set of the traditional public accountant.

During the last decade clients' needs have become increasingly varied and sophisticated, particularly so in the area of wealth accumulation, management and preservation.

In the all too common annual 'How shall we distribute this year's corporate net income?' meeting, often the tax practitioner tends to focus on traditional salary/bonus/dividend mixes.

Here the tax practitioner tries to integrate corporate and personal tax rates to minimize current tax burdens and maximize disposable after-tax income. The question that tax practitioners are asking themselves in light of the litigious era we all operate in today is: 'Am I aware of alternative strategies and solutions that will achieve my client's short and long-term financial goals, particularly if their goals are not necessarily tax driven?'

To successfully meet your small business owner clients' needs, you must be able to think beyond traditional tax-based solutions.

Most small business owners' issues, be they related to strategic business planning, estate planning, succession planning, charitable giving, investments or insurance, are as significant as anything tax-related.

Avoid the 'distribution trap'

As mentioned previously, accountants find their clients falling into the 'profit distribution trap,' usually during the annual review meeting.

During this meeting, someone inevitably asks how the year's net corporate income should be allocated. Many accountants mistakenly recommend a standalone salary/bonus/dividend mix without considering the alternatives. This one-dimensional strategy rests on two underlying assumptions:

- No obvious tax planning opportunities exist for corporate-held investments funded from undrawn net income. Therefore, the accountant and their small business owner clients are reluctant to leave funds in the corporation.
- It is assumed the small business owner wants to maximize his or her after-tax dollars.

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Peter Merrick, president of MerrickWealth.com

The first assumption neglects the variety of other options available, while the second simply assumes too much. In fact, the client's goals may not be tax-driven at all.

Remember, you'll usually have viable alternatives (or complementary solutions) to the traditional salary/bonus/dividend mix strategy. Make sure to ask your clients to consider all the available options.

Review your choices

Opportunities often exist whereby corporate held monies created from undrawn net income can compound tax-free within the company, or be invested in tax-favourable, tailored executive benefit plans.

These opportunities can be achieved through several means, including Individual Pension Plans (IPP), Retirement Compensation Arrangements (RCA), corporate-owned universal life insurance, employee profit-sharing plans and health and welfare trusts.

However, make sure to speak with a certified financial planning professional in tax, financial planning and employee and executive benefits before trying to apply any of these strategies.

Paying capital gains instead of salary

Clients who own incorporated businesses can structure their cash withdrawals as capital gains rather than salary or dividends. Capital gains are only taxed on one-half the income earned.

So an individual who has used up his or her lifetime capital gains exemption, who pays himself $300,000 in capital gains and who has a Ontario personal marginal tax rate of 46 per cent will pay $69,000 of tax as compared to taking the same amount out as regular income, which that would require paying the Canada Revenue Agency $138,000 in personal taxes.

Individual pension plans and retirement compensation arrangements

If you have a small business owning client over the age of 50 and employed by an incorporated business, you should consider recommending the creation of a 'super-sized RRSP' – that is, an IPP or RCA.

Contributions to these two vehicles will exceed maximum allowable registered retirement savings plans (RRSP) limits, meaning your client can save a great deal more money for their retirement in a tax-efficient way.

Both are fully deductible by the sponsoring company and are non-taxable benefits for the individual. Increases in the total value of the assets held are tax-deferred until withdrawn.

Corporate-owned universal life insurance

Universal life insurance allows tax-sheltered growth within the policy.

A corporate-owned life insurance contract can tax shelter much of your client's retained earnings in the cash-value portion of the policy provided the premiums are not deducted.

Your clients can access these funds for their businesses or personal use throughout their life by collateralizing the policy through loans from the policy or from a bank.

For example, your client might borrow funds annually in order to increase his or her retirement cash flow.

Make sure your client has the appropriate documentation and guarantee fees in place to avoid a personal benefit (which forces your client to play a lot of unnecessary personal tax). Any related bank or policy loans would be repaid automatically 'upon your death' from a portion of the policy proceeds.

At the same time, a credit to the corporate capital dividend account would be created equal to the full policy proceeds. Another added benefit is if your client has put this type of policy in place if they become critically ill or disabled they will be entitled to have the entire cash value paid out to them, without any requirement to repay the policy.

Employee Profit Sharing Plan

An Employee Profit Sharing Plan (EPSP) is a special purpose trust that allows the beneficiaries of the plan to share in the profits of a company. The allocation to an EPSP is taxable in the hands of an employee and a deductible expense for an employer.

An EPSP is a non-registered savings plan in which the employer contributions are computed by reference to a company's profit. Advantages of an EPSP are they attract neither Employer/Employee Canada Pension Plan nor EI contributions.

EPSPs allow for more control over retirement assets. They are treated as pension or RRSP eligible earnings. Source deductions and withholdings are not required by the EPSP trustee or employer. They allow for income splitting opportunities.

All amounts paid from an EPSP to an employee are not subject to a reasonableness test, unlike salaries.

The 'kiddie tax' rules should not apply to income received by minor children through an allocation from an EPSP, if they are bona fide employees of the business. Contributions to the EPSP can be made up to 120 days after a corporate year end.

Health spending accounts

A health spending account (HSA) is a corporate bank account with deposits available exclusively for healthcare expenses. Having a HSA allows you to convert health-care expenses into 100 per cent business deductions equal to the annual deposits into the HSA.

Payments of these expenses are treated as a non-taxable benefit to you. You'll determine the contribution amount each year and also how to spend the benefit dollars. Unlike traditional medical and dental plans, if the deposits are not spent in the current year, the funds remain in the account, available for future use.

If your clients' needs aren't being satisfied they will become open to fresh advice. Today's public accountant should at least be aware of the options listed above and should be prepared to bring them to clients' attention when appropriate.

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